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REPORT ON THE LATIN AMERICAN ECONOMY. SECOND HALF OF 2021. OUTLOOK, VULNERABILITIES AND POLICY SPACE

ABSTRACT

The economic recovery in Latin America appears to have firmed in the second half of the year, having come to a halt in practically all the countries in Q2 owing to the unfavourable course of the pandemic. This has led in recent months to an across-the-board upward revision in growth forecasts in the region for 2021. Against this background, the region's banking systems remain healthy, although some indicators, such as non-performing loans, are beginning to be impacted by the persistence of the crisis. There has also been a notable slowdown in lending, linked partly to the generalised withdrawal of support programmes. The path of the recovery, which is uneven from country to country, will be determined by the pandemic being overcome. It is expected that the recovery will continue to be underpinned by the strength of external demand and commodities prices, by the widespread support of economic policies (albeit gradually with less intensity) and by the favourable financing conditions in the region which, though they have recently tightened, remain accommodative in historical terms. One key conditioning factor will be inflation, which has risen notably across the region as a whole, and, specifically, how transitory this development proves. Given the high uncertainty surrounding the economic outlook, the Report presents alternative scenarios referring to a series of epidemiological, economic and financial variables. The indicators of macro-financial vulnerability in the region remain contained in the external and banking sectors but high in respect of public finances, against a backdrop of notable uncertainty over the future course of economic policies.

Keywords: Latin America, Latin American economy, economic outlook, health crisis, mobility, commodities, inflation, financing conditions, capital flows, household savings, political and social unrest, monetary policy, public debt sustainability, IMF Special Drawing Rights.

JEL classification: C11, E31, E52, E58, E62, F01, F30, F47.

Executive summary

The economic recovery in Latin America appears to have firmed in the second half of the year, having come to a halt in practically all the countries in Q2 owing to the course of the pandemic. This has led in recent months to an across-the-board upward revision in growth forecasts in the region for 2021. The recovery remains uneven from country to country and is underpinned by favourable external demand and commodities prices; by the widespread support of economic policies which, though they have begun to be withdrawn, retain an expansionary stance; and by the region's financing conditions which, while they have tightened recently, remain accommodative in historical terms.

Against this macro-financial background, the region's banking systems remain healthy. Some indicators, however, such as non-performing loans, are beginning to be impacted by the persistence of the crisis. Further, there has been a notable slowdown in lending, especially to business, linked in part to the generalised withdrawal of public credit support programmes. Bank profitability rose in some countries in parallel with the increase in the yield curve slope, as did capital ratios.

The normalisation of the pandemic continues to be the main conditioning factor of the recovery. The main sources of pandemic-related uncertainty stem from the potential emergence of new variants that may detract from the effectiveness of the as yet incomplete vaccination process. Should new strains emerge, this might particularly impact the emerging economies. But, among the emerging regions, Latin America has recently been evidencing one of the highest percentages of vaccine take-up and of a naturally immune population.

The intensity of the recovery will depend, in any event, on whether certain macro-financial risks ultimately materialise. The Report offers estimates of the economic costs associated with several risk scenarios for the region's two main economies, Brazil and Mexico. These include a higher-than-expected increase in commodities prices; a scenario in which the recent rise in inflation ultimately proves more persistent than anticipated, and which might pass through to inflation expectations and to higher policy interest rate rises than discounted by the financial markets; and a scenario that simulates the effect of an increase in uncertainty over the future course of economic policies.

The region's macro-financial vulnerabilities remain contained in the external and banking sectors and are notably high in respect of public finances and as regards the political environment. In this respect, the Report highlights the risks associated with the emergence or heightening of political and social unrest, against the background of the region's intense electoral cycle.

Inflation has risen notably and across the board in the region. This rise appears to be predominantly transitory, as it has not passed through to medium-term inflation expectations. But the region's central banks have initiated a cycle of monetary policy tightening, although their monetary policies continue to be clearly expansionary. If the increase in inflation were more permanent or if external financing conditions became harsher for the Latin American economies, the room for manoeuvre of monetary policy would be restricted.

The public finances position has improved recently, given the observed reduction in budget deficits, although debt levels remain high and condition fiscal policy leeway. Despite the brighter GDP growth outlook, significant risks persist as to public debt dynamics, especially given the absence of clear future frameworks for the necessary budgetary consolidation in the medium term.

Against this background of narrowing national macroeconomic policy space, the role of the global and regional safety net remains crucial. In this connection, the IMF approved an issue of special drawing rights (SDRs) in August 2021 which provides a significant financial buffer by means of reducing risk and strengthening the external position of the emerging countries, including those in the region. Moreover, this new issue of SDRs might be complemented by mechanisms for their reallocation from the developed to emerging and developing countries, through multilateral trusts.

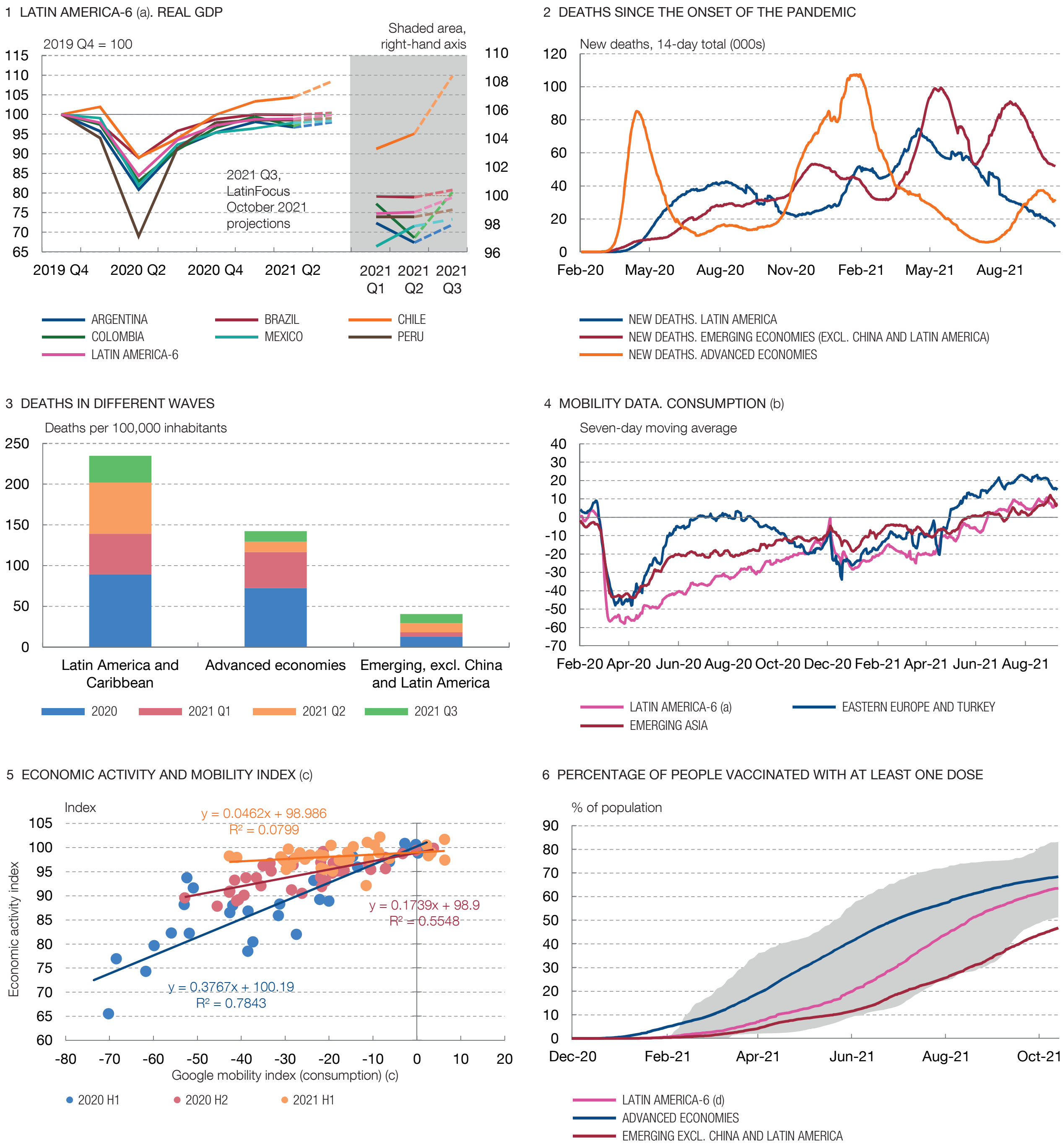
The economic recovery in Latin America continued in 2021 H2, conditioned by the course of the pandemic

On the latest information, aggregate economic activity in the main Latin American economies could post an increase of close to 1% in Q3 this year compared with Q2 (see Chart 1.1 and Table 1), suggesting a firming of the recovery in the second half of the year. This recent, more buoyant performance is providing for a return to a more generalised path of economic recovery given that, with the notable exception of Mexico and, to a lesser extent, Chile, this recovery had come to a halt in Q2. Indeed, the economies of Argentina, Brazil and Colombia posted declines in GDP that quarter, while in Peru growth was zero. Idiosyncratic reasons, such as the heightening of social unrest in May in Colombia, partly lay behind these developments. But chiefly they reflected a common factor linked to the course of the incidence of the health crisis, after some of the restrictions to address the increase in infections were reinstated in several countries and also because of the preventive measures by populations themselves (see Chart 1.2 to 1.4). However, the economic impact of the reduction in mobility continues progressively to diminish, as there can be seen to be less correlation between mobility and activity, perhaps reflecting the growing adaptation by economic agents to the health emergency (see Chart 1.5).

Chart 1

RECOVERY IN ECONOMIC ACTIVITY IN THE FINAL STRETCH OF 2021, STILL CONDITIONED BY THE PANDEMIC

A more buoyant activity performance in Q3 is providing for a return to a more generalised path of economic recovery, which had been interrupted by the pandemic in Q2. Nonetheless, the correlation between mobility and activity remains weakened. Vaccination rates in the region have stood above the average for other emerging economies.



SOURCES: John Hopkins, Google Mobility Report, Refinitiv, LatinFocus and national statistics.

a Argentina, Brazil, Chile, Colombia, Mexico and Peru.
b Mobility data on consumption-related activities. "Consumption" is the average of "retail and recreation" and "food and pharmaceutical products" activities. The reference value is calculated during the five-week period from 3 January to 6 February 2020.
c The dots represent the monthly data of the six main economies of Latin America (Argentina, Brazil, Chile, Colombia, Mexico and Peru) in each of the half-year periods indicated.
d The shaded area represents, for each point in time, the maximum and minimum value for the six countries comprising the aggregate (Argentina, Brazil, Chile, Colombia, Mexico and Peru).

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Table 1

LATIN AMERICA: MAIN ECONOMIC INDICATORS

	2007-2019 average	IMF Projections (October 2021 WEO)			2020				2021		
		2020	2021	2022	Q1	Q2	Q3	Q4	Q1	Q2	Q3 (a)
GDP (change with respect to previous period) (b)											
Latin America and the Caribbean (c)	2.1	-7.0	6.3	3.0	-2.1	-13.8	11.1	4.0	0.6	0.0	1.0
Argentina	1.6	-9.9	7.5	2.5	-4.3	-15.5	12.9	4.5	2.8	-1.4	1.3
Brazil	1.9	-4.1	5.2	1.5	-2.3	-9.0	7.7	3.1	1.2	-0.1	0.5
Mexico (d)	1.9	-8.5	6.2	4.0	-0.9	-17.3	12.7	3.3	1.1	1.5	0.5
Chile	3.1	-5.8	11.0	2.5	1.9	-12.7	5.4	6.5	3.4	1.0	3.9
Colombia (d)	3.7	-6.8	7.6	3.8	-2.6	-14.8	9.7	6.2	2.9	-2.4	3.3
Peru	4.9	-11.0	10.0	4.6	-6.0	-26.6	32.4	7.2	0.6	0.0	0.5
CPI (year-on-year rate) (b)											
Latin America and the Caribbean (c)	5.5	6.4	9.3	7.8	3.6	2.5	2.9	3.5	4.2	6.1	7.2
Argentina	17.8	42.0	n/a	n/a	50.4	43.9	39.8	36.4	40.6	48.5	51.9
Brazil	5.6	3.2	7.7	5.3	3.8	2.1	2.6	4.3	5.3	7.7	9.6
Mexico	4.2	3.4	5.4	3.8	3.4	2.8	3.9	3.5	4.0	6.0	5.8
Chile	3.3	3.0	4.2	4.4	3.7	2.9	2.7	2.9	3.0	3.6	4.9
Colombia	4.2	2.5	3.2	3.5	3.7	2.9	1.9	1.6	1.6	3.0	4.3
Peru	3.0	1.8	3.1	2.5	1.9	1.7	1.8	2.0	2.6	2.7	4.7
Budget balance (% of GDP) (b) (e)											
Latin America and the Caribbean (c)	-3.8	-8.7	-2.4	-1.0	-3.9	-6.9	-8.1	-8.6	-8.3	—	
Argentina	-2.0	-8.3	n/a	n/a	-4.3	-7.1	-8.2	-8.3	-7.1	-4.5	
Brazil	-4.9	-13.6	-6.2	-7.4	-6.1	-11.1	-13.5	-13.6	-12.7	-7.3	
Mexico	-2.2	-2.6	-4.2	-3.5	-1.9	-2.7	-2.1	-2.6	-2.9	-2.3	
Chile	-0.6	-7.3	-7.9	-1.6	-2.8	-5.0	-7.5	-7.3	-7.6	-7.1	
Colombia	-3.1	-8.1	-8.4	-6.4	-1.7	-4.5	-6.2	-8.1	-8.8	—	
Peru	-0.9	-9.4	-5.4	-3.9	-2.8	-4.8	-7.2	-9.4	-9.4	-7.4	
Public debt (% of GDP) (b)											
Latin America and the Caribbean (c)	52.7	77.2	72.7	73.3	62.6	68.2	70.6	69.8	69.8	65.2	
Argentina	44.3	86.3	n/a	n/a	82.7	94.6	90.9	86.3	83.1	70.5	
Brazil	61.3	88.8	90.6	90.2	76.9	83.6	88.7	88.8	87.8	83.2	
Mexico	38.4	53.9	59.8	60.1	51.4	54.8	56.0	53.9	56.0	52.3	
Chile	14.6	32.5	34.4	37.3	29.1	30.8	32.0	32.5	32.4	32.6	
Colombia	47.4	61.8	66.7	67.6	52.9	56.8	61.0	61.8	63.7	63.1	
Peru	29.7	34.7	35.0	36.9	26.3	30.2	31.9	34.7	36.3	33.9	
Current account balance (% of GDP) (b) (e)											
Latin America and the Caribbean (c)	-1.9	0.2	-0.6	-1.0	-2.1	-1.7	-0.5	-0.1	-0.1	0.0	-0.6
Argentina	-1.3	0.8	1.0	0.8	0.1	1.2	1.8	0.9	0.9	0.8	1.0
Brazil	-2.3	-1.8	-0.5	-1.7	-3.8	-3.2	-2.1	-1.8	-1.7	-1.3	-0.8
Mexico	-1.5	2.4	0.0	-0.3	0.0	-0.5	1.1	2.4	2.6	2.9	0.6
Chile	-1.4	1.3	-2.5	-2.2	-3.3	-1.3	0.2	1.3	0.7	-1.1	-3.9
Colombia	-3.6	-3.7	-4.4	-4.0	-4.4	-4.2	-3.6	-3.6	-3.9	-4.5	-4.4
Peru	-2.5	0.8	0.4	0.1	-0.4	0.0	0.8	0.8	0.1	-0.9	0.5
External debt (% of GDP) (b)											
Latin America and the Caribbean (c)	35.2	56.3	49.8	48.9	39.1	42.5	45.1	47.3	47.4	45.1	
Argentina	38.4	71.0			61.9	65.9	68.3	69.8	68.9	63.2	
Brazil	35.4	44.3			35.1	37.0	40.1	44.0	44.6	44.6	
Mexico	21.3	34.2			28.5	31.8	33.8	34.3	34.6	31.6	
Chile	68.3	82.5			72.4	80.9	83.6	82.3	78.1	72.9	
Colombia	38.9	56.9			44.3	49.9	52.8	56.7	55.8	53.8	
Peru	40.1	43.2			35.4	39.0	41.6	43.3	44.9	41.9	
MEMORANDUM ITEMS: Aggregate of emerging economies excluding Latin America and China (IMF, October 2021 WEO)											
GDP (year-on-year rate)	4.5	-3.5	5.4	5.3							
CPI (year-on-year rate)	7.0	6.3	7.3	6.1							
Budget balance (% of GDP)	-0.7	-6.4	-4.1	-3.1							
Public debt (% of GDP)	39.6	57.9	58.0	58.6							
Current account balance (% of GDP)	0.7	0.0	0.7	0.4							
External debt (% of GDP)	27.6	29.3	28.7	27.8							
Weight in world GDP, in PPP (%)	31.5	32.0	31.8	31.9							

SOURCES: IMF, Refinitiv, LatinFocus and national statistics.

a GDP and current account balance data correspond to LatinFocus October 2021 projections. Published data for CPI.
b Latin America and the Caribbean account for 7.3% of world GDP, measured in PPP. The six economies shown represent 86% of the total for Latin America and the Caribbean (IMF).
c Quarterly aggregate data for the six largest economies (Argentina, Brazil, Chile, Colombia, Mexico and Peru). For inflation, the aggregate excluding Argentina is used.
d Seasonally adjusted series.
e Four-quarter moving average.

External factors have continued to support the recovery in Latin America

Notable among the external factors supporting recovery in the region is the growth in its main trading partners, including most notably the euro area and, though they have slowed somewhat in recent months, the United States and China (see Chart 2.1). Another is the favourable trend of commodities prices and, therefore, of the terms of trade, which are holding above their historical averages. And, as is the case of oil, some commodities have recently posted significant increases (see Chart 2.2). Likewise, as will later be described in greater detail, global financing conditions have remained favourable, underpinned by continuing expansionary policies in the developed economies. Also, capital flows to Latin America continue to be positive, as do remittances to the region, which are particularly significant for Mexico and the Central American and Caribbean economies.

Domestic factors, for their part, have improved on the health front, and show less support by economic policies and some tightening of financing conditions

The lockdown measures were tightened in the opening months of 2021 in response to the heightening of the pandemic, differing from country to country. They began clearly to be more flexible once again from May, ceasing to restrict the buoyancy of activity thereafter. In this respect, moreover, it should be stressed that the vaccination process has quickened notably, and vaccination rates in the region have generally stood at high levels compared with other emerging economies (see Chart 1.6). The across-the-board support[1] of economic policies was crucial in mitigating the economic impact of the health crisis and, in the early stages of the pandemic, in keeping the financial markets operating normally; but support has begun to be withdrawn, especially in the case of monetary policy, although it retains an expansionary stance. Meantime, domestic financing conditions have tightened following an increase in longer-dated, local-currency-denominated interest rates.

The economic outlook for 2021 as a whole has improved

Against this backdrop, and unlike the case for other emerging markets, such as the Asian economies, the growth projections for the Latin American countries have been revised upwards for 2021. And this after the region saw in 2020 the worst contraction in its GDP since figures have existed and offered up the worst performance of all the

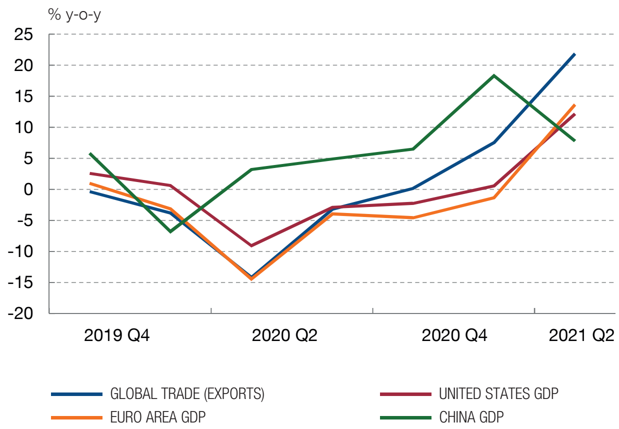
1 For a description of the main economic policy measures taken by the countries in the region see, among others, Banco de España (2020a), Banco de España (2020b) (for the debt securities purchase programmes), Banco de España (2020c) (for the role of international institutions), inter-American Development Bank (2021) (in particular for micro and macro-prudential measures). See also Banco Central de Chile (2020) for a description and assessment of the measures adopted in countries such as Chile and Peru which authorised private pension scheme savers to withdraw a proportion of their savings.

Chart 2

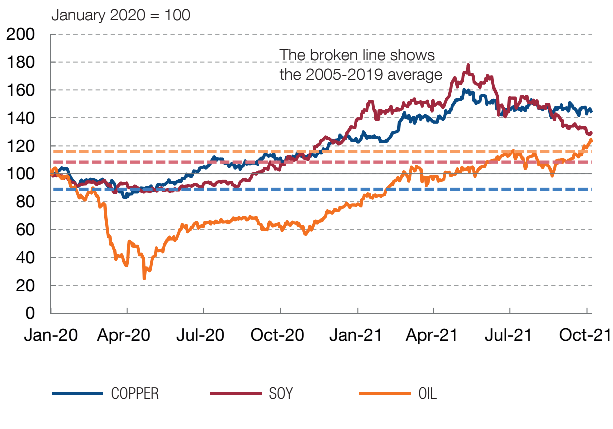
THE RECOVERY IS BEING UNDERPINNED BY FAVOURABLE EXTERNAL FACTORS AND IS HETEROGENEOUS ACROSS COUNTRIES

External factors are contributing to the recovery, such as growth in the main trading partners and the favourable trend in commodities prices, which are holding above historical averages. The recovery is uneven across countries. Brazil, Chile and Colombia could recover their pre-pandemic level this year but the others are not expected to do so until 2022 at the earliest. The adverse effects on the labour market are proving more persistent than those on activity.

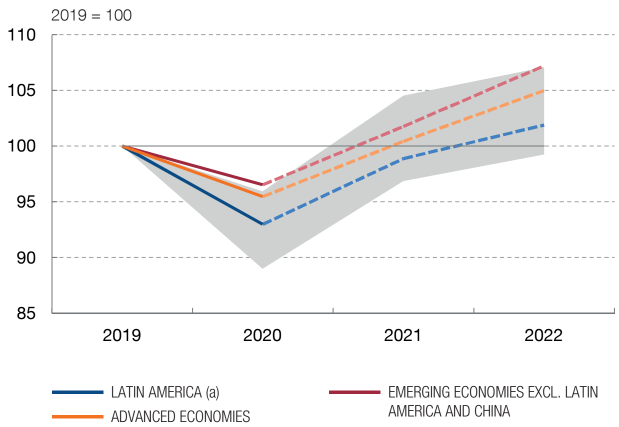
1 EXTERNAL DETERMINANTS



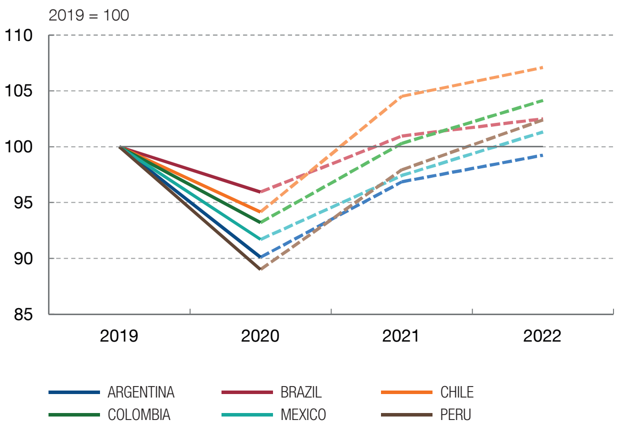
2 COMMODITY PRICES



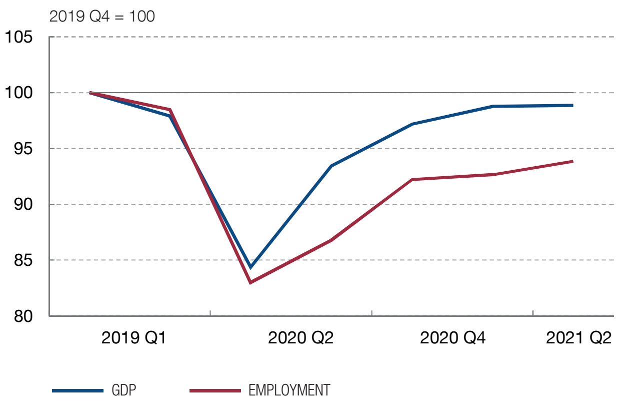
3 GDP LEVEL BY AREA



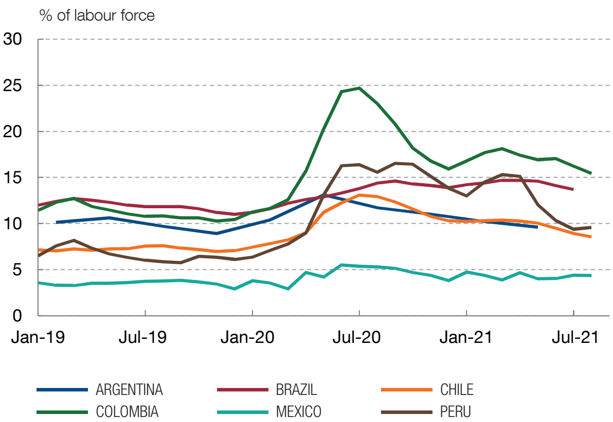
4 GDP LEVEL IN THE SIX MAIN LATIN AMERICAN ECONOMIES



5 ACTIVITY AND EMPLOYMENT



6 UNEMPLOYMENT RATE



SOURCES: IMF, Refinitiv and CPB World Trade Monitor.

a Latin America and Caribbean aggregate (IMF). The shaded area corresponds to the range between the maximum and minimum value for each year for the six main economies of Latin America (Argentina, Brazil, Chile, Colombia, Mexico and Peru).

