INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE

Forty-Eighth Meeting
October 13–14, 2023

IMFC Statement by Rosanna Costa
President of the Central Bank
Chile

On behalf of

Argentina, Bolivia, Chile, Paraguay, Peru, and Uruguay

Statement by Governor Rosanna Costa, President of the Central Bank of Chile

On behalf of the Southern Cone Constituency

(Argentina, Bolivia, Chile, Paraguay, Peru, and Uruguay)

Global outlook, economic policies, and multilateral cooperation

The global economic landscape remains complex with a slow and uneven recovery. Advanced and major emerging economies have shown resilience despite significant monetary tightening. However, many developing countries are still struggling with the aftermath of the pandemic, multiple shocks, and debt distress. Medium-term issues such as declining global growth, slow income convergence around the world, and slow progress in achieving Sustainable Development Goals and emissions targets are prominent.

Global risks are more balanced than in April but still skewed towards the downside. Uncertainty surrounds China's economic trajectory, persistent core inflation, additional monetary tightening, financial risk complacency, extreme weather events, and geopolitical tensions, all impacting the outlook. Rising long-term interest rates, coupled with increasing public debt and interest service burdens in advanced economies, are concerning. Sudden changes in interest rates and risk premiums could spill over to the international financial system and emerging and developing economies.

Policymakers must take a multifaceted approach to address current challenges. In the short term, central banks should finish the job on inflation, adjusting monetary policy as inflation recedes to maintain appropriate financing conditions. Governments should continue normalizing fiscal policy to manage debt effectively and rebuild fiscal space, while protecting vulnerable populations. Regulators and supervisors should strengthen financial systems and address regulatory gaps. Policymakers need to tackle the secular decline in economic growth and expedite the green transition. Key actions include bolstering labor market participation, better governance, regulatory improvements, promoting competition and innovation, and enhancing social policies.

Global cooperation is essential for future economic prosperity and stability. Multilateral action is essential to tackle shared challenges, support vulnerable countries, and counter the increasing fragmentation. To provide timely support to vulnerable countries, a strong, well-funded, and readily accessible global financial safety net is necessary. Comprehensive collaboration between official creditors and the private sector is also vital to strengthen the debt resolution framework and extend its reach to vulnerable middle-income countries. Furthermore, addressing medium-term challenges such as climate change, migration, and digitalization, and reviving trade as a key engine of development will require strong cooperation.

IMF priorities

The IMF must continue its role as a trusted advisor and supporter of its members, while also promoting a resilient and prosperous future. Against the backdrop of a more shock-prone environment, the global economy needs a nimble and well-resourced Fund capable of providing real-time support to its members through tailored policy advice, catalytic financial assistance, and integrated capacity building. Additionally, in today's fragmented global economy with various shared challenges, the IMF's role in convening and fostering consensus is crucial.

Surveillance

We appreciate the focus on critical issues such as achieving a well-balanced macro policy mix, addressing emerging macro-financial vulnerabilities, rebuilding buffers, and pursuing medium-term growth and resilience-oriented reforms. Regarding the implementation of the Integrated Policy Framework, it is essential to tackle related macrofinancial vulnerabilities while also considering the long-term benefits of financial integration and flexible exchange rates, in line with the Institutional View. Furthermore, we value the ongoing review of the Fund’s AML/CFT strategy and its integration into surveillance activities.

On the integration of new strategies, it remains essential to maintain a disciplined focus on macro-critical aspects that align with the Fund's core mission and expertise. We look forward to the interim surveillance review to assess progress in these new areas of work and adjust priorities as needed.

We also support the emphasis on multilateral surveillance and analytical work covering the interaction and coordination of monetary and fiscal policies in major economies and their global spillovers, and the impact of trade and industrial policies. Similarly, we welcome recent work on the consequences of geopolitical fragmentation, digitalization, and climate change on the global economy. We encourage close collaboration with the World Bank, World Trade Organization, BIS, and other relevant international organizations with expertise in these areas.