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emerging regions (-7%)[2] (see Chart 2.3). The latest IMF forecasts[3] point to growth of 6.3% in 2021, entailing an upward revision of 1.7 pp on its April projections,[4] in line with the generalised trend by analysts to improve the economic outlook for the region.[5] Country by country, considerable unevenness is expected, with growth rates for 2021 ranging from the figure of 5.2% forecast for Brazil to that of 11% for Chile. Generally, however, the average expected rate of GDP growth estimated for 2021 largely reflects the marked dynamism of the region's economies in the second half of 2020, which is giving rise to a significant carry-over effect this year[6] (see Chart 2.4).

The recovery remains uneven across the region's different countries and sectors

Several factors account for the different recovery rates across the region: the uneven pre-pandemic starting point in respect of economic vulnerabilities; differences in initial support and the pace of withdrawal of economic policies;[7] external demand developments, regarding both the composition in terms of products and trading partners, and the degree of openness of the economies; and the different virus-containment strategies, both in mobility-restriction measures and in vaccination roll-out (see Chart 1.6). Hence, certain economies such as Brazil (which received notable economic policy support and had less stringent mobility restrictions) and Chile (with a greater vaccination take-up) are expected on the latest available projections to have already recovered their end-2019 level of GDP in 2021 Q3 (see Chart 1.1). However, the effects of the crisis prompted by the COVID-19 pandemic on the labour market are proving more persistent, and were much greater than those in previous crises:[8] there were notable losses in employment levels (see Chart 2.5), a decline in labour market participation and much more marked increases in the unemployment rate[9] (see Chart 2.6).

In terms of sectors of activity, the increase in manufacturing did not appear to have been significantly slowed in the first half of the year by the bottlenecks in global

2 See Banco de España (2020d), Banco de España (2021) and Hernández de Cos (2021), which consider the characteristic structural differences of Latin America that might explain the greater decline in activity observed in 2020.

3 See IMF (2021a).

4 See IMF (2021b).

5 See Box 1 in this Report for a quantitative assessment of the main explanatory factors behind this increase in the GDP growth forecasts in 2021 for the two biggest economies in the region (Brazil and Mexico).

6 Regarding the carry-over effect, see González Mínguez and Martínez Carrascal (2019).

7 Notable in this respect are the sizeable stimuli (especially fiscal) in Brazil, Chile and Peru, and on a much lesser scale in the case of Mexico. See Banco de España (2020a), Inter-American Development Bank (2021) and "Database of Country Fiscal Measures in Response to the Covid-19 Pandemic" in Methodological and Statistical Appendix del Fiscal Monitor.

8 Moreover, unlike in previous crises, there has been no observable increase in informal employment that would have enabled part of the shock to be absorbed.

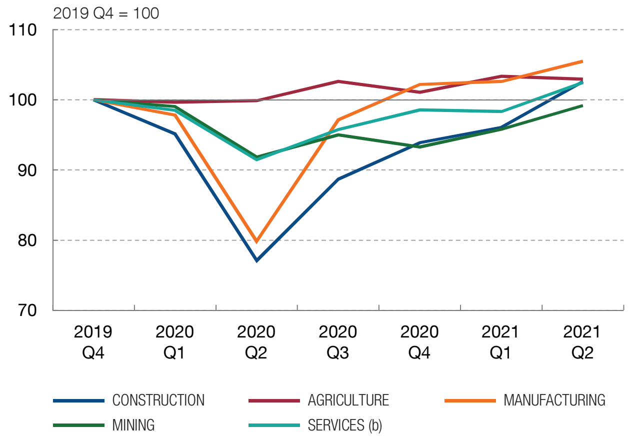
9 The impact of the crisis is proving unequal by sex and by income and educational levels in the region. See ECLAC (2021a).

Chart 3

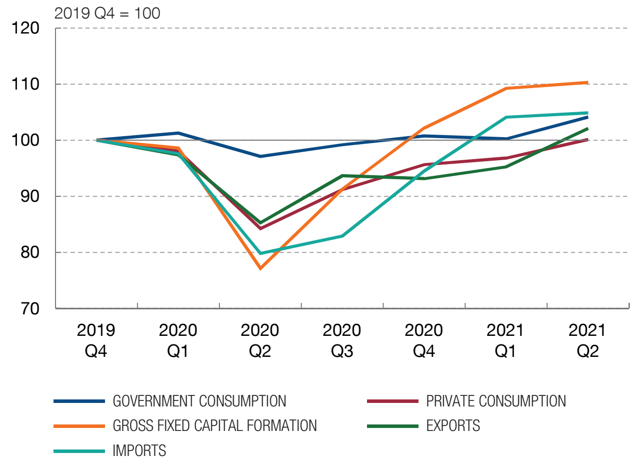
UNEVEN PERFORMANCE BY ECONOMIC SECTOR AND DEMAND COMPONENTS. SAVING REMAINS HIGH

In terms of sectors of activity, manufacturing continued its sustained increase, and services were more dynamic. On the demand side, there was a notably strong recovery in investment. Saving remains at high levels and, in some cases, is still at its highest point in the last two decades.

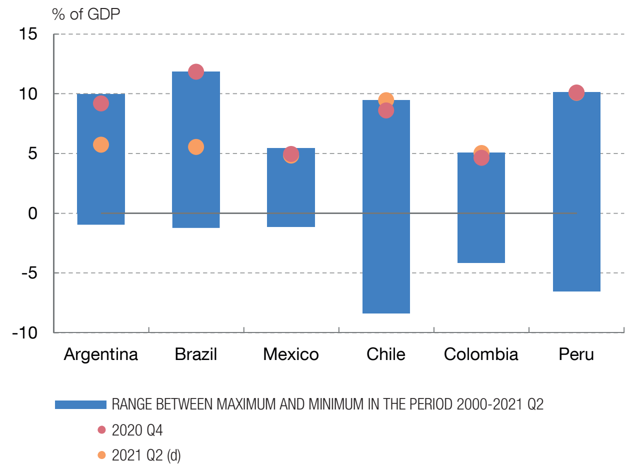
1 SUPPLY-SIDE GDP COMPONENTS (a)



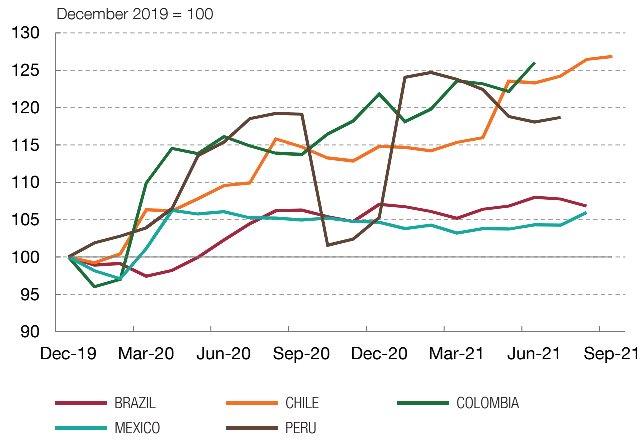
2 DEMAND-SIDE GDP COMPONENTS (a)



3 SAVINGS (c)



4 BANK DEPOSITS (e)



SOURCES: Refinitiv and national statistics.

a Aggregate of Argentina, Brazil, Chile, Colombia, Mexico and Peru.
b Services sector does not include exactly the same sub-sectors in all countries.
c Net lending (+) and net borrowing (-) of the domestic private sector.
d 2021 Q1 for Colombia.
e In real terms.

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value chains, and services were more dynamic (see Chart 3.1). On the demand side, there was a notably strong recovery in investment (see Chart 3.2), which was above its pre-pandemic level in virtually all the economies, with the notable exception of Mexico, after having been the GDP component that had performed the worst since 2014 in the region.

Current account balances also performed unevenly in the first half of 2021, after having posted mainly surplus positions in 2020 (see Table 1), depending essentially on the performance of the goods trade balance. In this respect, in some countries such as Chile, Colombia and Peru, there has been a strong recovery in imports, in line with domestic demand and outstripping exports, in spite of the latter also being very buoyant and of favourable terms of trade. The income balance, which has historically run a deficit in Latin America, has been even more in the red (as foreign companies' gains have increased), as has the services account (tourism-related services remain depressed compared with their pre-pandemic level). The only account bucking this trend is the transfers balance, given the favourable course of remittances in some economies. In any event, the current account position is generally much more favourable than in the previous decade and, on this occasion and unlike other past episodes in the region, there are less onerous external financing constraints.

Inflation has risen notably and across the board in the region

In the main economies of the region, inflation now stands above the upper limits of the tolerance bands. The increase from the lows recorded in 2020 (see Chart 4.1) is mainly due to the most volatile components, i.e. food and energy (see Chart 4.3), which have a greater weight in consumption baskets in the emerging economies in general, and in Latin America in particular. That said, core inflation (see Chart 4.2) has also risen. Behind this increase in inflation are a series of common factors. They include most notably the influence of base effects, the rebound in private consumption, supply-side issues linked to disruptions in value chains, and the delayed impact of currency depreciations,[10] given that on this occasion the increase in commodities prices has not been accompanied by exchange rate appreciations as in previous episodes[11] (see Chart 4.4). National idiosyncratic factors may also be mentioned. For instance, Brazil has undergone a severe drought that has affected the price of electricity and certain foodstuffs, while in Colombia there were street protests over a rise in food prices.

The region's central banks stress that the economies in general maintain a negative output gap.[12] But the changes in consumer behaviour and the supply-side problems in some sectors, prompted by the pandemic and the attendant lockdown measures, have altered the relative prices of certain goods and services. That hinders distinguishing between transitory or more permanent shocks and, therefore, makes

10 See Forbes et al. (2020).

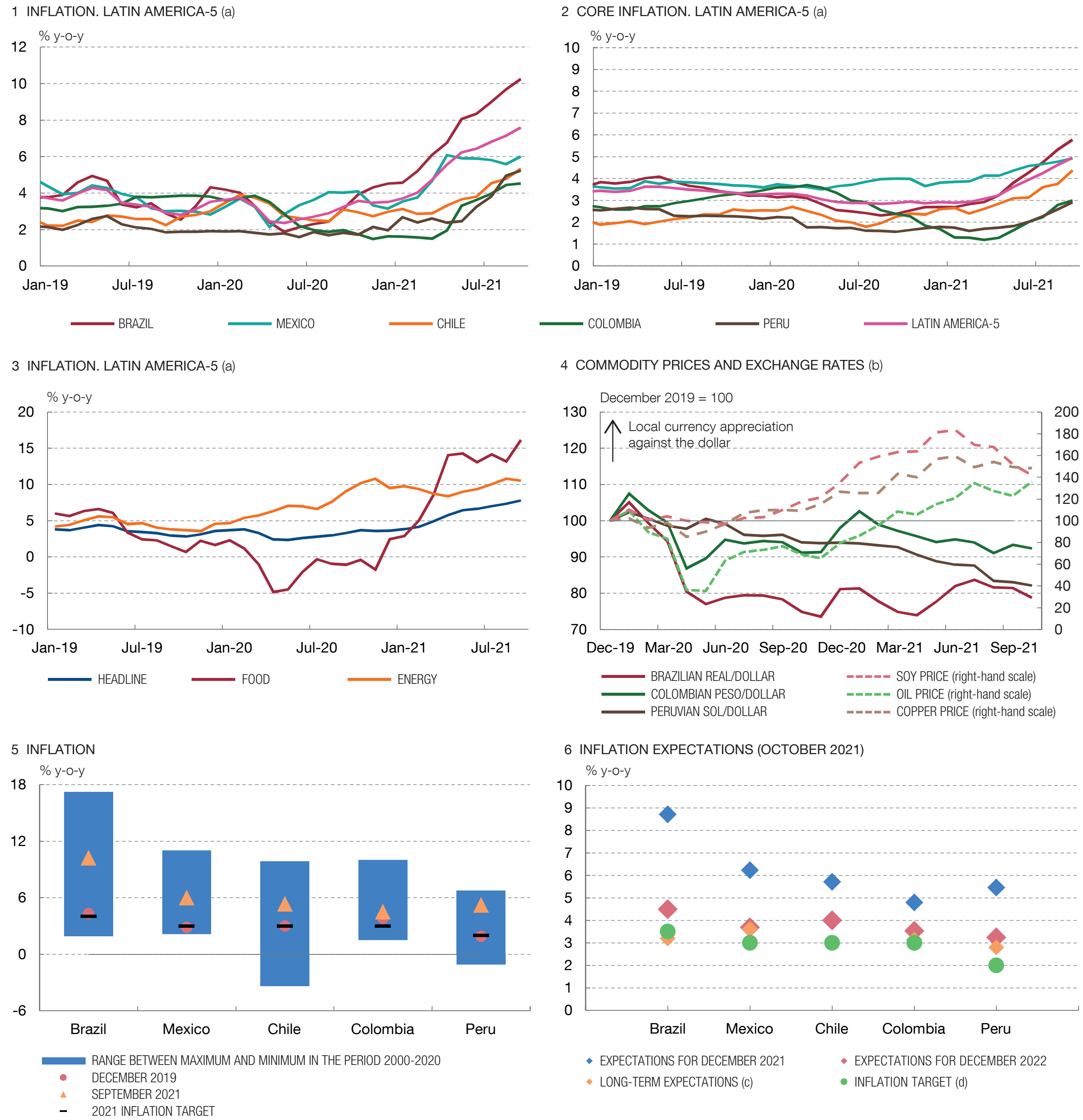
11 The increase in commodities prices would usually be accompanied by an appreciation of the exchange rates in the exporting countries of these products. But on this occasion, depreciations were observed, partly because capital inflows to invest in these sectors were not on the same scale as in previous episodes.

12 In the case of Chile, however, domestic demand has been very buoyant thanks to income transfers from the public sector and the funds withdrawn from pension schemes.

Chart 4

INFLATION HAS RISEN NOTABLY ACROSS THE REGION, OWING MAINLY TO THE MOST VOLATILE COMPONENTS (ENERGY AND FOOD)

The increase in inflation from the lows recorded in 2020 is mainly due to an increase in food and energy prices, although core inflation has also risen. Another factor that could lie behind this increase is widespread currency depreciation in the region as a whole. Indeed, on this occasion the increase in commodities prices has not led to an exchange rate appreciation. This situation could be transitory, as inflation expectations for end-2022 and for the longer term are close to the different central banks' inflation targets.



SOURCES: Refinitiv, Consensus Forecast and national statistics.

a Aggregate of the five countries with inflation targets (Brazil, Chile, Colombia, Mexico and Peru) weighted by purchasing power parity.
b The broken lines correspond to the main commodity exported by the countries, and the solid lines of the same colour depict the exchange rate.
c Inflation expectations at the longest term possible available for each country, obtained from the surveys conducted by the central banks.
d The dots indicate the central value of the inflation target, which is constant for all countries, except for Brazil, whose targets are 3.75% in 2021, 3.50% in 2022, 3.25% in 2023 and 3.00% in 2024 (the target for 2022 is depicted in the chart).

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it difficult to diagnose the nature and scale of the inflationary pressures. In this respect, these inflationary pressures, which can also be seen globally, albeit with less intensity, appear to be predominantly transitory. This is borne out by the fact that the region's inflation expectations for end-2022, and for the longer term, are close to the different central banks' inflation targets (see Charts 4.5 and 4.6). Nonetheless, given the unusually high uncertainty over how inflation will behave globally, a greater persistence of the upward momentum in prices cannot be ruled out.[13]

Financing conditions in the region remain accommodative in historical terms, but they began to tighten as from February this year

Faced with the recent increase in inflation, and as this Report will later detail, the region's central banks have initiated a cycle of monetary policy tightening, despite the prevailing negative output gaps and downside risks to growth. Further, a series of idiosyncratic factors have been operating, related to the uncertainty over the future course of fiscal policy in certain countries prompted in part by the social and political unrest witnessed in the period under study. They have led to an increase in volatility on domestic markets (see Charts 5.1 and 5.2), to increases in long-term, local-currency-denominated interest rates (see Chart 5.3) and, in some cases, also to wider sovereign yield spreads (see Chart 5.4), which might be partly affecting currency (see Chart 5.5) and stock market (see Chart 5.6) dynamics. Portfolio capital inflows slowed from May, due above all to those earmarked for the stock market (see Charts 5.7 and 5.8).

Against this macro-financial background, the region's banking systems remain healthy. Some indicators, however, such as the NPL ratio, are beginning to feel the persistence of the crisis, and lending has slowed notably

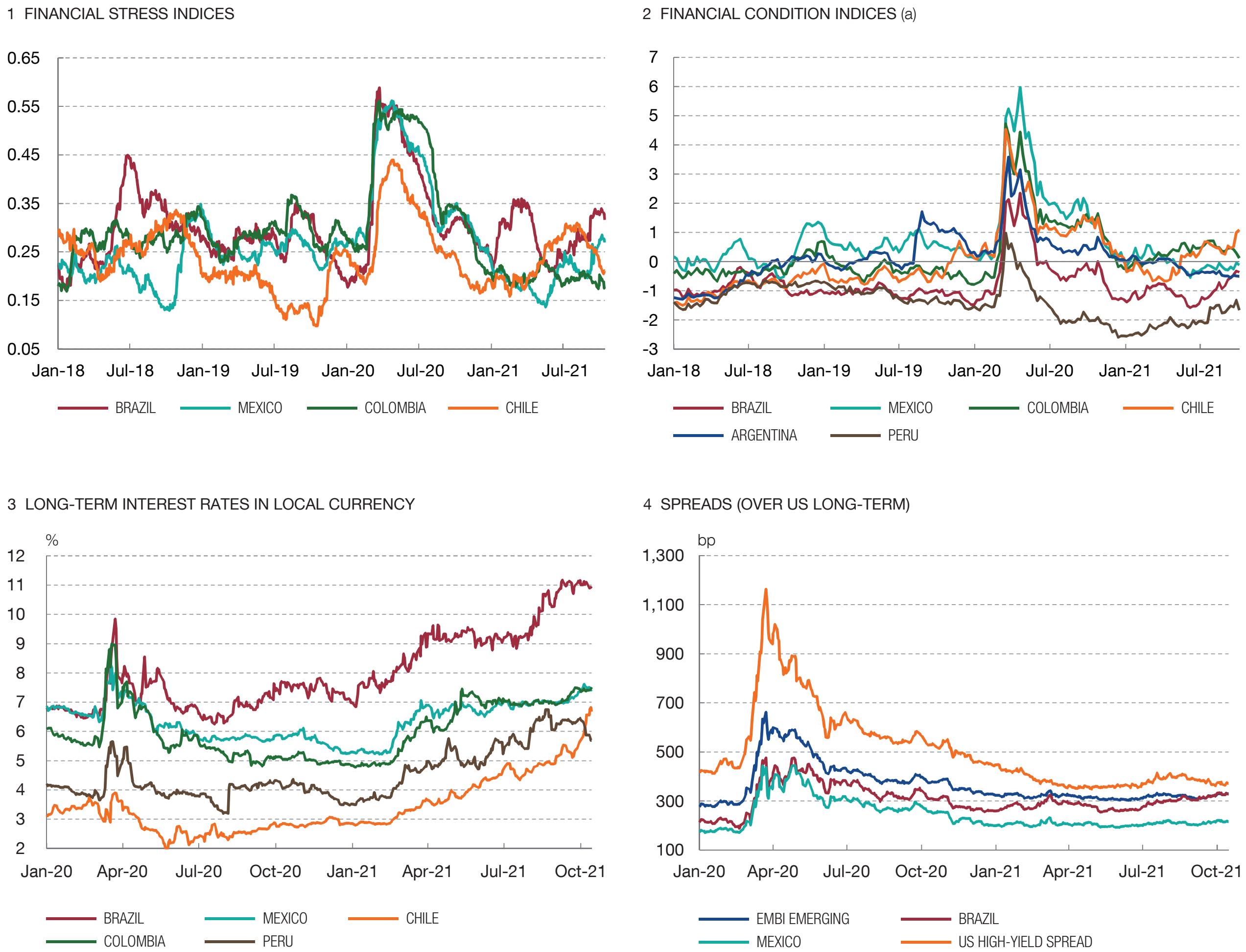
The Banco de España identifies five Latin American countries among those of "material" significance, i.e. those that may pose a greater risk owing to the proportion of exposures of the Spanish banking system (Mexico, Brazil, Chile, Peru and Colombia). Over the last six months, lending in these countries was seen to slow markedly (see Chart 6.1). This stemmed, on one hand, from the expiry or reduction towards the end of last year of the amounts involved in several of the credit-maintenance programmes set in place to alleviate the effects of the pandemic;[14] and, on the other, from the increase in credit risk, linked in part to the heightening uncertainty over the future course of economic policies in some countries. The breakdown by sector would suggest, in the region as a whole, that the slowdown observed was due to the marked deceleration in lending to companies, while lending

13 See, for example, chapter 2 of IMF (2021a).

14 See Buesa *et al.* (2021).

Chart 5
LATIN AMERICAN FINANCIAL MARKETS

Financing conditions began to tighten as from February 2021, following the increase in inflationary pressures which led the region's central banks to initiate a normalisation of monetary policy. As a result of idiosyncratic factors, the financial variables of some of the region's countries behaved significantly worse than those of their peers, particularly in local debt markets. Portfolio capital inflows slowed, especially in those for the stock market, as fixed-income issuance recorded new highs in cumulative terms.



SOURCES: Refinitiv, Dealogic and Banco de España.

a An increase denotes a tightening in financial conditions.