Lending and debt

We recognize the Fund's crucial role in the global financial safety net and its ongoing efforts to strengthen its lending toolkit for a stable global monetary system. We commend the Fund for its assistance to emerging market and developing economies during times of uncertainty, including initiatives like the Food Shock Window, the Resiliency and Sustainability Trust (RST), temporary increases in access limits in the General Resources Account (GRA), and other efforts.

Addressing resource gaps in the Poverty Reduction and Growth Trust (PRGT) and RST is essential to ensure they can fulfill their mandates promptly and with adequate terms. We look forward to the review of the Fund's Concessional Facilities and Financing, the PRGT, and GRA access limits and surcharge policy, based on a holistic analysis.

We welcome the recent review of precautionary facilities. The approved reforms enhance the Fund’s lending toolkit, promoting strong policies and institutional frameworks, boosting market confidence, and offering readily accessible liquidity support against tail risks. These changes ensure the toolkit remains effective and aligned with the need of emerging market economies.

We acknowledge and commend the Fund's role in recent progress with the Common Framework for Debt Treatments and the Global Sovereign Debt Roundtable. Given the increasing number of low and middle-income countries in debt distress, we urge greater efforts to expedite the implementation of the Common Framework for Debt Resolution and other initiatives enhancing debt transparency and the contractual approach. Considering this, we endorse the Fund's debt policy framework and its exploration of reform options to bolster its ability to assist countries in debt restructuring.

Capacity development

We endorse strengthening the integration of capacity development (CD) with lending and surveillance. We welcome recent initiatives like providing guidelines for countries' considering Central Bank Digital Currencies (CBDCs), and collaboration with the World Bank and other partners under the Domestic Resource Mobilization Initiative. We look forward to the CD strategy review at the end of this year.

IMF resources

We support a timely conclusion of the 16th General Review of Quotas (GRQ). Given today's challenges and the risk of global fragmentation, it's crucial to maintain a representative, well-resourced, and quota-based IMF at the heart of the international financial safety net. We stress the significance of continuing the reform process beyond the 16th GRQ to strengthen the primary role of quotas, increase lending resources, and tackle representation and governance issues.

ARGENTINA

Global economic outlook

Amidst overlapping crises, the global economic outlook remains challenging. As a consequence of the pandemic crisis, the recent period of inflationary pressures as a result of the war in Ukraine, and the geopolitical fragmentation, fiscal buffers have been eroded and growth has slowed down. Global growth is forecast to slow from 3.5 percent in 2022 to 2.9 percent in 2023 and 2024, which represents a downward revision from the growth envisaged by the IMF in July. Furthermore, global growth will remain well below the 3.8 percent average registered between the beginning of the millennium and the outbreak of the pandemic.

This reduction in growth trends is even more pronounced among Emerging Market and Developing Economies (EMDEs), where the slowdown in growth will affect the global economic performance. Furthermore, these conditions are particularly detrimental for the Latin American and Caribbean region, whose growth trends, impacted by its capacity for international insertion, will be further affected by the reduction in demand from the rest of the world.

These conditions, coupled with post-pandemic, climate transition and social needs, put pressure on the financing requirements of EMDEs. The recent tightening of global financial conditions—especially in Advanced Economies, to cope with rising inflationary pressures, are further hindering these countries' access to affordable and sustainable financing. These interest hikes have a direct impact on financing costs for market borrowing as well as for IMF loans, the latter also further being burdened with surcharges.

Argentina is not exempt from this process of slowing growth and rising inflation. In addition to the main consequences of the conflict in Ukraine—a sharp increase in the international prices of agricultural commodities, energy, and other imports—there was also a historic drought that wrecked the country's exportable capacities in 2023, hindering its external position even more.

Recent economic developments in the Argentinean economy—protection of the most vulnerable

Argentina's economic activity in 2023 is already showing the impact of the drought, which, in terms of duration and intensity, has become the strongest in history, affecting 173 MM of hectares, implying huge agricultural production losses. Economic activity continued to grow at a rate of 1.4 percent year on year and 0.9 percent compared to the previous period during the first quarter of the year. However, given the seasonal component of the sector, the greatest impact was recorded in the second quarter when the agricultural sector dropped 40.2 percent, which implied a 4.9 percent GDP contraction and a 2.8 percent fall quarter-on-quarter on a seasonally adjusted basis. Based on these data, official estimates for 2023 indicate that the year will end with a 2.5 percent decline in GDP.

With regard to the labor market, during the second quarter of 2023 the activity rate stood at 47.6 percent, showing a fall of 0.7 p.p. with respect to the previous quarter and of 0.3 p.p. in the year-on-year comparison. On the other hand, the employment rate registered a slight decrease of 0.4 p.p. in the second quarter, reaching the same level as in the same quarter of 2022, after having registered a historical peak of 45.0 percent in the first quarter of 2023. Nevertheless, the unemployment rate stood at 6.2 percent in the second quarter of 2023, the lowest value since the beginning of the current published statistical series that started in 2004. In the quarterly comparison, the unemployment rate decreased 0.6 p.p., while it decreased by 0.7 p.p. on a year-on-year basis.

The drought also affected domestic food supply and exportable capacity and generated inflationary pressure on major food products, such as fruits (+72 percent YoY in the first 8 months of the year), vegetables (+66 percent YoY) and meat (+50 percent YoY) and was one of the factors that drove the acceleration of inflation in the first months of the year. After the slowdown registered between April and July, the CPI recorded a monthly increase of 12.4 percent in August. This was mainly due to the steep devaluation that occurred on August 14th and the introduction of new tax (*Impuesto PAIS*) on most of the imports, measures adopted in line with the IMF program requirements despite being in a complex scenario outlined by the national electoral process which suggested that these measures would prove to be unsustainable.

Following the foreseeable inflationary shock triggered by the abovementioned devaluation, the National Government was compelled to intensify different lines of action in a coordinated manner to reduce the impact on consumer prices and thus protect the population's purchasing power, particularly targeting the most vulnerable. The National Government will continue to stand by the commitment of protecting the most vulnerable, and with a poverty rate of 40.1 percent in the first semester of the year, measures were called for to avoid hindering the social situation. These were added to broader programs already in place to protect the purchasing power of the population, such as the "Program to Strengthen Economic Activity and Income", which covered fuels, medicines, prepaid services, public transportation, and food and mass consumption products.

Despite the challenging short-term outlook, in the medium term, Argentina's economy shows a huge growth prospect due to some strategic sectors export potential. In addition to the productive and exportable potential of Argentina's traditional sectors such as agriculture, livestock, and the manufacturing sector, the country has enormous natural and mineral resources necessary for the energy transition, and skilled human capital to ensure its growth in the coming years. It is expected that, thanks to the investments being made in Vaca Muerta and the gas pipeline, the energy sector will shift from a net trade deficit to a surplus as of 2024. Similarly, in the mining sector Argentina is the fourth global producer of lithium and has abundant cooper resources, mining exports, mainly lithium and copper, which are expected to continue their upward trend, rising from annual exports of around $4.5 bn to almost $20 bn by the end of the decade. Likewise, the knowledge-based economy sector is receiving investment and promotion to foster the development of one of the sectors that generates the highest value-added exports. All these provide Argentina with enormous growth opportunities in the medium term.

Finally, it is worth noting that, even under the most adverse conditions, Argentina has always sought to honor its international commitments, both those with the members of the Paris Club and those with the IMF. This led us on occasions to seek operations with third parties or other countries in order to honor our commitments, as was the case of the latest payment to the Fund for which we sought assistance from the government of Qatar, China and even the CAF – Development Bank of Latin America and the Caribbean, showing Argentina's strong commitment to keep performing even under the most challenging domestic and international conditions.