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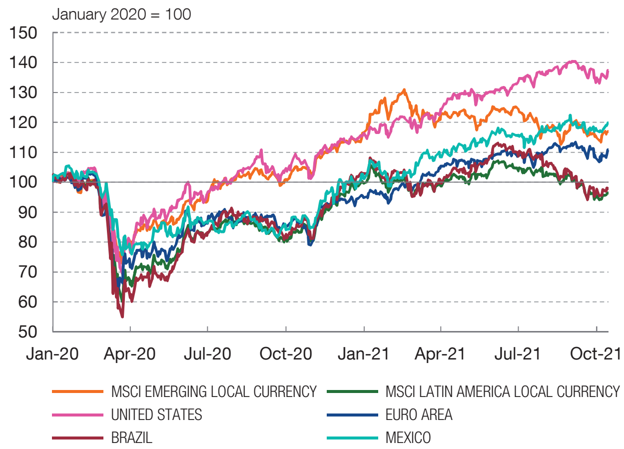
to households is estimated to have held on a moderately rising path, with the growth rate of approved mortgage loans generally quickening. At the same time, the ongoing de-dollarisation of lending witnessed since the start of the pandemic has continued, possibly owing to the fact that the credit-maintenance programmes were instrumented in local currency, meaning that dollar-denominated lending fell at a pace of 23% year-on-year on average in Mexico from early 2021, compared with 3% in the case of peso-denominated credit. Chile followed a similar pattern (-20% in dollars and +4% in pesos), while in Peru the rate of dollarisation of loans to the private sector fell by 24%, set against the increases of around 30% in the pre-pandemic period.

Chart 5
LATIN AMERICAN FINANCIAL MARKETS (cont'd)

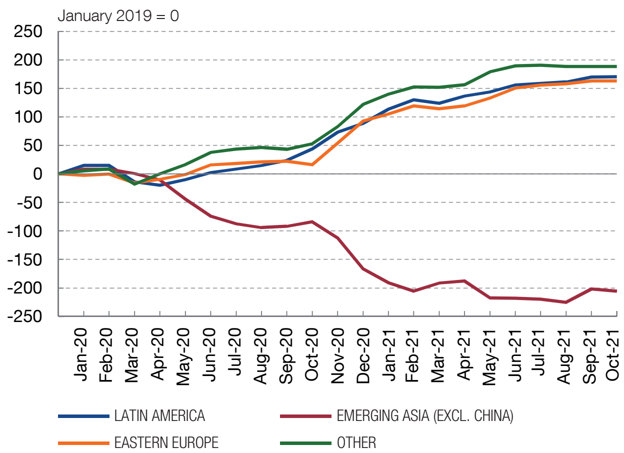
Financing conditions began to tighten as from February 2021, following the increase in inflationary pressures which led the region's central banks to initiate a normalisation of monetary policy. As a result of idiosyncratic factors, the financial variables of some of the region's countries behaved significantly worse than those of their peers, particularly in local debt markets. Portfolio capital inflows slowed, especially in those for the stock market, as fixed-income issuance recorded new highs in cumulative terms.

5 EXCHANGE RATES AGAINST THE DOLLAR

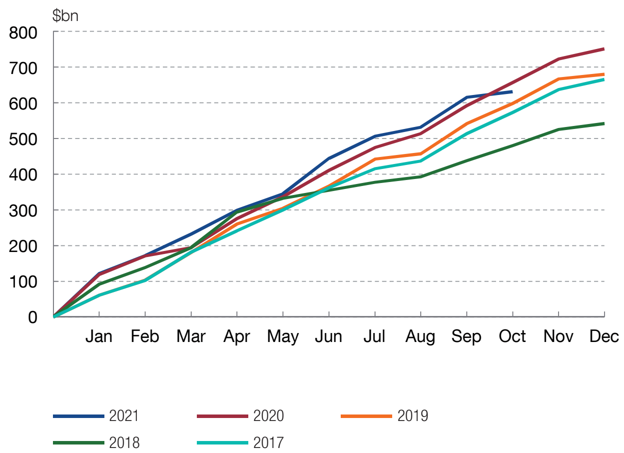
6 STOCK EXCHANGE INDICES



7 PORTFOLIO CAPITAL FLOWS ($bn, cumulative)



8 EMERGING ECONOMIES' FIXED-INCOME ISSUES IN INTERNATIONAL MARKETS ($bn, cumulative)



SOURCES: Refinitiv, Dealogic and Banco de España.

a Emerging economies aggregate exchange rate.

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Loan interest rates in the region as a whole are still below their pre-crisis levels. The slowdown in lending has been milder, however, than that in deposits. As a result, the leverage ratio has fallen throughout the region, as have banks' fixed-income issues on international markets. There were also further improvements in capital ratios in the first two quarters of the year (see Chart 6.2), as most of the macroprudential measures adopted since March 2020 remained in place. The increase is due to the decline in risk-weighted assets in Chile, Mexico and Peru, while in Brazil and Colombia it was prompted by the entry into force of the Basel III rules in January

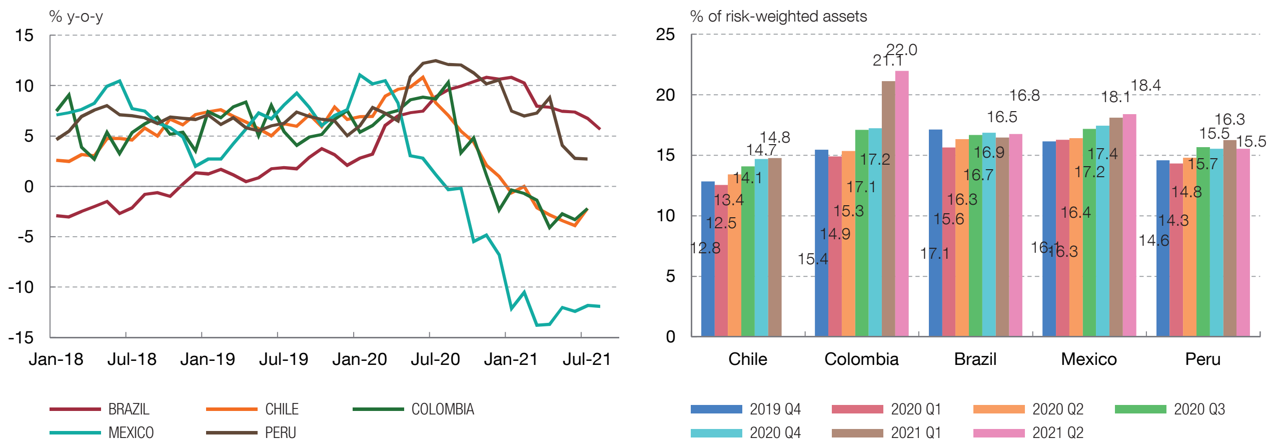
Chart 6

RECENT PERFORMANCE OF THE LATIN AMERICAN BANKING SYSTEMS MOST RELEVANT FOR THE SPANISH BANKING SECTOR

Over the last six months, lending slowed markedly. This stemmed from the expiry or reduction of the amounts involved in several of the credit-maintenance programmes set in place to alleviate the effects of the pandemic, and from the increase in credit risk, owing in part to the heightening uncertainty over the future course of economic policies. Bank profitability rose as interest rates increased, while capital ratios remained high thanks to a decline in risk-weighted assets.

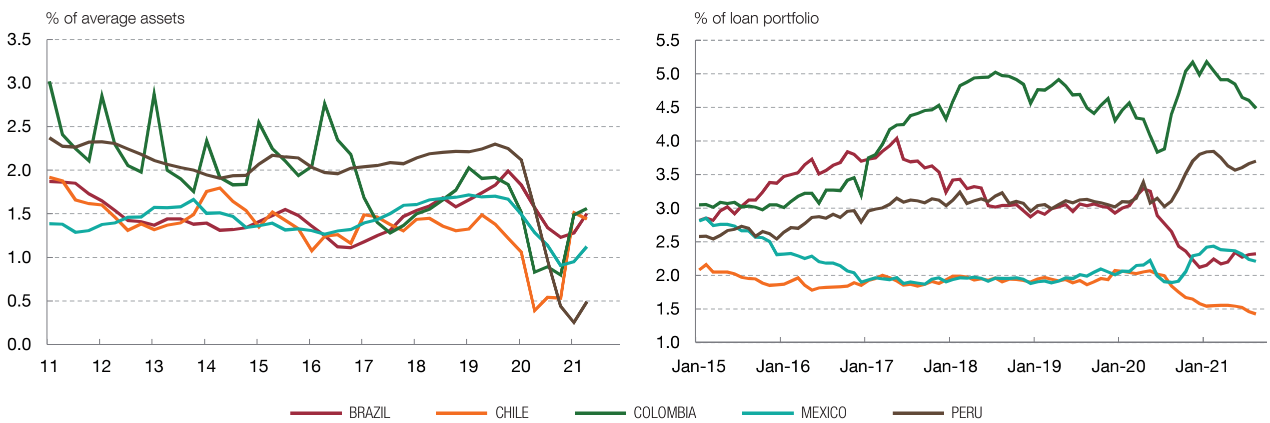
1 CREDIT TO THE PRIVATE SECTOR (a)

2 REGULATORY CAPITAL



3 PROFITABILITY (b)

4 NON-PERFORMING LOANS



SOURCES: National statistics, Refinitiv, IHS Markit and IMF.

a In real terms.
b Return on average assets (ROA).

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2021.[15] The profitability of the region's financial institutions has risen recently thanks, in most cases, to the reduction in the number of portfolio assets and to the increase in net interest income, arising partly from the start of the normalisation of interest

15 The application of Basel III has twin effects: first, it translates into an increase in capital requirements (with the numerator increasing) but also, and to a greater extent, into a reduction in the density of risk-weighted assets (RWAs) owing to the application of a more granular method as is the Standardised Approach under Basel III, and of credit risk mitigation (CRM) techniques.

rates. Meantime, provisions continued rising throughout the region (see Chart 6.3). In this connection, and with the discontinuation of some of the loan moratorium measures, the NPL ratio held on a rising trend in Colombia, Mexico and Peru, regaining previous highs; it rose in Brazil from very low levels (basically owing to loans to firms and, under this heading, those that were earmarked by the public sector); and, conversely, it remained contained at low levels in Chile, in all business segments (see Chart 6.4).

In the medium term, the robustness of the recovery will depend on the normalisation of the pandemic, external demand, the degree of support by economic policies, continuing favourable global financial conditions and how the social climate evolves

As earlier mentioned, the Latin American economies have been assisted by a favourable external environment. However, the economic outlook for the countries with the closest trade ties with the region has been revised somewhat downwards for the second half of 2021 and for 2022. In the case of the United States, these revisions are due to the greater persistence of supply-side bottlenecks and to the high uncertainty over the announced multi-year fiscal packages *(American Jobs Plan and American Families Plan)* being approved. In China's case the reasons would lie with the setting of specific pandemic-containment measures, the lower growth in public investment and deleveraging in the real estate sector. Markets are also listing commodity futures prices not very different from those discounted some months back; accordingly, this should not be a factor that would accelerate expected growth. Maintaining easy financial conditions rests on confirming the temporariness of the rise in inflation in the developed countries and, especially, in the United States. It will also hinge on portfolio capital flows to the economies in the region holding up.

As to domestic conditioning factors, pandemic-related developments continue to be the main determinant. Overcoming the health crisis would lead to the normalisation of economic activity, and to a more intensive use of the liquidity buffers households have built up. Here, progress in vaccination take-up is of crucial importance. As at the cut-off date for this Report, developments are positive. Vaccination has accelerated in recent months, meaning that 83.1% of the population in Chile, 72.2% of the population in Brazil, 66.7% in Argentina and just over 50% in Colombia (54.6%), Mexico (51.7%) and Peru (51.1%) have received at least one dose of a vaccine against COVID-19. The average in the advanced economies was at around 68% of the population and, in the emerging economies (excluding Latin America and China), around 47%. For more decisive headway in achieving resilience against the virus in the region, it is crucial that the recent pace of vaccination should continue and that more vaccines become available, in particular in those countries which, at present, have not procured sufficient doses to cover their entire population.

Economic policy stimuli, as will later be discussed in detail, are progressively being withdrawn. Those responsible here are the central banks of the five biggest inflation-targeting economies, which have set in train processes to raise policy interest rates that will foreseeably continue over the coming quarters, and certain fiscal authorities.

Bearing in mind all these factors, the latest IMF forecasts[16] consider that Latin America will post growth of 3.1% in 2022, following the aforementioned estimate of 6.3% (see Chart 2.3) for this year. The notable dispersion in the medium-term increases projected for the region's different economies (see Chart 2.4) is determined by the different intensity with which the factors discussed in the previous paragraphs are expected to operate. Specifically, differences in sectoral structure (e.g. the high significance of tourism for Mexico), in dependence on commodities prices (e.g. the reliance of Chile and Peru on copper prices, of Colombia on oil prices and of Argentina and Brazil on certain agricultural product prices), in the pace of withdrawal of monetary and fiscal stimuli, and in the degree of openness. Concerning this latter factor, the countries least open tradewise (in particular Argentina and Brazil) would benefit less from the global recovery than other more open economies in the region, such as Chile and Peru (benefits stemming from China), or Mexico (from the United States). However, since they are more integrated into global value chains, these economies might be more adversely affected by production bottlenecks.

Scarring from the crisis might bear adversely on the region's already-small growth potential in the medium term

If these forecasts hold, overall Latin American GDP would regain its pre-crisis level in 2022.[17] The region would thus evidence a fresh relative loss in GDP compared with the other emerging economies, excluding China, which are expected to post GDP in 2022 more than 7% higher than their pre-pandemic level. This poorer relative performance would compound that recorded in the previous five years: from 2014 to 2019, Latin America posted cumulative GDP growth somewhat under 4% whereas the related rate for the other emerging economies, excluding China, was over 27%.[18] The region's main challenge, therefore, once output gaps close, involves infusing economic activity with greater dynamism than that observed in the six years from 2014 to 2019 before the start of the pandemic. It will be vital to move to resolve the structural problems limiting potential growth, which is weighed down by sluggish investment and productivity. In this respect, moreover, the IMF has revised the region's potential growth downwards to 2.4%, compared with the

16 See IMF (2021a).

17 Taking the six main economies, Brazil, Chile and Colombia would restore it in 2021, while Mexico and Peru would do so in 2022, and Argentina at a later date.

18 Indeed, economies such as Argentina and Brazil posted a lower level of GDP in 2019 than that in 2013.

pre-crisis figure of 2.7%,[19] reflecting the effects of the pandemic on the region's medium-term outlook. Against this backdrop, then, it becomes even more important to launch an extensive structural reform programme enabling the region to achieve higher potential growth, especially via a sustained increase in investment and productivity.[20]

In any event, the uncertainty surrounding this economic outlook is very high. Accordingly, a set of risk scenarios grouped into two blocks is set out. First, hypothetical effects on activity of the materialisation of an epidemiological risk scenario are provided. Further, taking as a baseline a scenario in which the virus is gradually overcome, a set of macro-financial risks is considered.

The main sources of pandemic-related uncertainty are expected to stem from the emergence of new variants that detract from the effectiveness of the incomplete vaccination process

Of particular concern among the risks associated with the pandemic globally is that of the potential loss of immunity due to the emergence of new strains of the virus, some potentially more contagious and lethal.[21] The Delta variant, for example, would account for some of the increase in infections in many regions. There has been a lesser pass-through of this strain to deaths in regions of the world with a higher percentage of the population vaccinated, since vaccines have proven effective against it (see Charts 7.1 and 7.2). Given the positive headway by the vaccination process in Latin America (see Chart 7.3), therefore, a risk scenario would be determined by the emergence of new variants against which the current vaccines and naturally acquired immunity are less resistant. This might entail the need to introduce new containment measures.

To assess the hypothetical economic impact of this epidemiological risk, a scenario is simulated in which a new variant with these characteristics is assumed to emerge.[22] Specifically, it is considered that this new variant will ultimately be predominant and that the effectiveness of vaccines against it would fall to 50%.[23] Chart 7.4 shows that

19 See IMF (2019) and IMF (2021a).

20 See Banco de España (2020e).

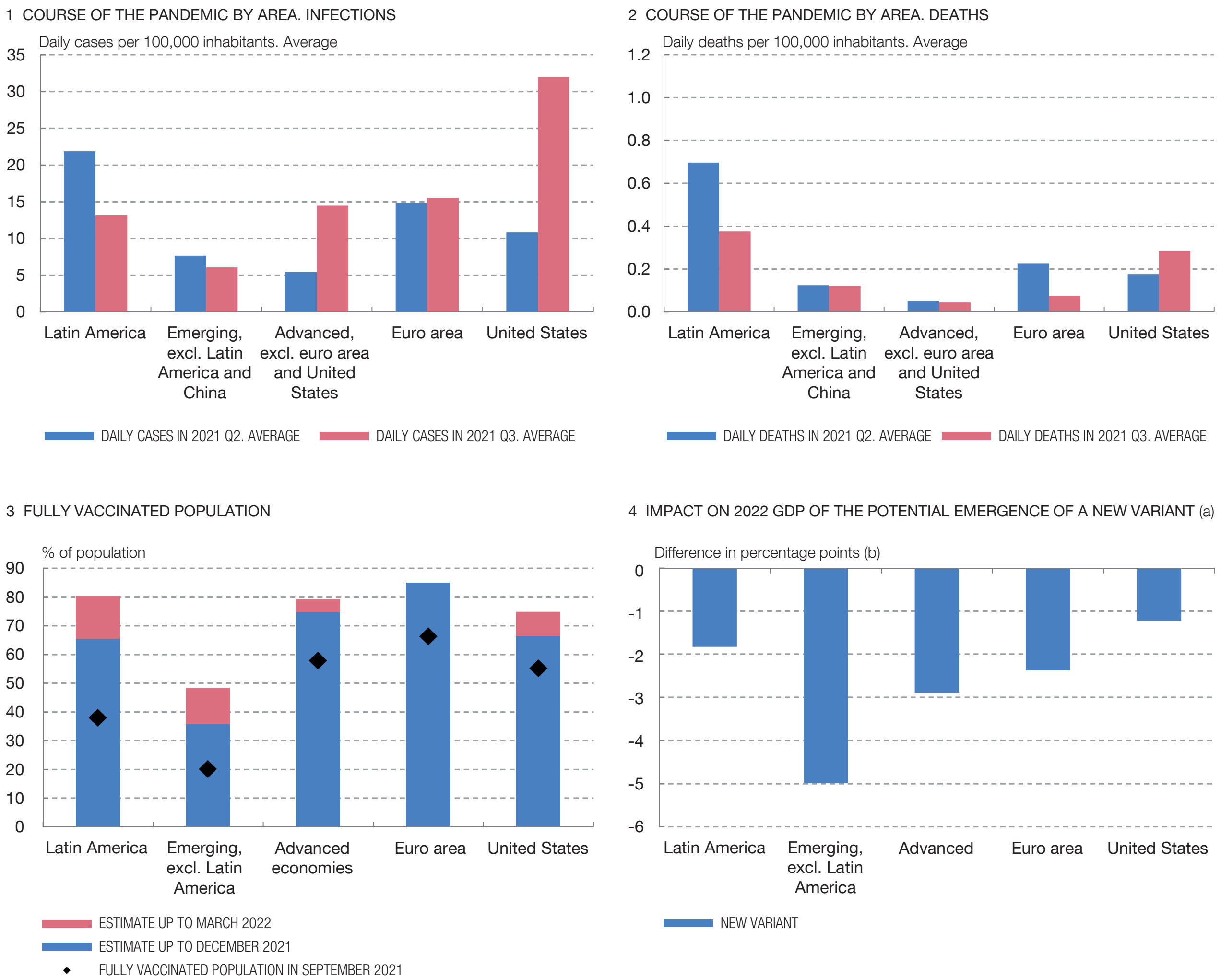
21 See Snell et al (2021).

22 The model developed by Rungcharoenkitkul (2021) has been adapted for these simulations. It is an SEIR-type *(Susceptible-Exposed-Infectious-Recovered)* epidemiological model that describes the evolution of the pandemic conditional upon the choice of mobility in society. The reduction in mobility translates into losses in terms of GDP using country-specific conversion factors, assuming a linear relationship between mobility and GDP. The factors are the ratios of the cumulative revisions of 2020 growth forecasts (the difference between consensus GDP growth forecasts for 2020 made in late 2020 and those made at the start of the year) and the decline in average mobility in 2020.

23 It is also assumed that natural immunity would only protect 75% of those already infected, and that the new variant takes three months to spread. Regard is also had to linear progress in the pace of vaccination such as that observed on average in the last three months until reaching a maximum vaccination rate of 85%, reflecting the reluctance of part of the population to take up vaccination.

Chart 7
EPIDEMIOLOGICAL DEVELOPMENTS

The main sources of pandemic-related uncertainty stem from the potential emergence of new variants that may detract from the effectiveness of the as yet incomplete vaccination process. Despite its potentially large impact on emerging economies, the impact on Latin America would be smaller, owing to the higher vaccine take-up and the higher percentage of a naturally immune population. Consequently, it is most important to achieve high levels of vaccination in order to be able to face potentially unfavourable pandemic-related developments from a better position.



SOURCES: Bloomberg, Duke Global Health Innovation Center, Our World in Data, COVID-19 INED and Rungcharoenkitkul (2021).

a Own calculations, drawing on the epidemiological model of P. Rungcharoenkitkul (2021). The "new variant" scenario assumes a loss of natural immunity (to 75%) and of the immunity through vaccination (to 50%) over three months. It considers linear progress in the pace of vaccination, such as the average pace observed in the last three months, to attain a maximum vaccination rate of 85%, reflecting the reticence of part of the population to the vaccinations.
b Difference in percentage points with respect to a baseline scenario. Cumulative impact in 2022.

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the aggregate loss of GDP in Latin America in 2022 might amount to 2 pp of growth, compared with the reference situation under which the pandemic is gradually overcome. The impact, in any case, would be less than in the other emerging economies, owing mainly to the fact that higher vaccination rates have been recorded in Latin America and that a greater percentage of its population are estimated to have acquired natural immunity on account of their prior exposure to the virus. These results underscore the importance of achieving high levels of vaccination, even in a setting in which vaccines were to lose some of their effectiveness, in order to be able to face potentially unfavourable pandemic-related developments from a better position.

Notable among macro-financial risks, on the upside, is a potential increase in commodities prices and, on the downside, a more pronounced increase in inflation and greater uncertainty over the future course of economic policies

Drawing on a baseline scenario similar to that envisaged by analysts, several macro-financial risk scenarios are considered: one on the upside, and two on the downside (see Box 1). First, a bigger-than-expected increase in commodities prices in 2022 is simulated, calibrated to replicate the upward “super cycle” of the early years of the 2010s. Second, a scenario is considered in which the risk that the recent rise in inflation may ultimately be more durable than expected materialises, feeding through to inflation expectations and leading to bigger rises in policy interest rates than those discounted by the financial markets. Under this scenario the path of interest rates is changed upwards in line with each country’s past experience in this type of episode. Third and finally is a scenario in which the effect of an outbreak of social unrest is simulated, calibrated using the events seen in Chile in 2019 and 2020 as a reference, which leads to increased uncertainty over economic policies. All these exercises are confined to the two largest economies, Brazil and Mexico, where the Spanish banking system has its biggest exposures in the region (see Boxes 2 and 3 for a more detailed description of both these economies’ main macro-financial indicators).

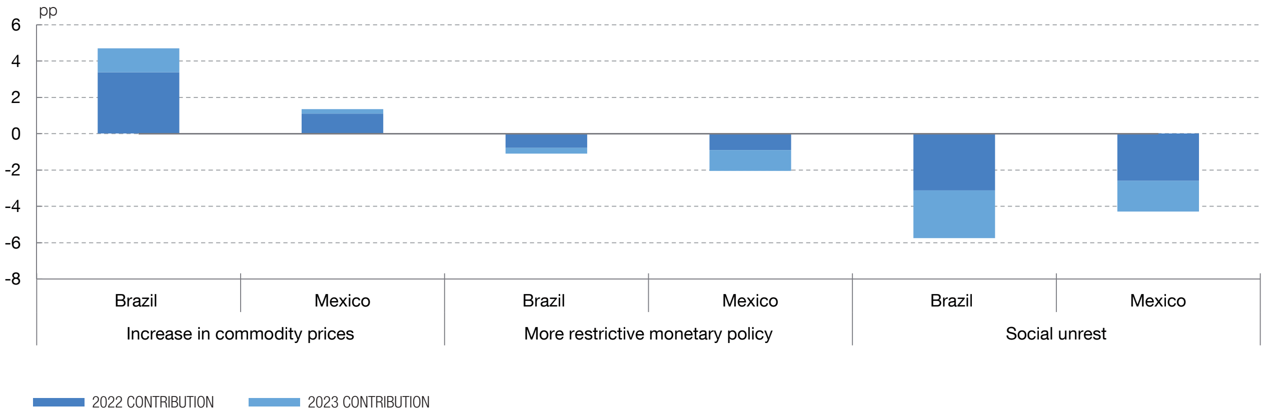
Chart 8 shows the main findings of these exercises. An additional increase in commodities prices would lead to higher GDP growth, both in Brazil and in Mexico. It would have a more notable impact in Brazil, since its exports are more sensitive to commodities prices, whereas Mexican exports are more concentrated in manufactured goods. The cumulative increase in output in 2022-2023 would be almost 5 pp in Brazil and around 1.3 pp in Mexico. Were monetary policy to be tightened more than the markets have discounted, GDP growth would be lower in the two countries. The cumulative decline in GDP in 2022-2023 would be close to 1 pp en Brazil and somewhat under 2 pp in Mexico. Lastly, under the scenario in which a pronounced increase in social unrest is assumed, there would be a loss in output in 2022-2023 of almost 6 pp in Brazil and of marginally over 4 pp in Mexico.