Final considerations

Against this backdrop of lower global growth rates, monetary tightening to cope with global inflation and geo-economic fragmentation, the economic outlook is becoming increasingly challenging for EMDEs. Additionally, the impacts of climate change are already affecting our economies and having consequences on our population's living conditions, which without bold action, will only worsen, affecting in particular the most vulnerable populations. The impact of the drought on the Argentinean economy is a clear example of how a climate-related event not only has a domestic impact—through a decrease in sectoral productivity and consequently on exports, tax collection, and GDP—, but can also affect the delivery of a Global Public Good (GPG) as food security.

Therefore, it is essential to mobilize affordable resources from advanced economies and International Financial Institutions to emerging countries to guarantee the provision of GPGs. If what EMEs are providing are GPGs, from we will all benefit, then the cost of such a provision should be born not only by us. Ensuring financial flows that seek to reduce poverty levels and address climate action will be critical.

To achieve this, it is necessary to carry out an integral reform of the International Financial Architecture, which should help to guarantee the real development of all countries and help those who deliver the GPGs. Meanwhile, within the IMF, we have tools that could be improved to generate resources to address the most urgent issues. Improving the functioning of the RST by ensuring the accessibility, flexibility, and adequate volume of its funds for middle-income countries will be an essential step in this direction. In addition, reducing rates and surcharges and extending maturities are intermediate mechanisms to improve current financial conditions.

Finally, to consolidate the central role of the IMF within the GFSN, it will also be essential to achieve an increase and redistribution of quotas, on the one hand to provide a greater level of liquidity at the international level and, on the other, to guarantee the correct representation of each member within the GFSN.

BOLIVIA

Despite the unfavorable global economic environment, characterized by the continuity of geopolitical tensions, the persistence of elevated inflation, high interest rates that do not give clear signs of having ended the upward cycle in advanced economies, and an imminent slowdown in the world economy, Bolivia continues its economic recovery process. Indeed, the Bolivian economy shows an important economic activity performance, driven mainly by domestic demand, with price stability, which has been one of the government's priorities to protect the population's quality of life and the dynamics of the productive sector.

The Bolivian economy's recent developments

In the first quarter of 2023, the Bolivian economy grew 2.3 percent, stimulated by domestic demand. The adverse external scenario, to which was added activity paralysis on the border with Peru and logistical problems due to fires in the port of Mejillones in Chile that affected the operations of the country's main mining company, caused net external demand contraction in the first quarter of the year. In this context, domestic demand once again demonstrated its strength and ability to continue boosting the economy and, therefore, job creation. Thus, domestic demand expanded 9.3 percent, supported mainly by investment. On the economic activity side, GDP growth was primarily driven by the positive performance of financial establishments; transportation and storage; other services, including restaurants and hotels; and manufacturing.

Labor market indicators showed a notable performance, in line with economic dynamism. Unemployment continued its downward trajectory. After peaking near 12 percent in mid-2020, it decreased to 3.8 percent in August 2023, one of the lowest rates in the last five years and in the South American region. Similarly, the occupancy level reached one of the highest historical levels. In this regard, according to a report by the Economic Commission for Latin America and the Caribbean (ECLAC) and the International Labor Organization (ILO) on the regional labor market, Bolivia stood out in 2022 as the country with the best recovery in employment to pre-pandemic levels in Latin America and the Caribbean.

Price stability continues to be one of the main features of the Bolivian economy. Despite external pressures and the impact of climate events on some products in the agricultural sector, inflation remained controlled, reaching an accumulated rate of 1.6 percent as of August 2023, the lowest in South America and one of the smallest in the world. The government persisted in efforts to contain prices through support and incentives for agricultural production, fuel subsidies, and its commitment to exchange rate stability, which it maintained despite the pressures experienced mainly at the end of the first and beginning of the second quarter of the year.