Chart 8

RISK SCENARIOS FOR MACROECONOMIC DEVELOPMENTS IN BRAZIL AND MEXICO

Three macro-financial risk scenarios of opposite signs, one on the upside (increase in commodity prices) and two on the downside (more restrictive monetary policy and a heightening of social unrest), are considered for the Brazilian and Mexican economies in 2022 and 2023.

GDP CUMULATIVE CHANGE IN 2022-2023 FOR EACH SCENARIO AND COUNTRY (a)



SOURCE: Banco de España.

a Deviation from the baseline scenario.

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In relation to the latter risk identified, the indicators of social unrest, political instability and uncertainty over economic policies notably stand at high levels in the region

The indices of social unrest and uncertainty over economic policies remain higher than those observed in the past decade, and have even increased recently in several Latin American countries (see Chart 9.1).[24] This might affect the ultimate launch of economic reforms in various areas and give rise to some upward pressure on public spending, in a situation in which budgetary space might be limited, as discussed later in this Report, and in an intense electoral cycle setting in the region (see Chart 9.2).

Bouts of instability can interact with certain structural shortcomings in the region, in an environment of still-partial recovery from the crisis. As in other global regions, the persistence of the COVID-19 crisis has emphasised even more certain structural failings in the education and public health systems,[25] while unemployment rates and inequality problems in the distribution of wealth have increased. In this connection,

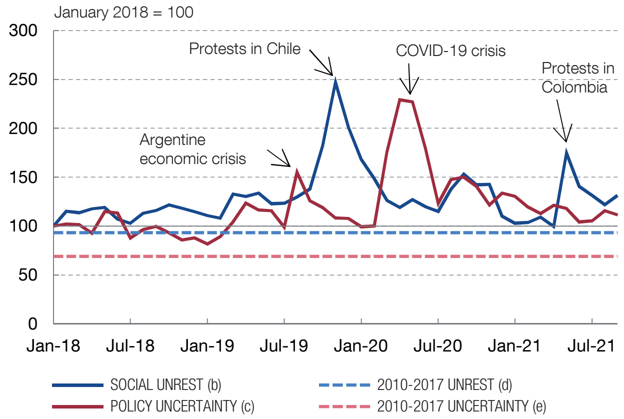
24 The social and political unrest and uncertainty indices are constructed drawing words related to each of these subjects from the local press. They are based on the methodology of Baker et al. (2016). See Andrés, Ghirelli, Molina, Pérez and Vidal (2021, forthcoming) and Ghirelli, Pérez and Urtasun (2021) for a Spanish press-based application for Latin America.

25 See ECLAC (2021b).

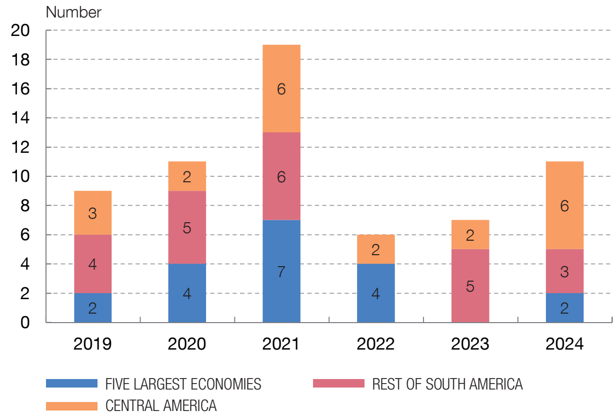
Chart 9
POLITICAL AND SOCIAL UNREST

The indicators of social unrest, political instability and uncertainty over economic policies stand at very high levels in the region, far higher than those observed in the past decade. This might affect the launch of economic reforms, in an intense electoral cycle setting. These bouts of instability may exacerbate structural shortcomings in the region, such as the erosion of the middle classes.

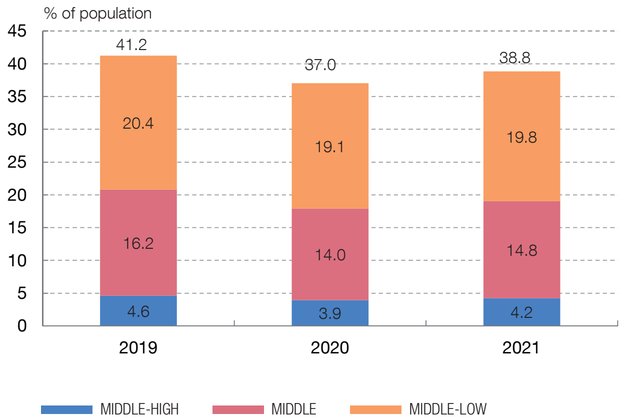
1 INDEX OF SOCIAL UNREST AND UNCERTAINTY OVER ECONOMIC POLICIES (a)



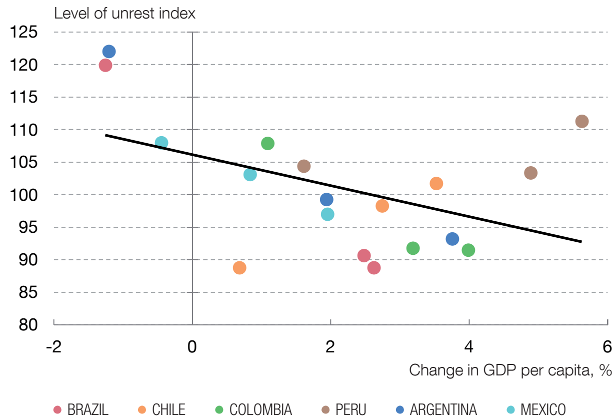
2 LEGISLATIVE AND PRESIDENTIAL ELECTIONS IN LATIN AMERICA



3 MIDDLE CLASSES IN LATIN AMERICA



4 GROWTH IN GDP PER CAPITA (f) AND INDICATOR OF SOCIAL UNREST (LASSI) (b)



SOURCES: ECLAC, World Bank and Banco de España (based on Ghirelli et al. (2021) and Andrés et al. (2021, forthcoming)).

a Average of Argentina, Brazil, Chile, Colombia, Mexico and Peru.
b Average of LASSI and LAPSI. The Latin America Social Strains Index (LASSI) is constructed drawing on the local press using words related to bouts of social unrest, based on the methodology of Baker et al. (2016). The Latin America Political Strains Index (LAPSI) is constructed drawing on the local press using words related to bouts of political unrest, based on the methodology of Baker et al. (2016).
c The Economic Policy Uncertainty (EPU) index is constructed drawing on the local press using words related to uncertainty over economic policies, based on the methodology of Baker et al. (2016).
d Average of LASSI and LAPSI between 2010 and 2017.
e Average of the EPU between 2010 and 2017.
f Average change in GDP per capita (in constant dollars) in each five-year period in 2005-2019.

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fresh increases in poverty and erosion of the middle classes – especially in the intermediate segments – were observed during the pandemic (see Chart 9.3). Structural economic problems, moreover, may continue in turn to prompt social and political unrest (see Chart 9.4).

In this setting, the region's public finance and political risk vulnerabilities remain high, although in accordance with the external and banking sector indicators they remain contained

Table 2 shows for each of the countries how the vulnerability indicators have evolved, aggregated by groups of variables, in the form of a heat map.[26] The macroeconomic vulnerability indicators reveal that GDP growth rates have recovered, returning to levels similar to those of 2019. By contrast, inflation rates have risen significantly throughout the region (see Chart 10.1), to highs not seen since 2016 – when the peak levels of the last cycle of policy interest rate hikes in the region were recorded – and above the average for the last 10 years. This is partly the reason for the widespread interest rate hikes made by many of the region's monetary authorities.

The clearest risk indicators for the region's main countries are in the field of public finances, as in the last Latin American report. In Brazil, these indicators stand at very high risk levels, both compared with past experience and with the other emerging market economies. Also, some risk elements could make this vulnerability more persistent, for instance: the composition of public debt, a large proportion of which is indexed to the policy interest rate (45% of the total) and to inflation (a further 22%), both of which are rising; uncertainty over the future course of fiscal policy, with expectations of new social transfer programmes;[27] and the need to meet the litigation-related payments facing general government, which could amount to up to 1% of GDP.[28] Beyond Brazil, public and private foreign and domestic debt levels in the rest of the region are significantly higher than their pre-pandemic levels at end-2019 (see Charts 10.2 to 10.5).

On the positive side, the region's external and banking vulnerabilities remain moderate or low, and also when compared with those of other emerging market economies. The region's current account imbalances are lower, its portfolio capital inflows are quite steady, its international reserves are higher (see Charts 10.7 to 10.9), and certain standard external debt sustainability metrics – such as the short-term debt-to-reserves ratio (see Chart 10.4) –have improved. Likewise, effective exchange

26 Drawing on the historical distribution of frequencies of each variable in each country, the percentile in which each item of data in each distribution lies is estimated, assigning colours that range from green (lower risks) to red (extreme risks). In a new development, the heat map includes a comparison at the same moment of time with another 26 emerging market countries. For more details, see Alonso and Molina (2021).

27 Specifically, the Emergency Assistance *(Auxilio Emergencial)* programme which is to replace the previous government's Household Support Allowance *(Bolsa Familia),* for those persons who were entitled to receive the special COVID assistance in December 2020. The programme was launched in March 2021 (https://www.in.gov.br/en/web/dou/-/medida-provisoria-n-1.039-de-18-de-marco-de-2021-309292254) and extended, in July, to October 2021 (https://in.gov.br/en/web/dou/-/decreto-n-10.740-de-5-de-julho-de-2021-330268082).

28 These payments arise from lawsuits that the Government has lost, with no further channel for appeal. The payments are mandatory and are booked as primary expenditure, so they limit the room for other policies within the expenditure ceiling. According to the Supreme Court, the payments will amount to almost 1% of GDP in 2022. The Government's response was to propose a constitutional amendment that regulates the payments and defers the largest payments for up to nine years (https://www.gov.br/economia/pt-br/centrais-de-conteudo/apresentacoes/2021/agosto/pec-precatorios.pdf).

Table 2
LATIN AMERICA: VULNERABILITY SITUATION (a)

SOURCE: Alonso and Molina (2021).

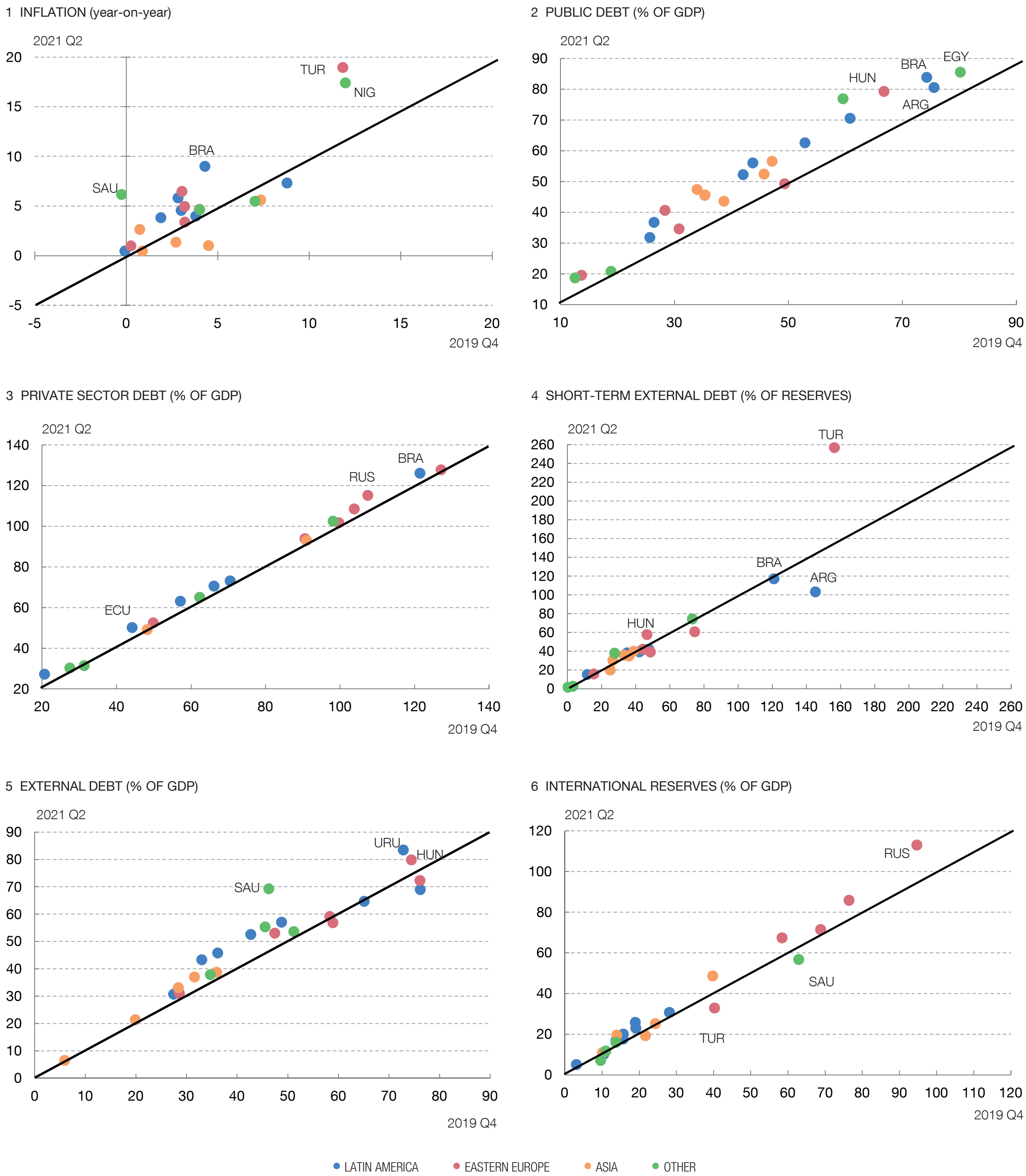
- **a** The risk level is indicated with shades of green (associated with lower levels of vulnerability), yellow (medium vulnerability) and red (variables in the riskier percentiles).
- **b** Sovereign spread (level and quarterly change) and quarterly change in equity index and in exchange rate.
- **c** Change in GDP and industrial production, inflation rate and change in GDP per capita.
- **d** General government balance and gross public debt (% of GDP).
- **e** Real change in credit and deposits, loan-to-deposit ratio, non-performing loans, net foreign assets of banks, banks' equity index, interest rate on banks' external debt, qualitative indicators (BICRA / IHS Markit), short-term interbank rate and net interest income.
- **f** Current account balance, direct and portfolio investment inflows, external debt, short-term external debt and external debt service, and international reserves.
- **g** IHS Markit political risk indicator, geopolitical risk indicator and GDP per capita.
- **h** August 2021 for financial markets (including banks' equity index and bond spreads), and for political risk, banking and GPR indicators. 2021 Q1 for GDP and balance of payments, external debt, public debt and budget deficit data. April 2021 for credit, deposits, non-performing loans and external position of banks.

rates are no more misaligned than they were in 2019 and, in general terms, the position of the region's banks' external position has not worsened.

However, the region's political risk indicators have deteriorated, especially in Peru where the new Government, which does not have a parliamentary majority, has

Chart 10
VULNERABILITY INDICATORS

Vulnerabilities in the region remained very high in the public finance sphere and in terms of political risk, while they remain contained according to external and banking sector indicators. The indicators of the countries of the region performed less well in terms of inflation rates, long-term interest rates on local currency debt and agencies' credit ratings.



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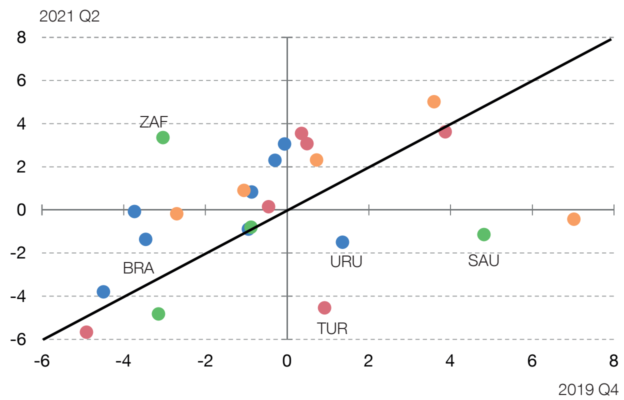
SOURCE: Banco de España.

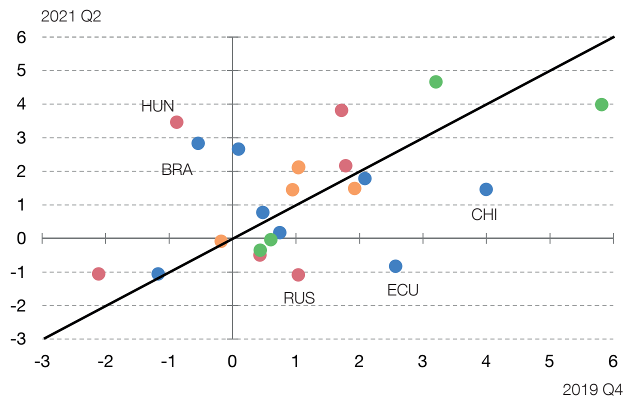
Chart 10
VULNERABILITY INDICATORS (cont'd)

Vulnerabilities in the region remained very high in the public finance sphere and in terms of political risk, while they remain contained according to external and banking sector indicators. The indicators of the countries of the region performed less well in terms of inflation rates, long-term interest rates on local currency debt and agencies' credit ratings.

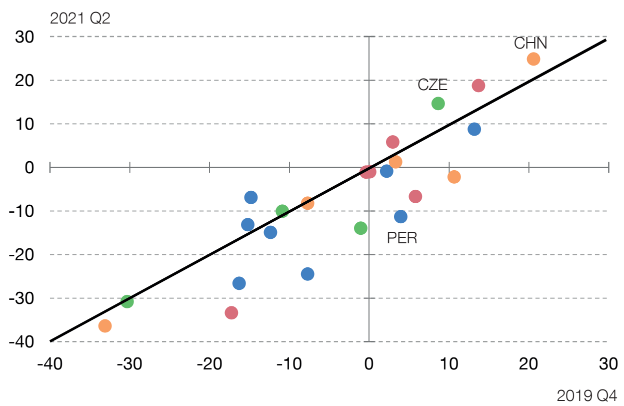
7 CURRENT ACCOUNT BALANCE (% OF GDP)



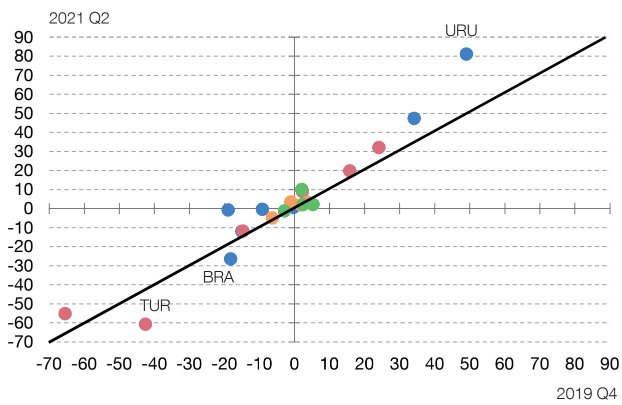
8 PORTFOLIO CAPITAL FLOWS (% OF GDP)



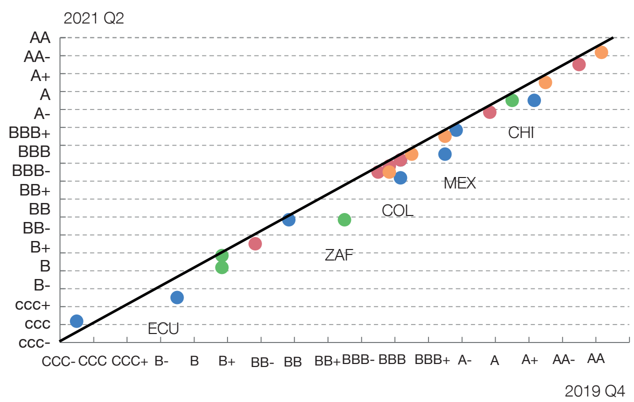
9 DEVIATION FROM THE NOMINAL EXCHANGE RATE



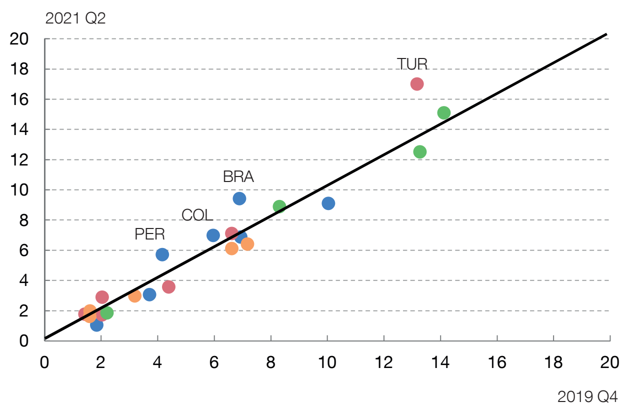
10 BANKS' NET FOREIGN ASSETS (% OF GDP)



11 SOVEREIGN RATING



12 LONG-TERM RATES ON LOCAL CURRENCY DEBT (%)



LATIN AMERICA   EASTERN EUROPE   ASIA   OTHER

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SOURCE: Banco de España.

announced that it intends to call a referendum to draw up a new constitution. There have also been various episodes of social unrest in Brazil, Chile, Colombia and Peru[29] (see Table 2); these appear to be quite persistent, in a setting, in addition, marked by numerous elections scheduled in the region over the next 18 months (see Chart 9.4). Compared with other emerging market economies, the Latin American economies have seen the most downgrades to their sovereign credit ratings during the pandemic, and also the highest increases in long-term interest rates in local currency (see Charts 10.11 and 10.12). This could be linked to the greater deterioration of their institutional and fiscal indicators in comparison with other emerging market economies.