Furthermore, the financial system remained resilient despite domestic shocks. In the first half of 2023, the sector resisted well the pressures of an unusual demand for dollars and the impact of the resolution of one of the most important banks in the sector. The financial system operations continued to recover, with the non-performing loan rate below 3 percent in July, one of the lowest in the region. In addition, the financial system maintained high level of bolivianization, that is, the predominance of operations in local currency, which remained at 99 percent in the case of credits and rose to 88 percent in deposits. The high use of local currency in the economy contributed to contain the pressures of potential impacts from the atypical demand for foreign currency. The availability of dollars has been gradually normalizing, supported by the authorities' commitment and efforts to ensure their provision to the economy in general and the financial system in particular.

During the first half of 2023, the fiscal accounts showed a slight deficit explained mainly by investment. Thus, the country recorded a current fiscal surplus. The authorities continue efforts in public investment execution, with a budget that allocates more than 40 percent of resources to productive sector projects. Despite the impact of the hydrocarbon sector performance and the adverse external context on tax revenues, tax collection remained high in the first half of the year, reflecting the continuity of economic activity dynamism and the government's actions to improve tax administration.

Economic policy to support the recovery

Against the backdrop of external and domestic shocks that threaten the economy and the government's policy response, the authorities continue to deepen efforts to contain their impact on the economic activity and Bolivians' living standards. In this vein, the government persists in prioritizing productive sector strengthening, under the industrialization with import substitution strategy. The latter is one of the pillars of Bolivia's national development plan towards achieving and consolidating a diversified and sustainable economy, with a higher well-being of the population.

In this regard, access to financing for the private sector continued to be promoted, especially for micro, small and medium-sized producers, through measures such as the SIBOLIVIA program, which channels credits with a preferential interest rate of 0.5 percent to sectors involved in import substitution; exemption from taxes on capital good import and sale; productive credit incentives; among others.

Moreover, from the public investment side, the authorities continue to promote and accelerate industrialization projects which will help diversification and import reduction in sectors in which the country has high potential. In this vein, and with the aim of reducing fossil fuel import dependence, biodiesel plant construction projects continue, with a first plant to be delivered in the first quarter of 2024. Furthermore, the government prioritizes a renewed push for hydrocarbon exploration. Progress is also being made with the Mutun plant, which will produce steel and reduce construction iron imports, and with the zinc separation plants. Similarly, given the country's significant lithium reserves, its industrialization is a pillar in the Bolivian development strategy. Efforts in this area are therefore accelerating. In addition to the lithium carbonate plant, developed with domestic investment and which will soon begin operations, agreements are in place and are being accelerated to bolster lithium industrialization with recognized international companies in the field.

Economic outlook

As a result of the productive sector boost and measures to strengthen demand, the Bolivian government foresees a positive economic performance, despite the adverse global scenario. Domestic demand dynamism will still stimulate the economy in 2023. According to international organizations' estimates, the country's growth this year will be among the highest in the region. Similarly, price stability is expected to continue, with inflation around 3 percent. In the medium term, the authorities expect sustained growth driven by relevant ongoing and planned projects under the import substitution strategy, which in turn will generate higher employment and income and, ultimately, ensure the Bolivian population's well-being.

CHILE

Despite external challenges, Chile's economy is advancing towards sustainable growth. Coordinated monetary and fiscal policies have successfully addressed the positive output gap, inflation pressures, and the current account deficit. In the short term, monetary policy is cautiously normalizing, and fiscal consolidation continues, alongside structural reforms to boost growth prospects and enhance fiscal, social, financial, and climate resilience.

Recent economic developments and projections

After a strong post-pandemic recovery, monetary and fiscal policies were significantly tightened to address macroeconomic imbalances. The economy is projected to contract between -0.5 and 0.0 percent in 2023, resuming growth next year and gradually reaching its potential, between 2 and 3 percent, by 2025.

Inflationary pressures are receding, and headline inflation is expected to return to the Central Bank of Chile (CBC)'s 3 percent target in the second half of 2024. Similarly, after reaching historic highs, the current account deficit is expected to moderate to 3.4 percent of GDP this year, reflecting reduced domestic demand and a weaker real exchange rate, stabilizing around 4 percent in 2024 and 2025.