Domestic economic policies have tightened, in the fiscal and, especially, in the monetary spheres

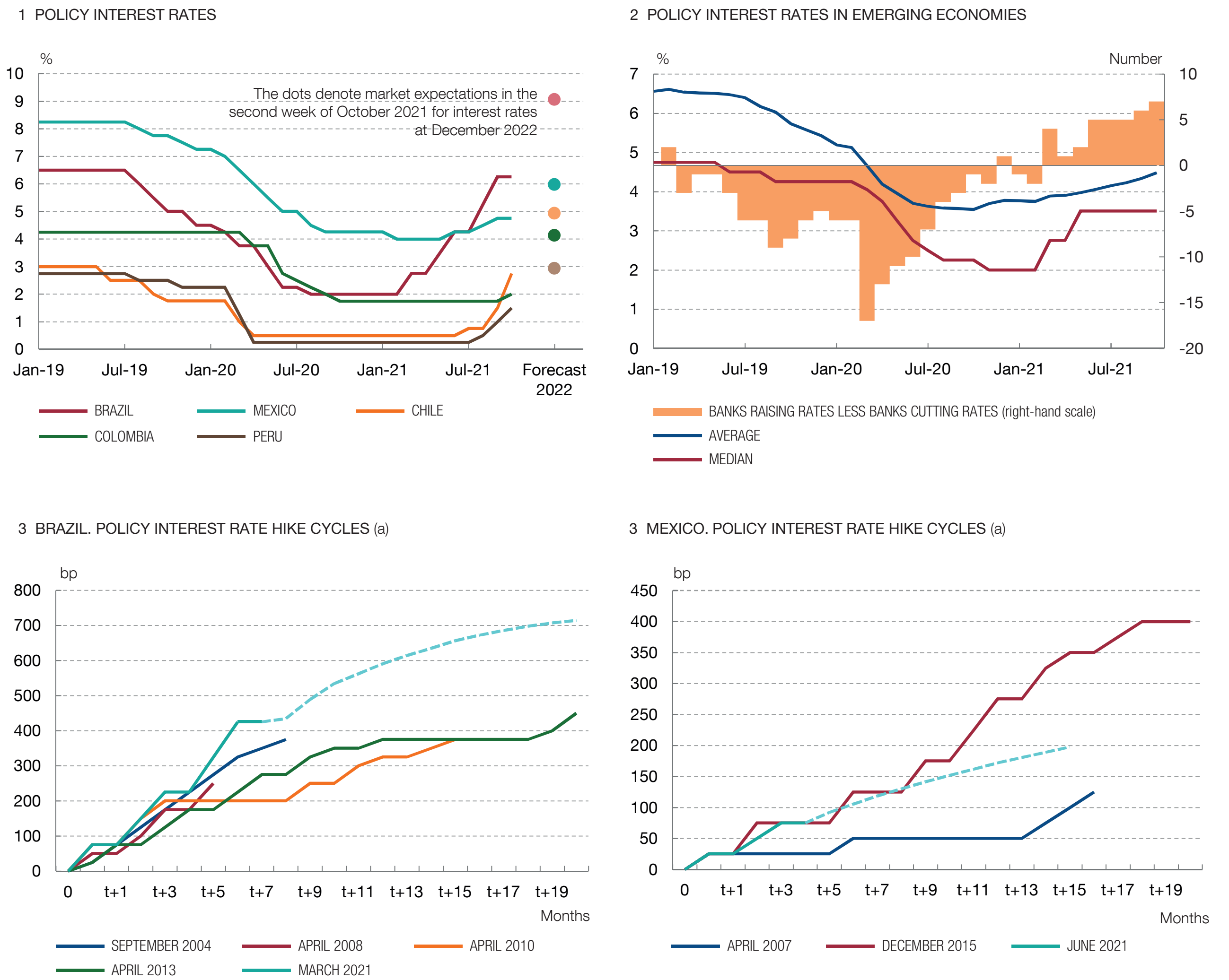
Given the increase in inflationary pressures indicated earlier in this Report, and despite the existence of negative output gaps, the central banks of the region's main inflation-targeting economies have begun to tighten their monetary policies (see Chart 11.1). This is partly to prevent the possible appearance of second-round effects, i.e. to prevent firms from passing higher costs on to their end prices and workers from passing price rises on to their wage demands. This policy shift is not exclusive to Latin America (see Chart 11.2). Policy interest rates have also been raised in other emerging market economies in eastern Europe and Asia, and in some smaller advanced economies. But the widespread nature of the monetary policy shift in the region is notable, as is, in some cases, the scale of the rate increases already made and of those factored in by the financial markets in comparison with the situation in other emerging regions. Also notable is the investor perception of higher inflationary risks, as reflected, in part, by the higher increases in longer-term interest rates in these economies (see Chart 5.4).

The Brazilian central bank began its tightening cycle in March and has now raised its policy rate by 425 basis points (bp). The financial markets are assuming that this is going to be a more aggressive monetary tightening than on previous occasions (see Chart 11.3). For its part, the Chilean central bank began its rate hikes in July; these now amount to 225 bp and further aggressive rate hikes are expected in coming months given the strength of domestic demand and especially of private consumption, partly owing to the fresh withdrawals of savings from pension funds. The other three central banks have made smaller rate rises, and more are also expected in the coming months (see Chart 11.1), albeit to a lesser extent than in Brazil or Chile (see Chart 11.4 for the case of Mexico). But it is important to note that in almost all cases rates were at record lows (see Chart 11.5) and that even if the policy rate rises factored in by the financial markets were to be made, generally, in real terms, rates

29 See Andres et al. (2021).

Chart 11
WIDESPREAD INCREASES IN POLICY INTEREST RATES OWING TO THE SURGE IN INFLATION

As in all other emerging economies, the main countries of the region have embarked on a cycle of interest rate hikes. The monetary policy tightening cycle is expected to be more aggressive than on previous occasions, especially in Brazil. However, given that interest rates started out from record lows, in real terms they continue to remain well below equilibrium rates. Central banks may have margin to again use other non-standard measures, such as larger asset purchases or increases in international reserves.



SOURCES: Refinitiv, Consensus Forecasts and national statistics.

a The broken lines denote the policy interest rates factored in by the market in the second week of October 2021.

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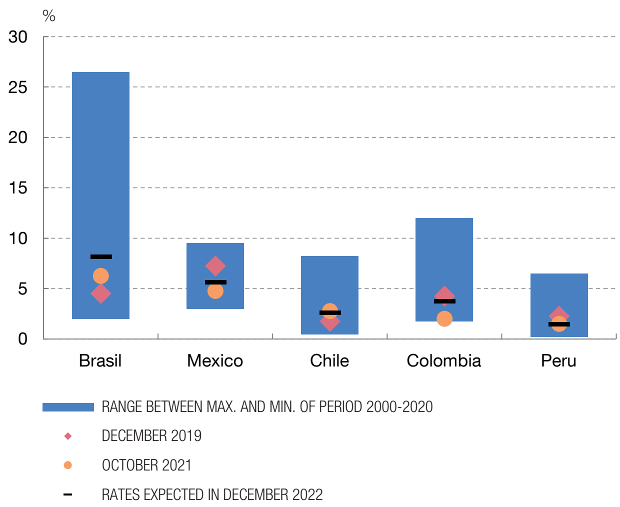
would still be below the neutral interest rates calculated by central banks. In other words, monetary policy would still be expansionary (see Chart 11.6).

Inflation is the variable that will most influence the future course of monetary policy. Despite the diagnosis that the recent surges in inflation are primarily transitory, as discussed above, risk scenarios of higher rate rises than those currently factored in by the financial markets cannot be ruled out, as illustrated by one of the macro-financial risk scenarios described above. Another key variable that will determine monetary

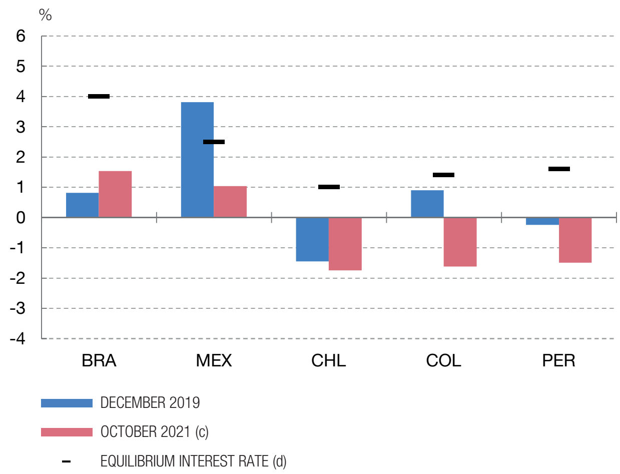
Chart 11
WIDESPREAD INCREASES IN POLICY INTEREST RATES OWING TO THE SURGE IN INFLATION (cont'd)

As in all other emerging economies, the main countries of the region have embarked on a cycle of interest rate hikes. The monetary policy tightening cycle is expected to be more aggressive than on previous occasions, especially in Brazil. However, given that interest rates started out from record lows, in real terms they continue to remain well below equilibrium rates. Central banks may have margin to again use other non-standard measures, such as larger asset purchases or increases in international reserves.

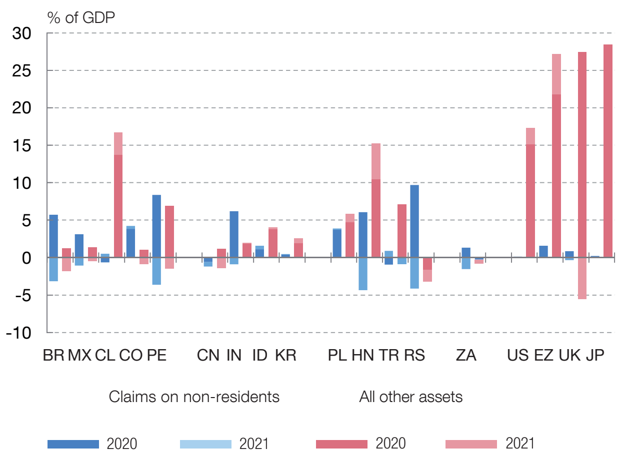
5 POLICY INTEREST RATES



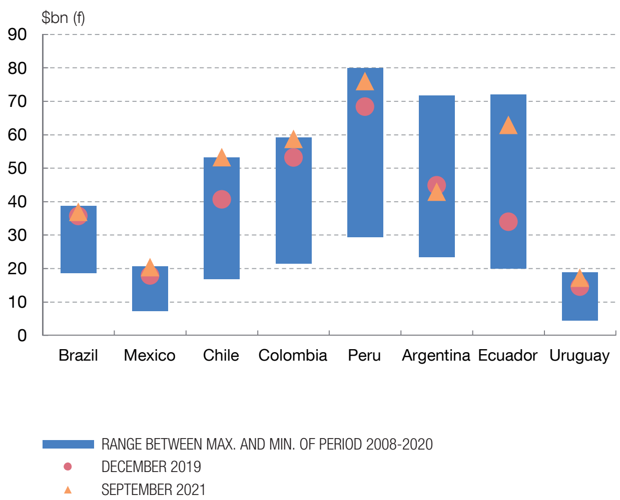
6 REAL INTEREST RATES IN THE MAIN LATIN AMERICAN ECONOMIES (b)



7 CHANGE IN CENTRAL BANKS' BALANCE SHEETS (2019 TO 2021) (e)



8 LEVEL OF INTERNATIONAL RESERVES



SOURCES: Refinitiv, Consensus Forecasts and national statistics.

b Real interest rates calculated as the difference between nominal interest rates and 1-year expected inflation.
c September 2021 for Mexico and Peru.
d On estimates of the region's central banks.
e Year-end data.
f For Brazil and Mexico, in $100 bn; for Ecuador in $100 million.

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policy in the Latin American economies in the coming quarters are external financing conditions, which could tighten in the coming months if the central banks of the developed economies were to alter their message that monetary policy will continue to be accommodative. Under such a scenario, the region's monetary authorities could be forced to adopt more restrictive monetary policies to meet their financial stability and inflation targets. Nevertheless, in the face of a potential tightening of external financing conditions, the region's central banks could resort to other tools: they could make larger financial asset purchases, as the central banks of Chile and Colombia did at the peak of the financial market tension in 2020[30] (making use of an instrument that was new to the region and which proved effective);[31] or they could intervene on foreign exchange markets, following the increases made by several economies to their international reserves in recent months (see Charts 11.7 and 11.8).

In the case of fiscal policy, economic recovery and higher commodities prices are driving up public revenue in Latin America (see Chart 12.1). On the expenditure side, there has been a decline in certain countries, especially in current transfers and subsidies, partly as a result of the withdrawal of some of the measures introduced in response to the crisis, while interest payments have remained close to previous years' levels. As a result of these revenue/expenditure dynamics, the region's aggregate budget deficit has narrowed in 2021 (see Chart 12.2). Yet budget deficits will remain high throughout the year: they are expected to narrow in Argentina, Brazil, Mexico and Peru, but will widen in Chile and Colombia, partly on account of the expenditure associated with the recent introduction of new social transfer programmes. Accordingly, public debt for the whole of Latin America as a percentage of GDP will fall in 2021 (by 5.3 pp to 73.8% of GDP), despite increasing in Chile and Colombia (see Chart 12.3). In the case of Colombia, both investors and credit rating agencies have perceived increased sovereign risk, as shown by the fact that two of the main agencies have downgraded it from investment grade. In addition, governments have generally failed to present clear proposals on the future framework of fiscal policy that will provide for the necessary fiscal consolidation, especially bearing in mind that, among the emerging regions, Latin America has the highest level of public debt and is also expected to have a high sovereign bond yield (see Chart 12.4) and one of the lowest rates of economic growth in the medium term.

To illustrate the possible constraints on the fiscal space available in the region's two main economies, Brazil and Mexico, the probabilities of public debt in those countries exceeding, under certain conditions, a set of reference values at end-2030 have been simulated (see Charts 12.5 and 12.6). The reference values are set within a range of 90%-120% of GDP for Brazil and of 30%-70% of GDP for Mexico,[32] in

30 See, for example, Banco de España (2020b), IMF (2021b), World Bank (2021) and IDB (2021).

31 Arslan et al. (2020) show that central bank bond purchases in emerging market economies banks significantly reduced long-term government debt yields for a set of emerging countries.

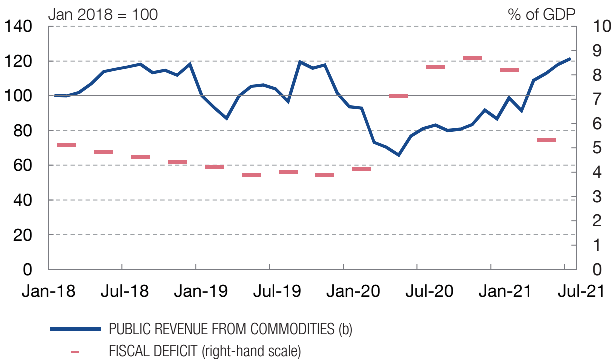
32 Using the Alloza et al. methodology (2021). The simulations are made using a stochastic analysis model of the sustainability of public finances. This allows for projection of future paths of the fiscal variables (budget deficit,

Chart 12

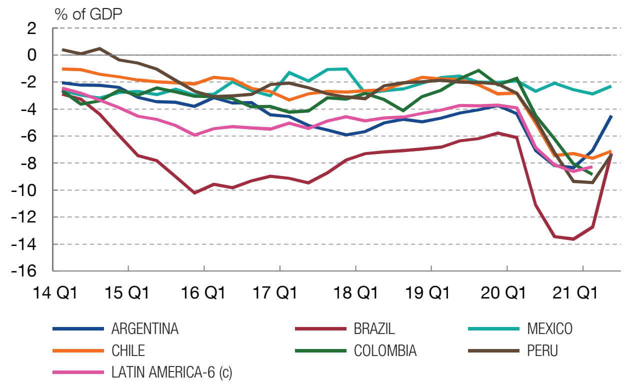
IMPROVED PUBLIC FINANCES (DESPITE THE HIGH DEFICIT LEVELS) AND HIGH PUBLIC DEBT

Although budget deficits still remain high, there is widespread improvement (save in Colombia and Chile) in government balances, thanks in part to the increase in public revenue from commodities. As a result of the lower budget deficits and GDP growth, public debt will fall in 2021 in the region overall, except in Chile and Colombia. By contrast, Latin America will continue to be the region with the highest cost of public debt.

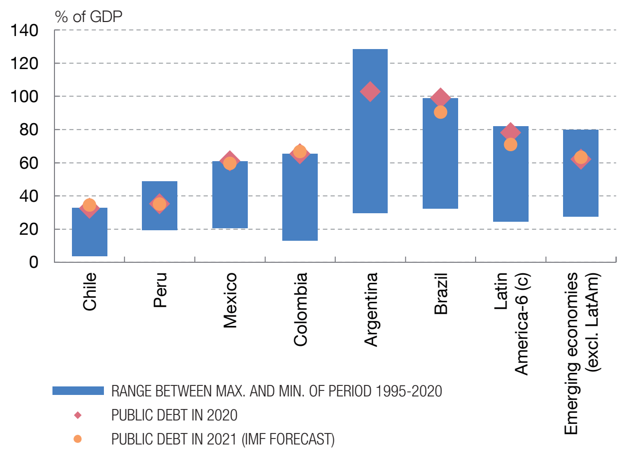
1 PUBLIC REVENUE FROM COMMODITIES AND BUDGET DEFICIT (a)



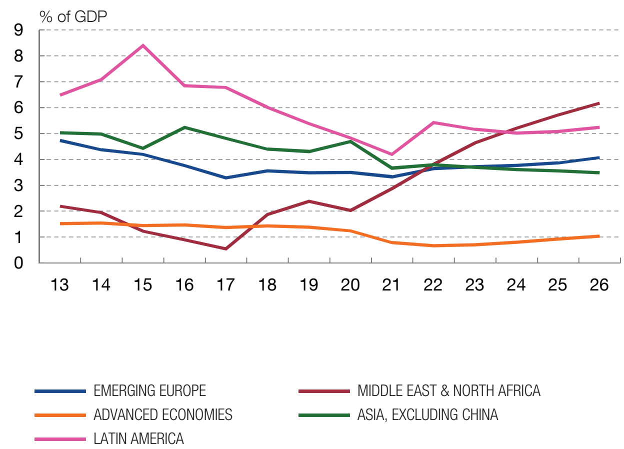
2 GOVERNMENT BALANCES



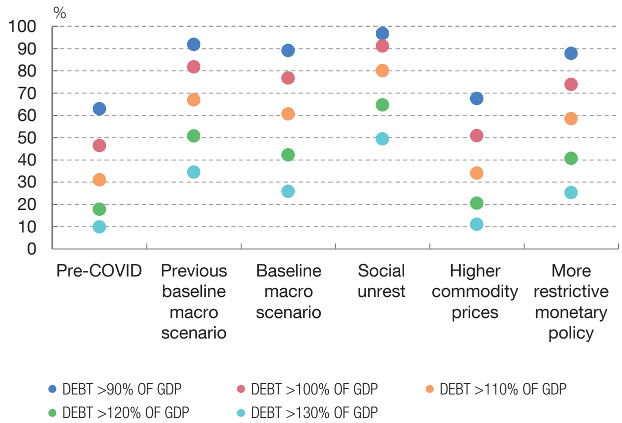
3 GROSS PUBLIC DEBT



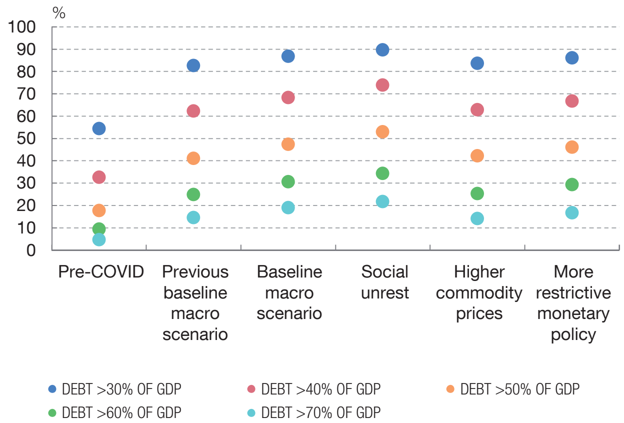
4 INTEREST RATE ON PUBLIC DEBT (d)



5 BRAZIL. PROBABILITY OF PUBLIC DEBT EXCEEDING A SET THRESHOLD IN 2030



6 MEXICO. PROBABILITY OF PUBLIC DEBT EXCEEDING A SET THRESHOLD IN 2030



SOURCES: IMF, Refinitiv, national statistics and Banco de España.

a Aggregate of Argentina, Brazil, Chile, Mexico and Peru. Monthly data not available for Colombia.
b Ratio of public revenue from commodities to total public revenue.
c Aggregate of Argentina, Brazil, Chile, Colombia, Mexico and Peru. Aggregate of Brazil, Chile, Colombia, Mexico and Peru for the 2021 public debt forecast in Chart 12.3.
d IMF data (WEO October 2021).

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accordance with their historical averages and with the latest dynamics observed in each of the two countries. To calculate the probabilities, a simulation model is used that projects the future paths of macroeconomic and fiscal variables up to 2030. The quarter taken as the starting point for the calculations varies in the simulations, to illustrate the impact of the latest data and projections on the dynamics of the probabilities calculated. Thus, in a first exercise, 2019 Q4 is taken as the starting point for the simulations (to reflect the analysis that would have been made immediately before the onset of the pandemic). The second exercise is that conducted in April in the framework of the last Latin American Report (for the baseline scenario at that time). The other exercises proposed contain simulations that are conditioned by the materialisation of the macro-financial scenarios presented in this Report and discussed earlier (baseline scenario and three risk scenarios).

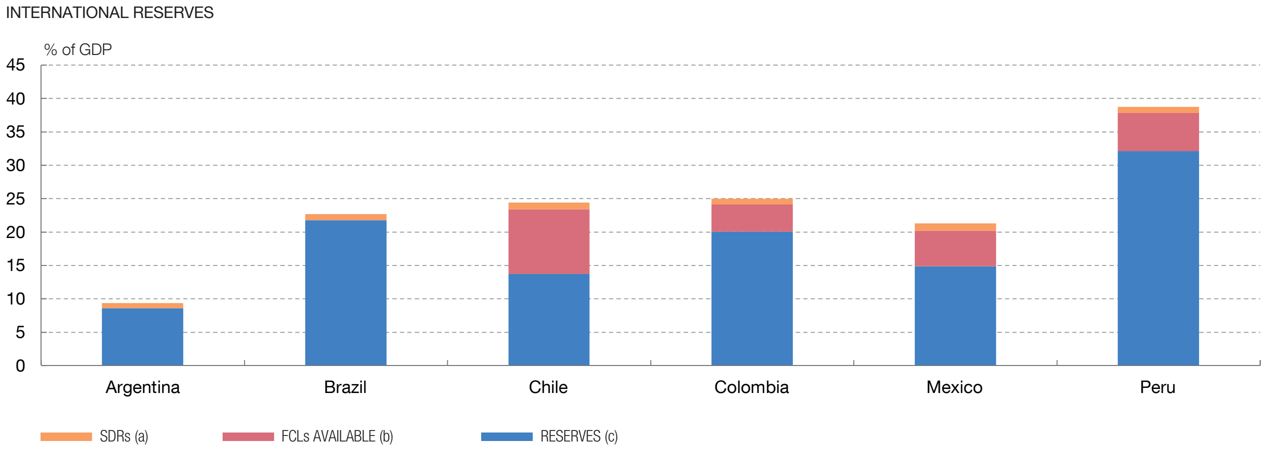
The results of these exercises are presented in Charts 12.5 and 12.6, for Brazil and Mexico, respectively. In the case of Brazil, if the present baseline macro-financial scenario is taken as the starting point, the probability of public debt being above 100% of GDP in 2030 is somewhat more than 75%, whereas in the exercise using the figures projected in April the probability is slightly higher than 80%. The improvement primarily reflects a more positive expected debt trajectory than that plotted six months ago. Among the alternative macro-financial scenarios, under that which envisages the most uncertainty as regards economic policy, the probability of public debt being above 100% of GDP is more than 91%, some 14 pp more than under the baseline scenario, whereas a better than expected commodities performance would enhance the fiscal accounts, thus reducing the probability of public debt being above 100% of GDP to 51%, 26 pp lower than under the baseline scenario. In the case of Mexico, taking the baseline scenario as the starting point, the probability of public debt being above 60% of GDP in 2030 is 31%. This probability is slightly higher than that estimated based on the figures projected in April, because the debt-to-GDP ratio is higher at the starting point. In any event, the underlying medium-term public debt trajectory in Mexico is steady and the outlook for public debt is similar under the different scenarios considered. Nevertheless, the crisis has had a major impact on public finances: the probability of public debt exceeding 50% of GDP in 2030 is now 47% under the baseline scenario, compared with slightly below 20% estimated before the onset of the pandemic. All told, it is important to note that the exercises performed do not include various additional sources of uncertainty that could significantly impact the simulations. Debt levels could vary, for instance, owing to exchange rate fluctuations, especially in Mexico.[33] Similarly, were contingent liabilities (such as possible bail-outs of State-owned companies) to materialise, public debt could rise above the levels considered in these exercises.

interest payments on debt) and the macroeconomic variables (GDP, inflation and interest rates) that are key to calculating future public debt trajectories that are consistent with compliance with public sector budgetary constraints. In turn, the future paths projected (Montecarlo simulations) permit quantification of the range of the debt trajectories at different horizons, taking the assumptions in each scenario as the starting point.