Monetary policy and inflation

The CBC undertook a decisive monetary policy tightening to address external and domestic inflationary pressures, raising the Monetary Policy Rate (MPR) from 0.5 percent in July 2021 up to 11.25 percent in October 2022. Over the past year, the tight stance effectively controlled inflation and led consumption to sustainable levels. In the past year, annual inflation fell from 14.1 to 5.3 percent. Recently, with evidence of inflation convergence emerged and closer alignment of inflation expectations to the target level, the CBC began an easing cycle, reducing the MPR by 175 basis points to 9.5 percent.

Looking ahead, the CBC is committed to flexible responses in case of internal or external risks. The extent and timing of further easing will depend on how the macroeconomic situation evolves and its impact on the inflation trajectory.

Fiscal policy and public debt

The authorities remain fully committed to fiscal responsibility and macroeconomic stability. The government is implementing a multi-year consolidation plan with the goal to achieve a structural balanced budget by 2026 (-0.5 percent of GDP), while also maintaining public debt below 45 percent of GDP. Consistent with the above, the recently submitted 2024 budget proposal envisions a structural fiscal deficit of 1.9 percent of GDP. To support its social agenda, the administration introduced a new "fiscal pact" proposal, including a comprehensive set of initiatives focused on social spending, revenue mobilization, investment and productivity enhancement, and increased transparency in public spending.

Climate change

Chile maintains a strong commitment to climate action, with a solid track record of policies and an ambitious agenda ahead. Recently, Chile enacted the Framework Law on climate change and issued the first Sustainability Link Bond. It is also working on a green taxonomy to guide private investment in climate projects. Additionally, Chile expanded its NDC to enhance ecosystem protection by 2030 and pledges to reduce methane emissions by 2025.

Chile is well-suited to contribute with renewable energy, green hydrogen, and critical minerals to the global green transition. The government has introduced a National Lithium Strategy for diversification, sustainability, mining development, and growth, and updated the Green Hydrogen Action Plan for 2030. Last June 2023, the World Bank granted Chile the first loan to support green hydrogen development, which will be catalytic to mobilize resources from the private sector and other multilateral partners.

PARAGUAY

The GDP growth forecast for 2023 stands at 4.5 percent, mainly explained by the recovery of agriculture, as well as greater electricity generation. Likewise, a favorable performance is expected for manufacturing and services. On the expenditure side, forecasts point to an important contribution from net external demand and, to a lesser extent, from consumption (public and private). As regards investments, a contraction is expected due to the lower dynamism of the construction sector. It is worth noting that during the COVID-19 pandemic, there was a significant surge in infrastructure projects undertaken by the public sector. Therefore, it was expected that the construction sector would converge towards a level more in line with the growth rate observed prior to the pandemic.

Available data reflects a good performance of economic activity and demand in the recent period. In the second quarter, GDP expanded at an interannual rate of 5.9 percent, higher than the 4.9 percent growth registered in the first quarter, due to the greater dynamism of services and manufacturing, as well as the good performance of agricultural production and the generation of electric energy. On the expenditure side, the improvement is mainly explained by consumption (public and private) and gross fixed capital formation. In cumulative terms, the growth rate stood at 5.4 percent at the end of the first half of the year.

The labor market has also shown a favorable performance, with an increase in employment and a fall in the unemployment rate. In inter-annual terms, employment increased by 4.4 percent in the second quarter of 2023 and the employment rate rose from 65.5 percent to 67.2 percent. The unemployment rate fell from 6.7 percent to 5.8 percent in the same period. The favorable labor market results, along with a consumer confidence index in the optimistic zone, are factors that are anticipated to positively influence the evolution of domestic demand in the coming months.