33 Around 25% of Mexican public debt is foreign-currency denominated.

Chart 13
NEW ALLOCATIONS OF SPECIAL DRAWING RIGHTS (SDRs) STRENGTHEN THE EXTERNAL POSITION

The fresh allocation of special drawing rights (SDRs) to the region, amounting to $51.5 billion, and the extension of new credit lines by the IMF bolster the international reserve buffer, reducing the risk and strengthening the external position of the countries in the region.



SOURCES: Refinitiv and IHS Markit.

a New SDRs allocated and 2020 GDP.
b 2020 GDP.
c Reserves data and 2021 Q2 GDP.

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As the domestic policy space has progressively shrunk, the global and regional safety network has become increasingly important for addressing a possible tightening of global financing conditions

The Federal Reserve's swap lines with the central banks of Brazil and Mexico and its temporary FIMA overnight repo facility to boost the supply of dollars in the economies of the region have played a particularly important role in maintaining favourable financing conditions and capital inflows into Latin America. In addition, in August 2021 the IMF approved an issue of special drawing rights (SDRs) worth $650 billion, an increase of 224% in the SDR holdings prior to the allocation. The resulting higher international reserves provide a substantial financial buffer for emerging countries, including those of Latin America, as they reduce their risk and strengthen their external position. In this respect, the region received the equivalent of $51.5 billion (7.9% of the total and 18.7% of the funds distributed to developing and emerging economies) (see Chart 13). In addition, this new issue could be supplemented with mechanisms for reallocation of SDRs from developed to emerging and developing countries, through multilateral trusts.[34]

27.10.2021.

34 See Garrido et al (2021).

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Box 1

ASSUMPTIONS OF THE BASELINE SCENARIO AND DESCRIPTION OF THE MACRO-FINANCIAL RISK SCENARIOS FOR BRAZIL AND MEXICO

The short and medium-term economic outlook for Latin America has improved, as it has for most countries and regions, owing to the global remission of the pandemic. But it continues to depend on future epidemiological developments, as discussed in the main text of this Report. Even under a scenario in which the pandemic gradually subsides, however, other macro-financial risks could affect Latin America's economic recovery profile. This box attempts to reflect in broad terms the possible impact of some of these risks on the region's main economies (Brazil and Mexico). To this end it describes, first, a baseline scenario for the performance of these two economies in the period 2021-2023, under the assumption that the virus is gradually brought under control. Second, based on this scenario, three alternative scenarios are constructed, focusing on: (i) the materialisation of a sharper escalation in commodity prices than indicated by futures price paths (the baseline scenario assumes the latter); (ii) the impact of a more restrictive monetary policy stance linked to the possibility of the current bout of inflation proving more persistent; and (iii) a possible increase in social unrest prompting heightened uncertainty over the future course of economic policy.

The baseline scenario uses the available short-term economic information, referring mainly to the financial and economic activity indicators up to the cut-off date of this Report. In Brazil, activity is expected to accelerate slightly in Q3 to grow by 0.3% quarter-on-quarter, following the contraction of 0.1% in the previous quarter. In Mexico, quarter-on-quarter growth of 0.7% is expected (1.5% in the previous quarter).

Beyond the short term, the baseline scenario assumes a gradual improvement in the epidemiological situation over the medium term. The projection assumes sustained convergence to a normal level of mobility and the complete lifting of constraints on the ordinary pursuit of economic activity. The baseline scenario is constructed on the basis of a series of technical assumptions[1] (shown in Table 1) relating to oil price trajectories, financial market volatility, short-term interest rates, exchange rates, sovereign spreads and economic policy uncertainty indices.[2] The path of oil futures prices has been revised up for both 2021 and 2022. Financial market volatility declined in 2021 and, according to the new assumptions, will persist at this lower level in 2022 and 2023. Among domestic financial variables, a higher-than-expected rise in Brazil's policy interest rate in the last six months also drove up the future path of Brazilian policy interest rates. In Mexico, the outlook for monetary policy likewise turned more restrictive, albeit less so than in Brazil. The current projections envisage a modest appreciation of the currency.

Table 1 also shows the assumptions for foreign demand. Growth in such demand has been lower this year in both Mexico and Brazil than expected in April 2021, while stronger foreign demand growth is assumed for next year.[3] The less buoyant foreign demand in 2021 was largely due to lower-than-expected US demand, particularly in Mexico, on account of persistent production bottlenecks and the failure of the full impact of the US stimulus package approved in March (American Rescue Plan), and factored into the April projection exercise,[4] to materialise.

The baseline scenarios obtained under these assumptions are shown in Chart 1. In Brazil, output is projected to grow by 5.2% in 2021 (in line with the consensus forecasts and after declining by 4.4% in 2020), 2.0% in 2022 and 2.2% in 2023. In the case of Mexico, following the contraction of 8.5% in 2020, the economy is expected to grow by 6.4% in 2021 (in the upper range of analysts' forecasts), 3.2% in 2022 and 2.2% in 2023. On these forecasts, Brazil would recover its pre-pandemic output level this year, while Mexico would do so over the course of 2022. As compared with the previous Half-Yearly Report,[5] the annual growth forecast for 2021 has been revised significantly upwards

1 The baseline scenario is founded on econometric models (Bayesian Vector Autoregressions, BVARs). The basic econometric model comprises ten macro-financial variables. A distinction is drawn between global variables (e.g. foreign demand, oil prices, financial market uncertainty and US short-term interest rates) and Brazilian and Mexican domestic variables. The latter are real GDP growth, core inflation, the exchange rate of the Brazilian real and the Mexican peso against the US dollar, each country's dollar-denominated sovereign spreads vis-à-vis US government debt, the economic policy uncertainty index and policy interest rates.

2 The technical assumptions are calculated following the methodology of the Eurosystem staff macroeconomic projections exercises. The cut-off date used for calculating the paths of these variables is 16 August 2021.

3 Each country's foreign demand is constructed on the basis of the ECB's September 2021 projection exercise.

4 In the previous forecasts, foreign demand was taken from the ECB's March projection exercise. The impact of higher foreign demand stemming from the US fiscal stimulus was then added using a general equilibrium model (NiGEM). See Box 3 of the Quarterly Report on the Spanish Economy, *Economic Bulletin* 1/2021 for further details on the simulation of the US fiscal stimulus package.

5 See Report on the Latin American economy. First half of 2021.

for both countries. Meanwhile, the 2022 forecast for Mexico has likewise been revised upwards and that for Brazil slightly downwards (see Chart 2 for a breakdown of the determinants of these revisions).

Developing a baseline scenario is essential for the construction of risk scenarios, since the latter are based on changes to one or more of the assumptions underlying the former. As an upside risk, the first alternative scenario assumes that the worldwide remission of the COVID-19 pandemic could lead to a more buoyant recovery in global activity than envisaged under the baseline scenario, prompting a sharper escalation in commodity prices than implied by futures price paths.[6] Specifically, oil prices are taken as a representative commodity[7] and are assumed to rise to $100 per barrel from early 2022, implying a similar increase (in constant prices) to that observed in 2008 Q2, at the peak of the previous commodities boom. From that level, it is assumed that oil prices gradually return to the baseline scenario path from 2023 Q1. Under this scenario, at end-2023 there would be a cumulative GDP increase vis-à-vis the baseline scenario of 4.7 pp and 1.3 pp in Brazil and Mexico,

Table 1
INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)

The baseline scenario rests on a series of assumptions which are detailed in this table and on the available short-term economic information. The alternative scenarios are based on changes to one or several of the assumptions underlying the baseline scenario.

Annual rates of change, unless otherwise indicated

	October 2021 projections (b)			Difference between current assumptions and the April 2021 exercise assumptions (c)	
	2021	2022	2023	2021	2022
International environment					
Foreign demand in Brazil (d)	13.0	6.4	4.3	-0.3	0.4
Foreign demand in Mexico (d)	13.6	6.7	4.4	-3.5	3.4
Oil price in dollars/barrel (level)	67.8	67.3	64.1	2.6	5.8
Monetary and financial conditions					
Volatility of global financial markets (VIX) (level)	19.1	16.6	16.6	-2.9	-5.4
US policy interest rate (level) (e)	0.1	0.3	0.7	0.0	0.2
Brazil's policy interest rate (level) (e)	4.1	7.6	8.8	0.9	2.3
Mexico's policy interest rate (level) (e)	4.5	5.8	6.4	0.4	1.0
Brazilian real/dollar exchange rate (level)	5.3	5.2	5.2	-0.3	-0.4
Mexican peso/dollar exchange rate (level)	20.1	19.9	19.9	-0.6	-0.8

SOURCES: ECB, Thomson Reuters, JP Morgan, Chicago Board Options Exchange and Banco de España.

a Cut-off date for assumptions: 16 August 2021. Figures expressed as levels are annual averages. Figures expressed as rates are calculated based on the relevant annual averages.
b For the projection period, the figures in the table are technical assumptions based on the ECB's September projections or, in their absence, the Eurosystem's methodology for joint projection exercises. The assumptions regarding commodity or financial variables are based on futures markets prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.
c Differences are expressed as percentage points for foreign demand and interest rates and as levels for the remaining variables.
d Foreign demand is approximated using a synthetic measure which includes the main trading partners of each country. This approximation is based on data from the ECB's September projections exercise.
e These variables are expressed in terms of percentages.

6 The energy transition to a more sustainable model could also be behind the simultaneous increase in the prices of industrial commodities and oil. Although oil prices should decline in the long term, a sharper slowdown in investment in oil exploration could drive up prices in the near term.

7 Oil is the only commodity included in the baseline assumptions. However, oil prices are historically correlated with those of other commodities, meaning a commodity demand shock can be identified in our model and calibrated taking a conditioned oil price path.

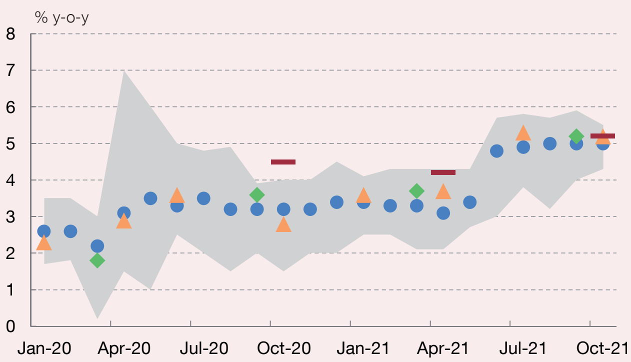
respectively; the larger impact in Brazil owes to commodities accounting for a greater share of its exports basket.

The second alternative scenario simulates the effect of more stringent monetary tightening than envisaged in the technical assumptions. The aim is to reflect the contingency of the recent inflation upturn proving more permanent than expected and ultimately feeding through to inflation expectations, leading to sharper rate increases than currently discounted. To do this, the path of interest rates is raised in keeping with each country's past experience in such episodes.[8] Under this scenario, more

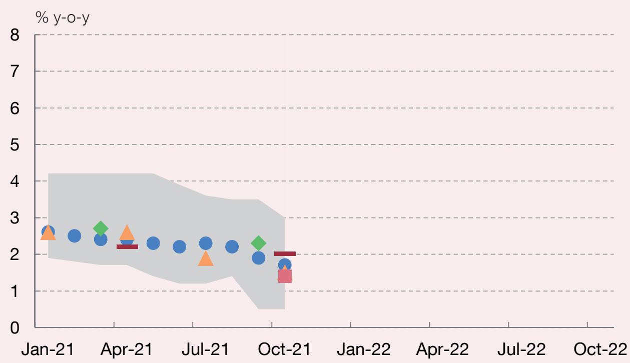
Chart 1
GROWTH FORECASTS

Our baseline scenario projects a 5.2% rise in Brazil's GDP in 2021, which would then stabilise at 2.0% in 2022. GDP growth in Mexico in the same years would be 6.4% and 3.2%. These projections are close to the latest forecasts of international organisations and private analysts, with the exception of Mexico's projection for 2021, which is somewhat higher although still within the consensus range. Were all the scenarios considered in this box to materialise, growth rates in 2022 would stand at around 1.4% and 1.0% in Brazil and Mexico, respectively.

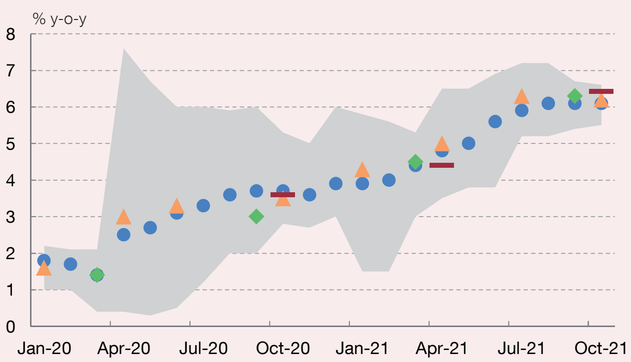
1 BRAZIL. GROWTH FORECASTS FOR 2021 (a)



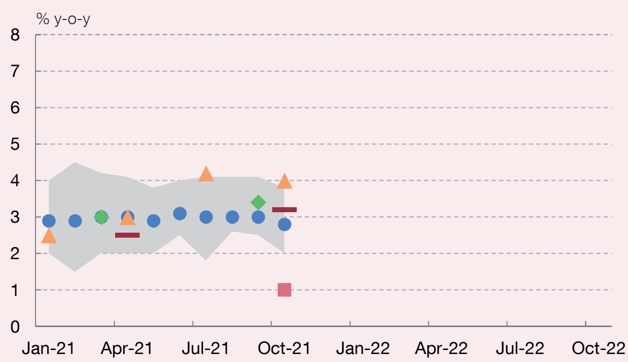
2 BRAZIL. GROWTH FORECASTS FOR 2022 (a)



3 MEXICO. GROWTH FORECASTS FOR 2021 (a)



4 MEXICO. GROWTH FORECASTS FOR 2022 (a)



CONSENSUS FORECAST · IMF · OECD · BANCO DE ESPAÑA (BASELINE SCENARIO) · BANCO DE ESPAÑA (ALL SCENARIOS COMBINED)

SOURCES: Consensus Forecasts, IMF, OECD and Banco de España.

a The shaded areas correspond to the range between the highest and lowest forecasts by private sector analysts in each month.

8 The scenario is constructed using policy interest rates in 2022 H2 of 10.50% in Brazil (+297 bp on the assumptions based on futures) and 8.00% in Mexico (+223 bp on the assumptions based on futures) and assuming that these rate increases are due to supply and demand shocks in similar proportions to past episodes of tightening in each country. As can be seen in Charts 11.3 and 11.4 of the main text, the monetary policy response tends to be stronger in Brazil than in Mexico.

restrictive monetary policy adversely affects GDP growth in Brazil and Mexico, with a cumulative end-2023 effect of -1.2 pp and -2.1 pp, respectively. The larger impact simulated for Mexico is consistent with the empirical evidence available[9] that monetary policy shocks tend to have a greater impact on GDP in Mexico than in Brazil.

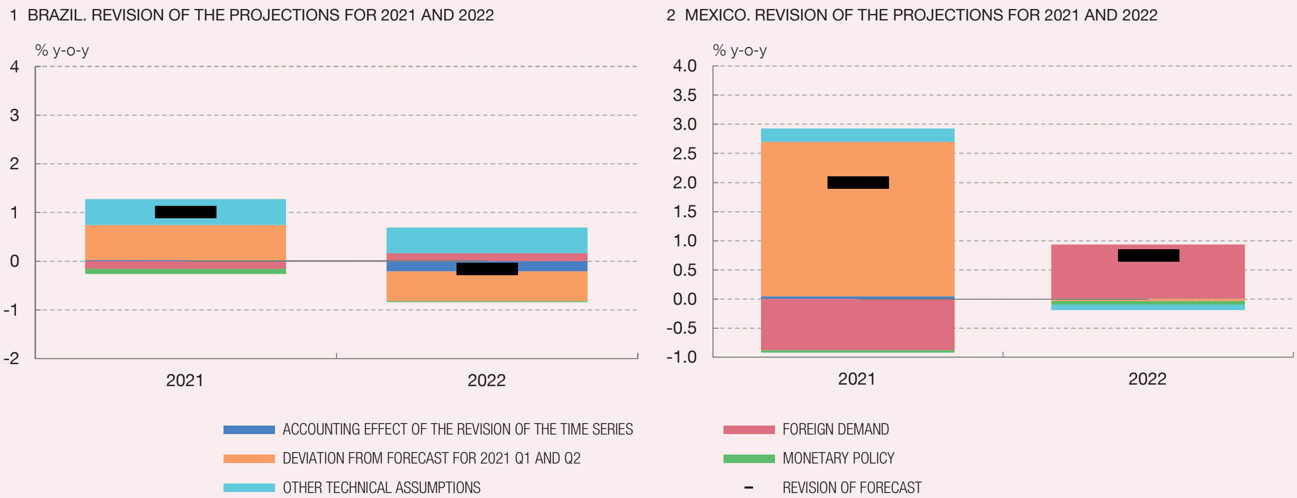
Lastly, the third alternative scenario assumes an escalation in social unrest, leading to increased uncertainty over the future course of economic policy. This takes as a benchmark the episode observed in Chile in 2019 and 2020, when economic uncertainty reached record highs.[10] Under this scenario, cumulative growth in 2021-2023 would be 5.8 pp and 4.3 pp lower than under the baseline scenario in Brazil and Mexico, respectively.

Were the risk scenarios to materialise, the simulations presented show that they would significantly impact both of the economies analysed. However, scenarios in which several of the shocks described occur at once cannot be ruled out. Specifically, should all three (two downward and one upward) alternative scenarios materialise simultaneously, GDP in Brazil and Mexico would grow 1.4% and 1.0% in 2022, respectively, compared with growth of 2.0% and 3.2% under the baseline scenario (see Chart 1). In cumulative terms, this circumstance would lead to additional GDP losses in 2022-2023 of 2.3 pp and 5.0 pp for Brazil and Mexico, respectively, relative to the baseline scenario.

In any event, it is important to bear in mind that the macro-financial scenarios presented in this box are based on the assumption that the pandemic will be overcome. However, much uncertainty persists in this respect despite the reduction in pandemic-related risks, as discussed in the main text of this Report and illustrated by a specific simulation exercise. In addition, the scenarios envisaged in this box do not factor in any possible economic policy response that might mitigate the impact of the shocks considered in this analysis.

Chart 2
REVISIONS OF GROWTH FORECASTS

Forecast revisions are mainly due to higher growth than that suggested by the short-term indicators in 2021 Q1 and Q2 and to less buoyant foreign demand in 2021, especially in Mexico, as the expected effect of the American Rescue Plan in the United States did not materialise. The expected changes in monetary policy revise the forecast downward in the two countries, albeit more in Brazil. The other technical assumptions have a positive net effect on the projections for 2021 and, in the case of Brazil, also for 2022.



SOURCES: ECB, Refinitiv and Banco de España.

9 See, for example, J.D. Quintero Otero (2015). "Impacts of monetary policy and transmission channel in Latin-American countries with an inflation targeting scheme", *Ensayos sobre Política Económica,* Vol. 33, No 76, pp. 61-75.

10 Therefore, a similar extreme event is simulated assuming an increase in the Economic Policy Uncertainty index (EPU, constructed based on local media articles containing terms related with economic policy uncertainty) equivalent to the 90th percentile of its historical distribution for Brazil and Mexico, and that this indicator holds at the new heightened level throughout 2022.

Box 2

MAIN MACRO-FINANCIAL INDICATORS FOR BRAZIL

Brazil, Latin America's largest economy, generates 2.2% of global GDP (see Chart 1). Services represent the bulk of the country's activity, with the primary sector and government services playing a greater role than elsewhere in the region. Brazil is a relatively closed economy in relative terms, with a degree of openness[1] of around 30%, the lowest (alongside Argentina) among the region's major economies, and with highly diversified exports and imports in terms of destination and origin. China accounts for roughly one-third of exports and one-fifth of imports, with the euro area accounting for around 13%, the United States for between 10% (exports) and 15% (imports) and Latin America, to which Brazil is linked via Mercosur, for between 13% (exports) and 17% (imports). As far as products are concerned, the primary sector and mining are prominent in exports (see Chart 1).

Brazil is a key economy for Spain, particularly as regards foreign direct investment and the exposure of Spanish banks. It is the fourth-ranked non-EU country in terms of the exposure of Spain's banking sector, and the first in terms of defaulted exposures (see Chart 2). The country has a highly concentrated banking sector (the six largest banks account between them for 74% of the system's deposits and 85% of loans). Public banks have a notable presence (34% of deposits and 49% of loans), while private domestic banks represent 50% of deposits and 35% of loans, and foreign-owned institutions 16% and 14%, respectively. Banco Santander is the country's largest foreign-owned bank (fifth in deposits and sixth in loans) (see Chart 2). Spanish banks are the main lenders to Brazilian residents, making up around 45% of all debts with foreign banks (see Table 1).

Brazil has a relatively robust macroeconomic policy framework, including inflation targets and fiscal rules. Nonetheless, on the institutional front, it continues to lag behind in terms of governance indicators, which can be attributed to high business start-up costs and red tape (see Chart 3). The country lost its investment-grade rating in 2015 Q4, and is currently rated between two and three notches below it.

Based on the available indicators, the main macroeconomic vulnerabilities are focused in public finances. Thus, budget deficit and public debt levels are at a record high, surpassing those of other emerging economies. Vulnerabilities can also be seen in certain aspects of the country's external position, such as its short-term external debt and many of its political risk indicators. Conversely, external imbalances have diminished and the banking sector does not currently evidence significant vulnerabilities (see Table 2). The 2020 health crisis has left various macro-financial indicators impaired with respect to their historical average (see Table 3).

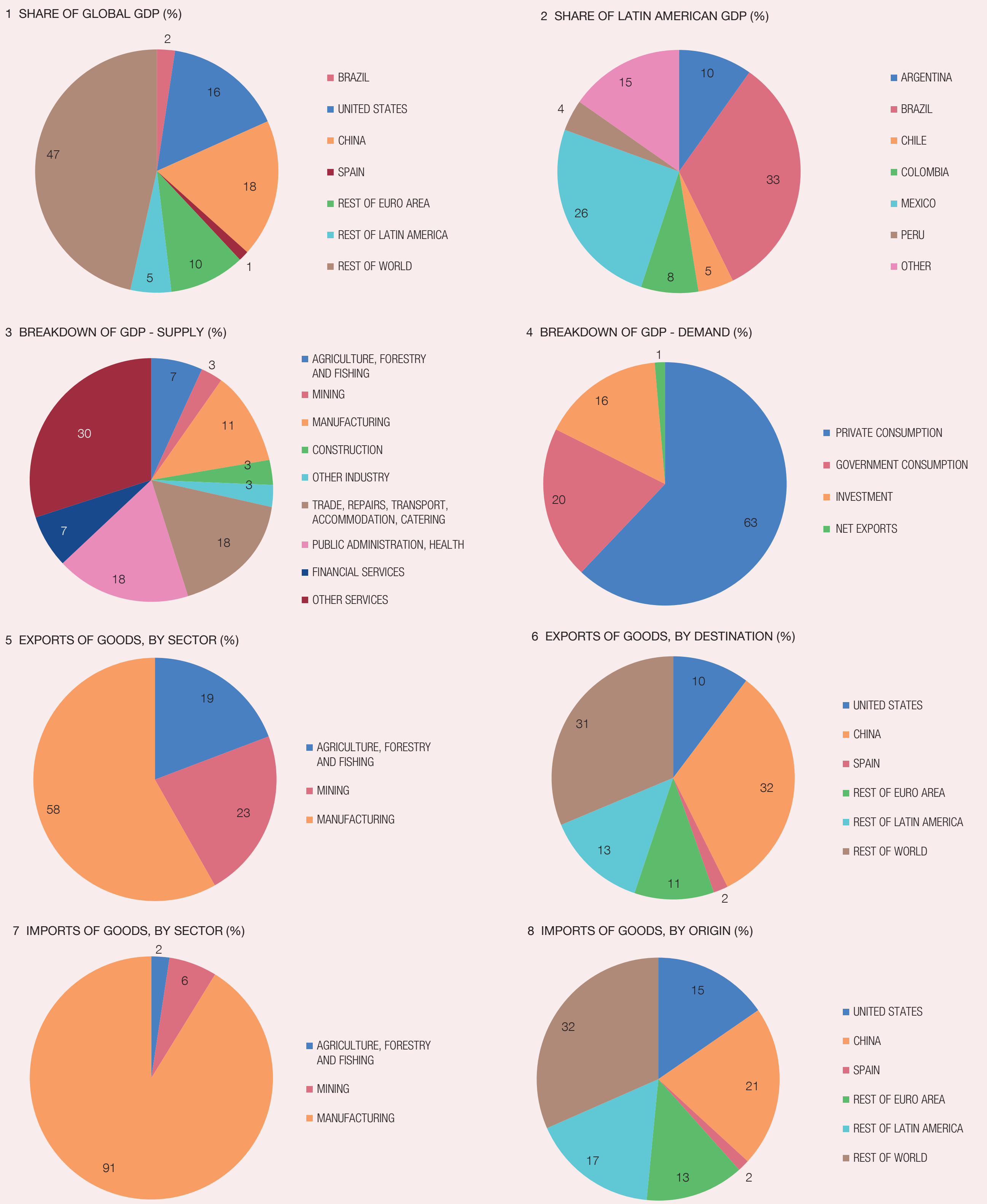
The banking sector maintains a historically low NPL ratio (thanks largely to the support policies set in place for the sector during the pandemic), high capital and liquidity ratios, and profits still above the lows seen in 2015. Financial conditions remain loose when set against their historical average, while tension on the financial markets eased after peaking during the pandemic.

1 Measured as the percentage of the sum of exports and imports over GDP.

Box 2

MAIN MACRO-FINANCIAL INDICATORS FOR BRAZIL (cont'd)

Chart 1
STRUCTURAL ECONOMIC DATA



SOURCES: OECD and IMF.

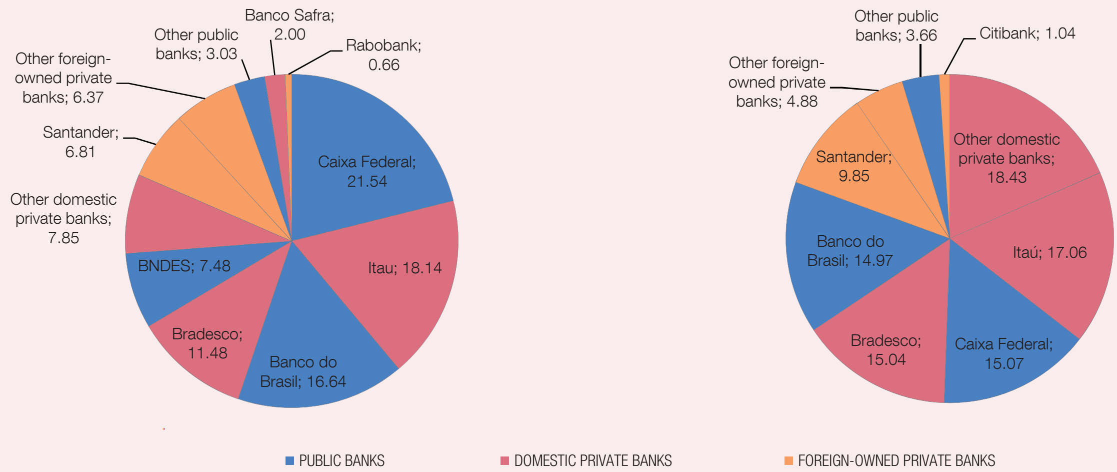
Box 2

MAIN MACRO-FINANCIAL INDICATORS FOR BRAZIL (cont'd)

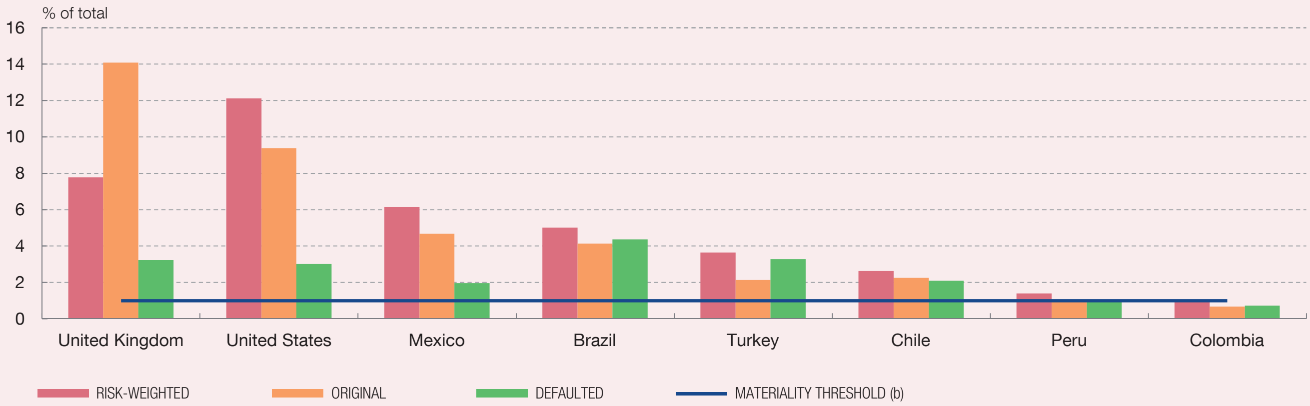
Chart 2
STRUCTURE OF THE BANKING SECTOR AND RELEVANCE FOR SPAIN

1 BREAKDOWN OF THE BANKING SECTOR: LOANS

2 BREAKDOWN OF THE BANKING SECTOR: DEPOSITS



3 EXPOSURES TO MATERIAL THIRD COUNTRIES BY TYPE OF EXPOSURE (2020) (a)



SOURCES: Banco Central do Brasil and Banco de España.

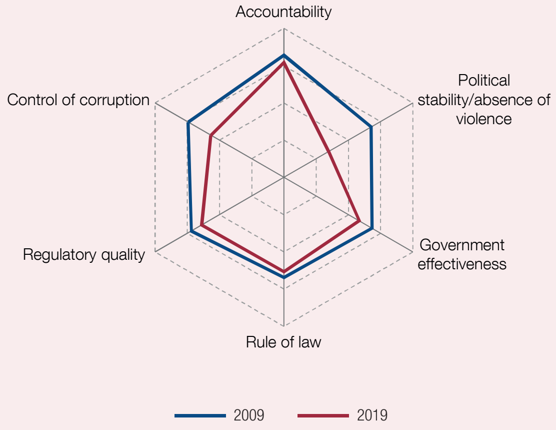
a Credit and other claims on households and non-financial corporations, excluding public entities and financial institutions.
b 1% of any of the types of exposure.

Box 2

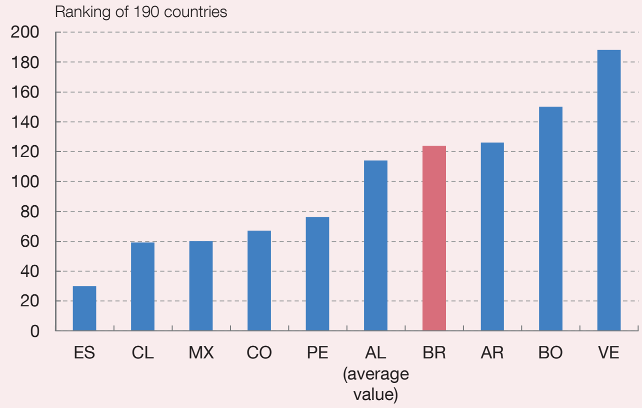
MAIN MACRO-FINANCIAL INDICATORS FOR BRAZIL (cont'd)

Chart 3
NEWS-BASED INDICATORS

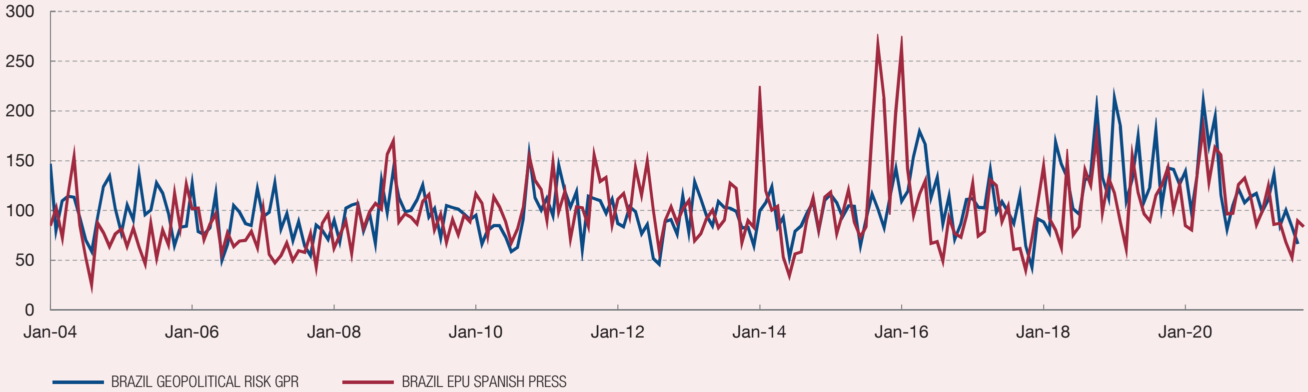
1 WORLD BANK GOVERNANCE INDICATORS (a)



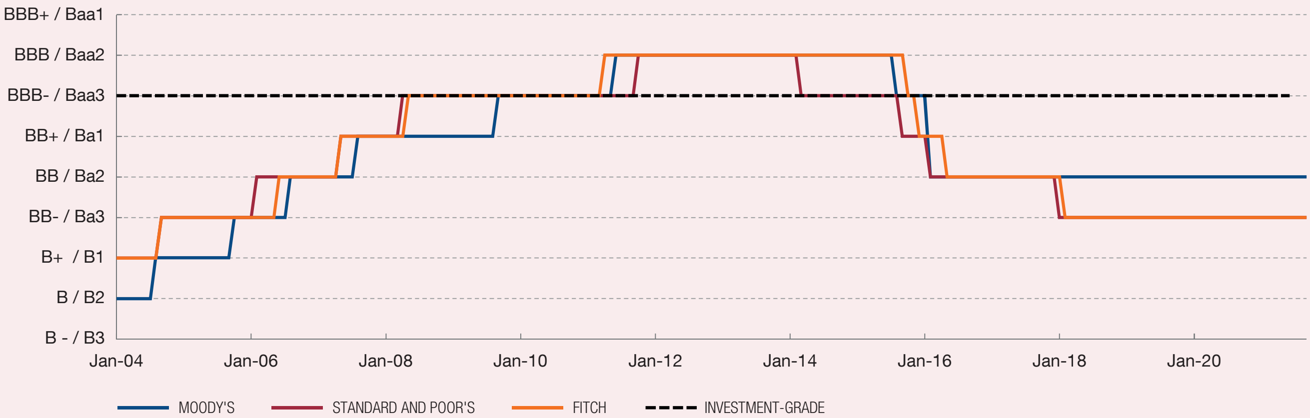
2 WORLD BANK DOING BUSINESS INDEX RANKING (b)



3 NEWS-BASED INDICATORS



4 SOVEREIGN RATINGS



SOURCES: Banco de España; D. Caldara and M. Iacoviello (2019), "Measuring Geopolitical Risk", Working Papers, Board of Governors of the Federal Reserve Board; C. Ghirelli, J. Pérez and A. Urtasun (2021), "The spillover effects of economic policy uncertainty in Latin America on the Spanish economy", *Latin American Journal of Central Banking;* Moody's; Standard and Poor's; and Fitch.

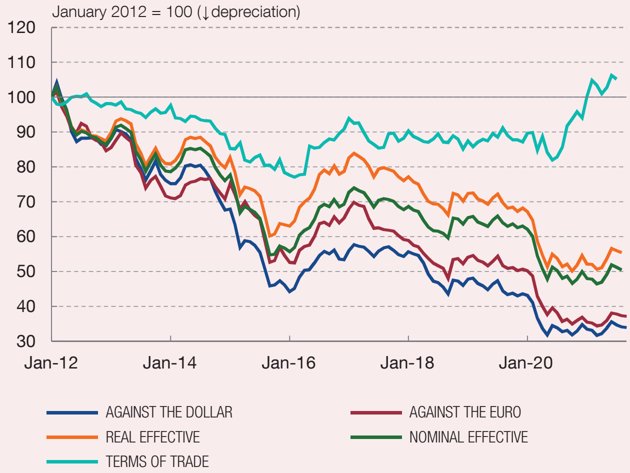
a A line closer to the origin represents a worse situation.
b Doing Business is an index published by the World Bank, ranking countries based on the simplicity of business regulations and the protection of property rights. See https://www.doingbusiness.org/en/doingbusiness for further information.

Box 2

MAIN MACRO-FINANCIAL INDICATORS FOR BRAZIL (cont'd)

Chart 4
EXCHANGE RATES, STOCK EXCHANGE, FINANCIAL CONDITIONS AND STRESS

1 EXCHANGE RATES OF THE BRAZILIAN REAL



2 STOCK EXCHANGE INDEX

3 SOVEREIGN SPREAD (EMBI+)

4 LONG-TERM INTEREST RATE IN REAIS

5 FINANCIAL CONDITIONS INDEX

6 FINANCIAL STRESS INDEX

SOURCE: Banco de España.

a Prepared using a principal component methodology drawing on changes in the stock exchange, short-term and long-term interest rates, the price of commodities and exchange rate variations.
b Prepared on the basis of the volatilities and spreads of six market segments, standardised and grouped discounting any cross-correlations.

Box 2

MAIN MACRO-FINANCIAL INDICATORS FOR BRAZIL (cont'd)

Table 1
SPAIN AND EURO AREA EXPOSURE TO BRAZIL

	$bn		Percentage of GDP		Percentage of total		Ranking	
	Euro area	Spain	Euro area	Spain	Euro area	Spain	Euro area	Spain
Exports of goods	33.0	2.9	0.25	0.21	0.68	0.87	27	20
Imports of goods	27.4	4.2	0.21	0.30	0.60	1.13	29	21
Exports of services	16.0	1.6	0.12	0.12	0.88	1.06	23	18
Imports of services	7.8	0.5	0.06	0.03	0.46	0.58	34	24
International Investment Position: foreign direct investment: assets	361.5	66.1	2.64	4.74	2.06	10.62	12	3
International Investment Position: foreign direct investment: liabilities	19.7	5.3	0.14	0.38	0.14	0.70	46	18
International Investment Position: portfolio investment: assets	101.5	3.3	0.76	0.24	0.70	0.44	22	18
International Investment Position: portfolio investment: liabilities	6.8	1.3	0.05	0.09	0.04	0.11	55	32
Credit exposure to Brazil of BIS reporting banks (a)	184.0	134.3	1.45	10.77	1.66	7.04	15	4
Claims of Brazilian banks vis-à-vis residents of the euro area or Spain	7.7	0.9	0.06	0.08	0.10	0.18	21	16
Debt of Brazilian residents to banks from the euro area or Spain (b)	184.0	134.3	12.83	9.37	61.34	44.79	—	1

SOURCES: IMF, OECD, Eurostat, BIS and national statistics.

a With respect to euro area and Spanish figures.
b With respect to Brazilian figures.

Box 2

MAIN MACRO-FINANCIAL INDICATORS FOR BRAZIL (cont'd)

Table 2
BRAZIL: SITUATION OF VULNERABILITY (a)

	Time series									With respect to other emerging economies
	2017		2018		2019		2020		2021	Latest figure
	H1	H2	H2	H2	H1	H2	H1	H2	H1	
Sovereign spread (bp)										
Stock market (quarterly change)										
Exchange rate (quarterly change)										
Sovereign spread (quarterly change)							0.731			
GDP (year-on-year)	0.732									
Inflation										
Industrial output						0.723				
Currency overvaluation										
Public sector balance sheet (% of GDP)					0.721					
Gross public sector debt (% of GDP)										
Credit (real, year-on-year)				0.749						
Deposits (real, year-on-year)							0.744			
Net foreign assets of banks (% of GDP)										
Non-performing loans (% of portfolio)										
Loan-to-deposit ratio										
Banks' equity index (quarterly change)										
Banks' external debt spread										
Interbank interest rate										
Net interest income										
Banking risk (BICRA)		0.72								
Banking risk (IHS)										
Current account balance (% of GDP)										0.731
Foreign direct investment (% of GDP)										
External debt (% of GDP)	0.71		0.738							
Short-term external debt (% of reserves)										
Reserves (% of GDP)										
External debt service (% of exports)										
Portfolio investment (% of GDP)			0.707							
GDP per capita (change)	0.7	0.7							—	
Political risk (IHS)										
Geopolitical risk (GPR)										
Sovereign rating										0.72
Doing business (percentile)									—	
Stability/Absence of violence (percentile)							—	—	—	

SOURCE: I. Alonso and L. Molina (2021), "A GPS navigator to monitor risks in emerging economies: the vulnerability dashboard", Occasional Paper No 2111, Banco de España.

a The risk level is indicated with shades of green (associated with lower levels of vulnerability), yellow (medium vulnerability) and red (variables in the riskier percentiles).

Box 2

MAIN MACRO-FINANCIAL INDICATORS FOR BRAZIL (cont'd)

Table 3
BRAZIL: MAIN ECONOMIC AND SOCIAL INDICATORS

	2020		2019
GDP per capita (constant $)	8,179	Life expectancy (years)	75.9
GDP per capita (PPP)	13,698	Poverty rate (% of population on less than $1.9 a day)	4.6
GDP ($bn)	1,453	Inequality (Gini)	53.4
Population (million)	211.4	Inflation target (2021)	3.75 +- 1.5

Monetary and real sectors, and prices	2000-2004 average	2005-2009 average	2010-2014 average	2015-2019 average	2020
GDP (year-on-year rate)	3.1	3.7	3.4	-0.5	-4.4
CPI (year-on-year rate)	8.7	5.1	5.9	5.7	3.2
Core inflation (year-on-year)	8.2	5.1	5.9	5.5	2.2
Official interest rate (%)	18.8	13.0	10.2	9.2	2.0
Unemployment rate (%)	11.6	8.6	7.1	11.3	13.2
Budget balance (% of GDP)	-5.3	-3.0	-3.2	-7.9	-13.6
Primary balance (% of GDP)	2.5	3.1	1.8	-1.7	-9.4
Public debt (% of GDP)	60.9	57.1	52.9	71.7	88.8
External sector					
Trade openness (% of GDP)	27.4	25.4	24.6	26.7	32.4
Current account balance (% of GDP)	-1.4	-0.1	-3.5	-2.3	-1.7
FDI received (% of GDP)	3.4	2.3	3.6	3.8	3.1
Portfolio capital inflows (% of GDP)	0.2	1.6	1.7	-0.3	-0.2
Reserves (months of imports)	9.1	13.3	18.1	25.6	23.2
Reserves (% of GDP)	7.0	10.3	14.1	19.1	24.2
ARA metrics (IMF) (a)	0.7	1.1	1.5	1.7	1.6
External debt (% of GDP)	39.1	16.2	18.1	29.4	37.4
Domestic debt held by non-residents (% of total)	—	7.7	14.5	12.9	9.2
Financial markets					
Exchange rate against the euro	2.74	2.88	2.63	3.98	5.89
Exchange rate against the dollar	2.62	2.41	1.98	3.52	5.16
10-year government debt yield (%)	12.57	12.26	11.64	11.10	7.15
Average government debt maturity (months)	34	34	46	51	44
Sovereign CDS (basis points)	—	168	140	241	209
Petrobras CDS (basis points)	—	170	195	410	300
Banking sector					
Size of the sector (% of GDP)	109.2	139.9	186.7	203.9	234.2
Credit to the private sector (% of GDP)	28.9	40.2	60.7	62.3	70.2
Credit-to-GDP gap (b)	—	3.9	7.3	5.0	9.4
Housing prices (year-on-year)	-1.1	11.5	8.0	-5.4	4.3
Regulatory capital/risk-weighted assets	16.3	17.3	16.6	17.0	16.4
Tier 1	—	14.1	12.9	13.6	14.0
Risk-weighted assets/total assets	—	81.3	85.3	68.1	64.1
Non-performing loans (% of portfolio)	6.6	4.4	3.8	3.2	2.8
ROA	1.3	2.3	1.6	1.5	1.6
ROE	12.9	21.2	14.7	14.2	14.8
Liquidity ratio	—	2.3	1.8	2.4	2.8
Primary expenditure (% of total revenues)	—	56.8	53.1	50.8	52.5
Net interest income (% of gross revenues)	—	78.0	76.3	71.1	58.1

SOURCES: IMF, Thomson Reuters and national statistics.

a Based on the IMF's calculations for assessing reserve adequacy, which takes into account the level of reserves relative to different aggregates and the related opportunity cost.

b Difference between the level observed and the trend in credit to the private sector as a percentage of GDP.

Box 3

MAIN MACRO-FINANCIAL INDICATORS FOR MEXICO

Generating 1.9% of global GDP, Mexico is the world's fifteenth largest economy and the second in Latin America after Brazil (see Chart 1). Its economic activity is underpinned by manufacturing – strongly geared to exports – and by services, where tourism plays a major role. Mexico is a very open economy: the sum of exports and imports accounts for roughly 80% of its GDP, with manufactured goods dominating both imports and exports. In particular, the country has strong trade links with the United States (81% of exports and 44% of imports), thanks to the regional trade deal currently in place (USMCA[1]), and, to a lesser degree, with China (19% of imports). The euro area accounts for 4% of its exports and close to 10% of its imports.

The Mexican and Spanish economies are closely interconnected (see Table 1). 10% of all foreign assets held by Spanish banks are Mexican. Mexico is the destination for 7% of Spain's foreign direct investment, and for 2% of exports of Spanish goods and services.

The banking sector is particularly exposed (see Chart 2). Mexico is the third-ranked non-EU country (after the United States and the United Kingdom) in terms of the exposure of Spain's banking sector. The Mexican banking sector is home to private and public institutions. Foreign-owned private banks comprise more than one-half of the country's banking sector. Domestically owned private institutions account for just over one-quarter. The rest (around one-sixth) is made up of public institutions (development banks). Mexico's seven largest private banks (both local and foreign-owned) represent over two-thirds of the system's deposits and loans. BBVA is the largest foreign-owned bank (ranked first in deposits and loans), earning around 33% of its ordinary profit between 2017 and 2019 in Mexico. Banco Santander is ranked third (12% of the country's deposits and 11% of its loans). Spanish banks are the leading lenders to Mexican residents, accounting for around 44% of all debts with foreign banks.

Compared with other countries in the region, Mexico has a relatively robust institutional and macroeconomic policy framework (see Chart 3 and Table 2). In particular, the country has to date pursued a prudent fiscal and monetary policy stance, while the flexible exchange rate (see Chart 4) acts as a buffer against external shocks. While governance indicators have for the most part remained unchanged over the past decade, its business regulations are among Latin America's most attractive. The country has kept its investment-grade rating since the early 2000s. Against this backdrop, and despite its government backing not being made explicit, PEMEX (the state-owned petroleum company) could represent a source of contingent liabilities risks for the country's sovereign debt in view of its huge debts (9% of GDP) and persistent losses.

Since 2019, Mexico has seen a major slowdown in economic growth, amid perceived growing uncertainty over its economic policies, exacerbated by the spread of the pandemic (see Tables 2 and 3). The Mexican banking sector has low NPL ratios and high capital and liquidity ratios. The size of the sector remains smaller than other similarly developed economies and competition is limited, as borne out by its high net interest income.

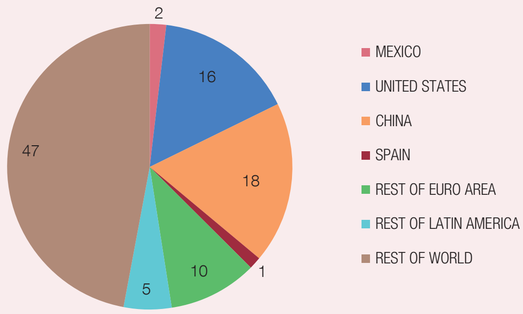
1 USMCA: "United States-Mexico-Canada Agreement", also known as the "Tratado entre México, Estados Unidos, y Canadá" (T-MEC). The USMCA/T-MEC is the trade agreement that entered into force on 1 July 2020, taking the place of the previous arrangement known as the "North American Free Trade Agreement" (NAFTA), in force since 1994.

Box 3

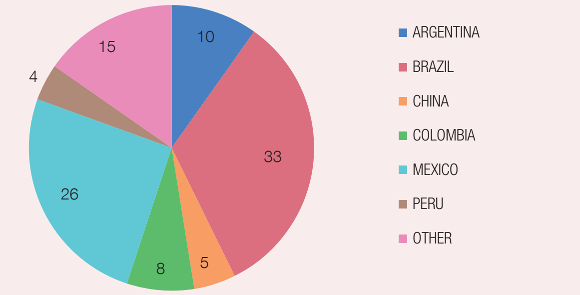
MAIN MACRO-FINANCIAL INDICATORS FOR MEXICO (cont'd)

Chart 1
STRUCTURAL ECONOMIC DATA FOR MEXICO

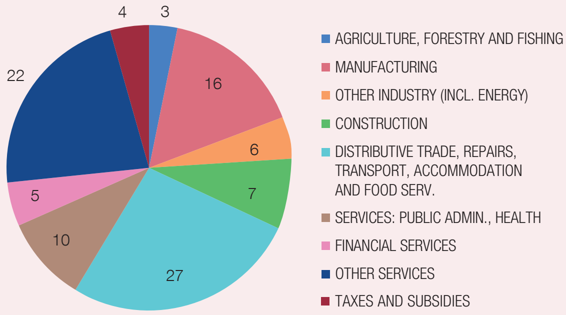
1 SHARE OF GLOBAL GDP (%)



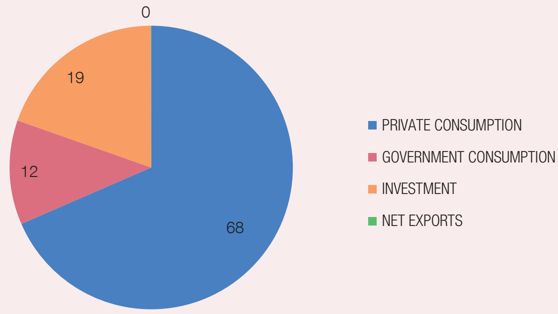
2 SHARE OF LATIN AMERICAN GDP (%)



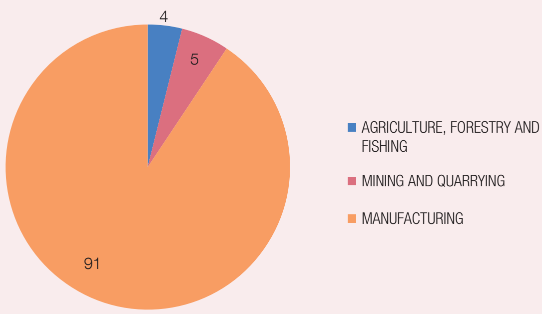
3 BREAKDOWN OF GDP - SUPPLY (%)



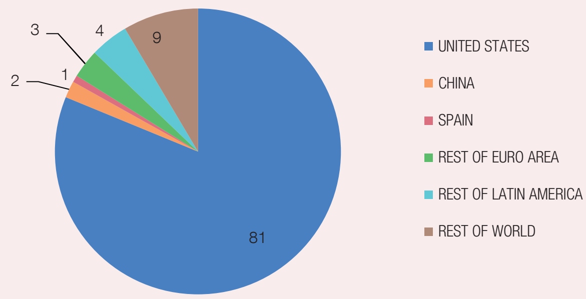
4 BREAKDOWN OF GDP - DEMAND (%)



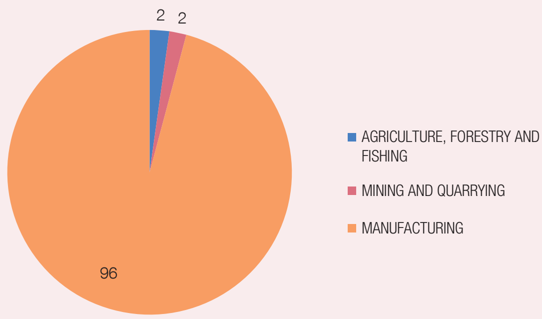
5 EXPORTS OF GOODS, BY SECTOR (%)



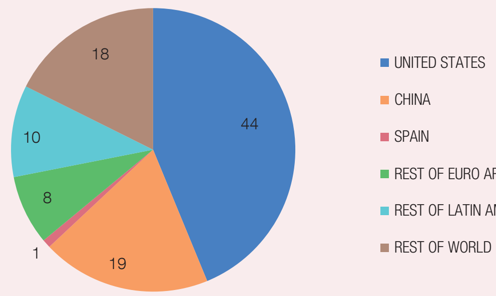
6 EXPORTS OF GOODS, BY DESTINATION (%)



7 IMPORTS OF GOODS, BY SECTOR (%)



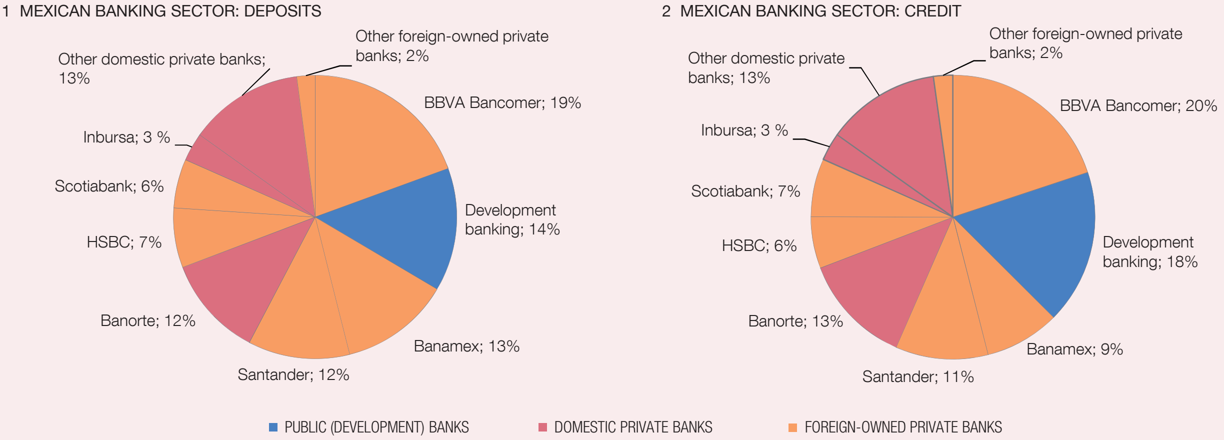
8 IMPORTS OF GOODS, BY ORIGIN (%)

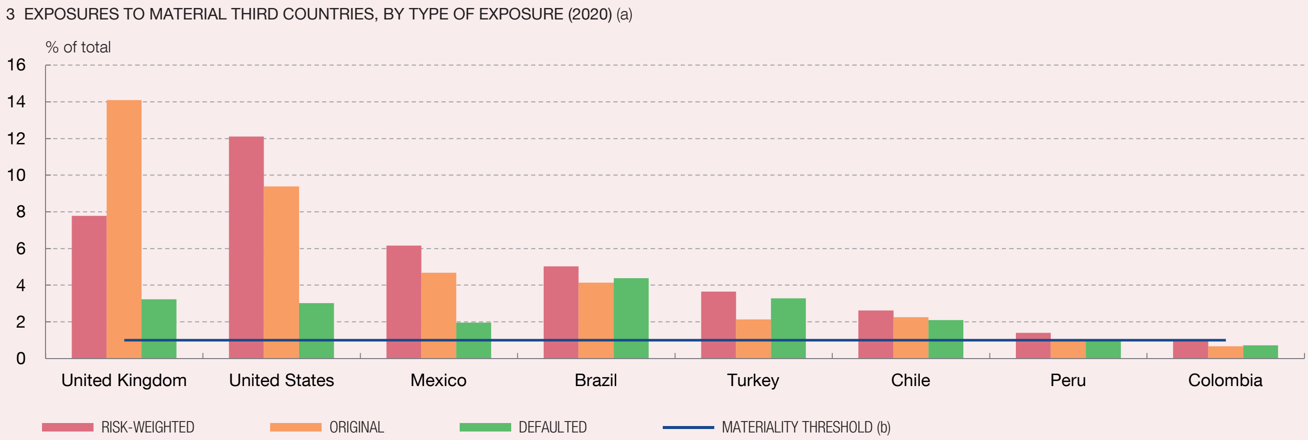


SOURCES: OECD and IMF.

Box 3
MAIN MACRO-FINANCIAL INDICATORS FOR MEXICO (cont'd)

Chart 2
COMPOSITION OF THE BANKING SECTOR





SOURCES: Comisión Nacional Bancaria y de Valores (CNBV) and Banco de España.

a Credit and other claims on households and non-financial corporations, excluding public entities and financial institutions.
b 1% of any of the types of exposure.

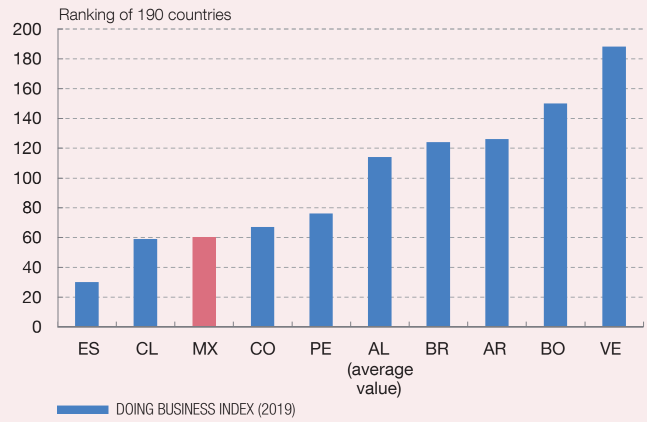
Box 3

MAIN MACRO-FINANCIAL INDICATORS FOR MEXICO (cont'd)

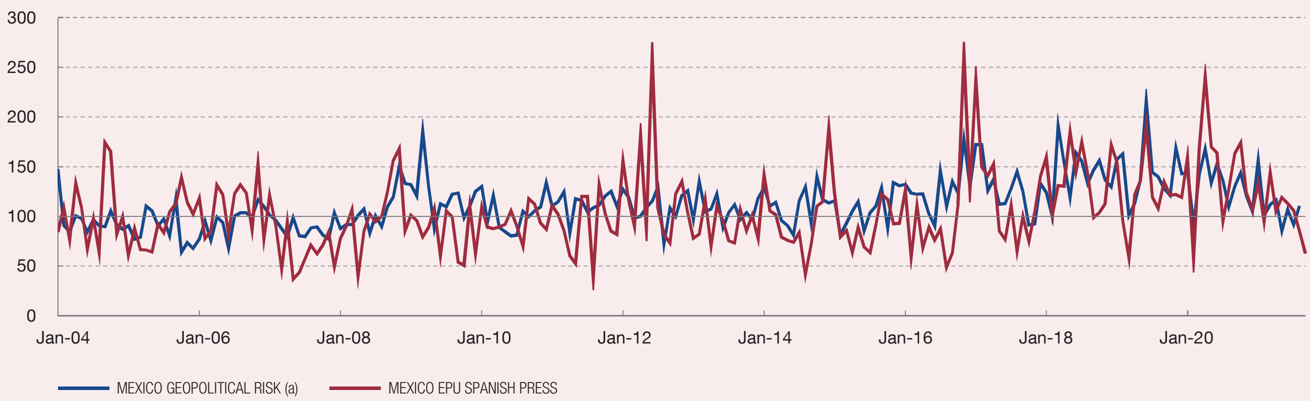
Chart 3
POLITICAL-INSTITUTIONAL INDICATORS

1 WORLD BANK GOVERNANCE INDICATORS (a)

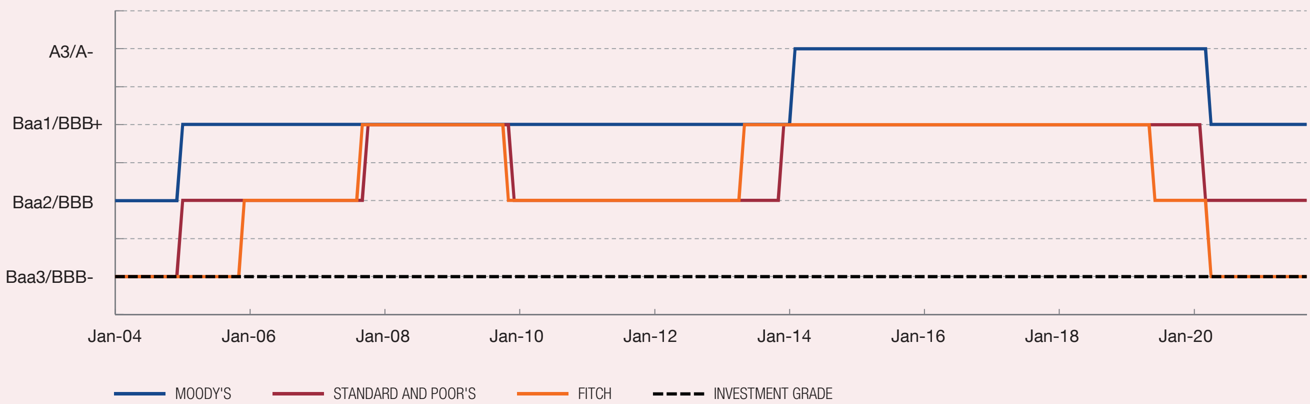
2 WORLD BANK DOING BUSINESS INDEX RANKING (b)



3 NEWS-BASED INDICATORS



4 SOVEREIGN RATING



SOURCES: Banco de España; D. Caldara and M. Iacoviello (2019), "Measuring Geopolitical Risk", *Working Papers,* Board of Governors of the Federal Reserve Board; C. Ghirelli, J. Pérez and A. Urtasun (2021), "The spillover effects of economic policy uncertainty in Latin America on the Spanish economy", *Latin American Journal of Central Banking;* Moody's; Standard and Poor's; and Fitch.

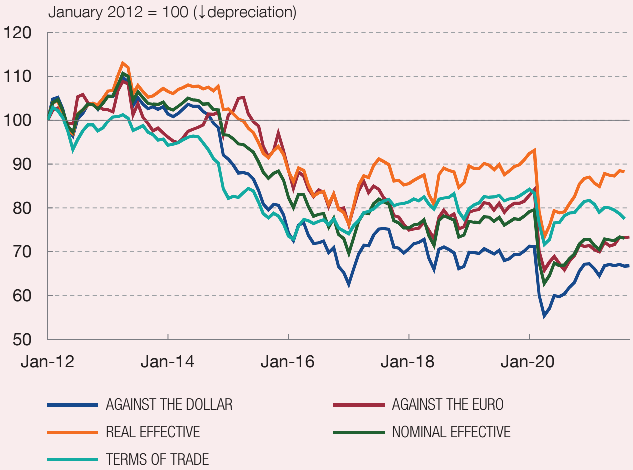
a A line closer to the origin represents a worse situation.
b Doing Business is an index published by the World Bank, ranking countries based on the simplicity of business regulations and the protection of property rights. See https://www.doingbusiness.org/en/doingbusiness for further information.

Box 3

MAIN MACRO-FINANCIAL INDICATORS FOR MEXICO (cont'd)

Chart 4
EXCHANGE RATES, STOCK EXCHANGE, FINANCIAL CONDITIONS AND STRESS

1 EXCHANGE RATES OF THE MEXICAN PESO



2 STOCK EXCHANGE INDEX

3 SOVEREIGN SPREAD

4 LONG-TERM INTEREST RATES

5 FINANCIAL CONDITIONS INDEX

6 FINANCIAL STRESS INDEX

SOURCES: Banco de España and Thomson Reuters.

a Prepared using a principal component methodology drawing on changes in the stock exchange, short-term and long-term interest rates, the price of commodities and exchange rate variations.
b Prepared on the basis of the volatilities and spreads of six market segments, standardised and grouped discounting any cross-correlations.

Box 3

MAIN MACRO-FINANCIAL INDICATORS FOR MEXICO (cont'd)

Table 1
SPAIN AND EURO AREA EXPOSURE TO MEXICO

	$bn		Percentage of GDP		Percentage of total		Ranking	
	Euro area	Spain	Euro area	Spain	Euro area	Spain	Euro area	Spain
Exports of goods	37.9	4.7	0.28	0.34	0.78	1.41	25	15
Imports of goods	25.7	4.9	0.19	0.35	0.56	1.32	32	16
Exports of services	12.8	2.8	0.09	0.19	0.70	1.77	27	12
Imports of services	5.8	1.1	0.04	0.08	0.34	1.39	42	14
International Investment Position: foreign direct investment: assets	184.4	45.5	1.35	3.26	1.05	7.30	19	4
International Investment Position: foreign direct investment: liabilities	46.2	8.4	0.34	0.60	0.32	1.10	33	14
International Investment Position: portfolio investment: assets	64.9	5.4	0.49	0.39	0.45	0.73	25	13
International Investment Position: portfolio investment: liabilities	9.9	0.4	0.07	0.03	0.05	0.03	44	39
Credit exposure to Mexico of BIS reporting banks (a)	183.3	161.4	1.44	12.94	1.65	8.46	16	3
Claims of Mexican banks vis-à-vis residents of the euro area or Spain	1.4	0.3	0.01	0.02	0.02	0.05	23	22
Debt of Mexican residents to banks from the euro area or Spain (b)	183.3	161.4	17.03	15.00	49.75	43.81	—	1

SOURCES: IMF, OECD, Eurostat, BIS and national statistics.

a With respect to euro area and Spanish figures.
b With respect to Mexican figures.

Box 3

MAIN MACRO-FINANCIAL INDICATORS FOR MEXICO (cont'd)

Table 2
MEXICO: SITUATION OF VULNERABILITY (a)

	Time series									With respect to other emerging economies
	2017		2018		2019		2020		2021	Latest figure
	H1	H2	H1	H2	H1	H2	H1	H2	H1	
Sovereign spread (bp)										
Stock market (quarterly change)										
Exchange rate (quarterly change)										
Sovereign spread (quarterly change)										
GDP (year-on-year)										
Inflation										
Industrial output										
Currency overvaluation										
Public sector balance sheet (% of GDP)										
Gross public sector debt (% of GDP)										
Credit (real, year-on-year)										
Deposits (real, year-on-year)										
Net foreign assets of banks (% of GDP)										
Non-performing loans (% of portfolio)										
Loan-to-deposit ratio										
Banks' equity index (quarterly change)										
Banks' external debt spread										
Interbank interest rate										
Net interest income										
Banking risk (BICRA)										
Banking risk (IHS)										
Current account balance (% of GDP)										
Foreign direct investment (% of GDP)										
External debt (% of GDP)									—	
Short-term external debt (% of reserves)										
Reserves (% of GDP)										
External debt service (% of exports)										
Portfolio investment (% of GDP)										
GDP per capita (change)									—	
Political risk (IHS)										
Geopolitical risk (GPR)										
Sovereign rating										
Doing business (percentile)									—	
Stability/Absence of violence (percentile)							—	—	—	

SOURCE: I. Alonso and L. Molina (2021), "A GPS navigator to monitor risks in emerging economies: the vulnerability dashboard", *Occasional Paper* No 2111, Banco de España.

a The risk level is indicated with shades of green (associated with lower levels of vulnerability), yellow (medium vulnerability) and red (variables in the riskier percentiles).

Box 3

MAIN MACRO-FINANCIAL INDICATORS FOR MEXICO (cont'd)

Table 3
MEXICO: MAIN ECONOMIC AND SOCIAL INDICATORS

	2019
GDP per cápita (thousands of dollars)	9,946
GDP per cápita (PPP)	20,448
GDP (thousands of dollars)	1,268,871
Population (million)	127.6

	2019
Life expectancy (years)	75.1
Poverty rate (% of population on less than $1.9 a day)	41.9
Inequality (Gini)	45.4
Inflation target	3.0% (± 1.0%)

Monetary and real sectors, and prices	2000-2004 average	2005-2009 average	2010-2014 average	2015-2019 average	2020
GDP (year-on-year rate)	2.0	1.0	3.3	2.0	-8.3
CPI (year-on-year rate)	6.0	4.4	3.9	4.0	3.4
Core inflation (year-on-year)	5.7	4.1	3.3	3.5	3.8
Official interest rate (%)	7.7	7.1	4.0	6.4	4.3
Unemployment rate (%)	3.1	4.0	5.0	3.7	4.7
Budget balance (% of GDP)	-0.7	-0.5	-2.6	-2.1	-2.9
Primary balance (% of GDP)	1.9	1.7	-0.7	0.4	0.1
Public debt (% of GDP)	—	26.2	36.4	47.0	53.9
External sector					
Trade openness (% of GDP)	46.5	52.7	60.5	72.0	75.4
Current account balance (% of GDP)	-1.8	-0.9	-1.5	-1.8	2.5
FDI received (% of GDP)	3.1	2.6	2.5	3.0	
Portfolio capital inflows (% of GDP)	0.5	-0.3	2.8	0.7	-0.4
Reserves (months of imports)	2.9	3.4	4.5	4.3	5.2
Reserves (% of GDP)	6.6	7.7	10.4	8.3	8.6
ARA metrics (IMF) (a)	0.9	0.9	1.3	1.2	1.3
External debt (% of GDP)	21.3	16.6	22.1	20.5	
Domestic debt held by non-residents (% of total)	7.3	20.0	44.6	60.5	51.5
Financial markets					
Exchange rate against the euro	10.5	15.4	17.0	20.9	25.5
Exchange rate against the dollar	10.2	11.3	12.9	18.3	21.6
10-year government debt yield (%)	10.1	8.3	5.9	6.7	5.8
Average government debt maturity (months)	26.0	59.2	89.6	95.3	92.3
Sovereign CDS (basis points)			116.5	120.1	115.9
CDS Pemex (basis points)			142.5	225.4	489.7
Banking sector					
Size of the sector (% of GDP)	34.5	32.5	34.4	39.2	44.1
Credit to the private sector (% of GDP)	—	—	16.0	19.3	21.0
Credit-to-GDP gap (b)	-7.8	1.6	5.0	5.6	3.2
Housing prices (year-on-year)	—	1.7	-0.5	4.0	2.2
Regulatory capital/risk-weighted assets for non-residents	—	15.6	16.0	15.5	17.7
Tier 1	—	14.2	13.9	13.9	16.1
Risk-weighted assets/total assets	—	0.0	65.6	65.2	60.9
Non-performing loans (% of portfolio)	—	2.3	2.6	2.2	2.4
ROA	—	—	1.4	1.5	1.3
ROE	—	—	13.6	14.1	12.4
Liquidity ratio	—	—	36.2	24.8	24.0
Primary expenditure (% of total revenues)	—	—	68.5	66.2	68.9
Net interest income (% of gross revenues)	—	—	7.0	5.5	7.1

SOURCES: IMF, Thomson Reuters and national statistics.

a Based on the IMF's calculations for assessing reserve adequacy, which takes into account the level of reserves relative to different aggregates and the related opportunity cost.
b Difference between the level observed and the trend in credit to the private sector as a percentage of GDP.