Regarding prices, inflationary pressures have eased more rapidly than initially expected, mainly due to the significant reduction in commodity prices (food and energy). Furthermore, the Central Bank of Paraguay (CBP)'s monetary policy reaction has also contributed to containing the second-round effects of the shocks and keeping inflation expectations close to the target, even at the most challenging period, when inflation experienced a notable surge. As a result, annual inflation has returned to the target range (between 2.0 percent and 6.0 percent) since April 2023, after having been above that range since September 2021, and stood at 2.9 percent in August 2023. Likewise, underlying inflation measures are also close to the target, and agents' expectations for all time horizons are aligned with the 4 percent objective. In this context, the CBP decided to reduce the monetary policy rate by 25 basis points in the August and September meetings, placing it at 8.00 percent annually.

The nominal exchange rate has remained stable during 2023. As of September, the Guaraní accumulated an appreciation of 1 percent against the US dollar. It is worth noting that this appreciation took place in the context of increasing International Reserves, which, as of September 2023, amounted to approximately USD 9.8 billion (22 percent of GDP). This current amount of the International Reserves represents an important level of liquidity to face possible excessive volatilities in the exchange rate. At the same time, it allows Paraguay to continue with a solid external position.

The local financial system has remained stable and solvent, and the capital levels comfortably surpass the minimum regulatory requirements. Additionally, the liquidity and non-performing loan (NPL) ratios have remained at adequate levels. Profitability has continued to recover, although it remains below pre-pandemic levels. Loans have continued to grow during 2023, both in local and foreign currency, as well as deposits. According to the CBP Survey, expectations for granting loans for the coming months remained in the optimism zone for all economic sectors. It is important to mention that progress is being made towards an integrated supervision of the financial system. Recently, the Securities Superintendency was created, replacing the National Securities Commission, as the authority for regulation, supervision, and control of the Stock Market. This Securities Superintendency will be part of the CBP.

Regarding the payment system, we emphasize the advancements made in strengthening and modernizing the country's financial infrastructure. Among them, the interconnection of the Paraguayan Payment System (SIPAP) with the Stock Exchange's Electronic Trading System. This development results in an increased level of sophistication in the process of negotiating public debt securities in the local market. Likewise, the implementation of new functionalities of the Instant Payments System in recent months is highlighted.

PERU

In the first half of 2023, Peru's economy contracted by 0.5 percent year-on-year, primarily driven by a slowdown in private investment and consumption. This downturn had pronounced effects on the manufacturing, construction, and services sectors. During the same period, there was an increase in inventories, particularly in the mining and manufacturing sectors. Climate shocks, such as El Niño Costero, had direct adverse effects on the production of the agriculture and fishing sectors, as well as their associated manufacturing components.

The supply shocks experienced in the first half of the year had a larger impact than initially forecasted. Subdued confidence among businesses and households has not rebounded as previously expected and will likely reduce momentum in non-primary sectors. Furthermore, persistent warm weather conditions are projected to negatively influence the agriculture and fishing sectors in the latter half of the year. Against this backdrop, GDP is forecasted to grow by 0.9 percent in 2023 and 3.0 percent in 2024, driven by a recovery in domestic demand and non-primary sectors.

Inflation in Peru has been one of the lowest and least volatile in the LAC region since 2001, averaging 3.0 percent between 2001 and 2022. Year-on-year inflation has decreased in recent months, moving from 8.5 percent at the end of 2022 to 5.6 percent in August 2023. Indicators for trend inflation and 12-month inflation expectations continue to show a declining path but remain above the 1 percent-3 percent target band set by the Central Reserve Bank of Peru (BCRP). Core inflation, which excludes food and energy, is projected to return within the target band by the end of the year, with headline inflation expected at 2.4 percent by 2024.

Credit extended to the private sector grew by 0.7 percent year-on-year, mirroring the performance of overall economic activity. Following a significant rise in the credit-to-GDP ratio in 2020, largely attributed to a large pandemic-related government-guaranteed loan program (*Reactiva Perú*), growth in credit demand is anticipated to decelerate to 1.0 percent in 2023, reflecting the modest growth expectations for the year.

The fiscal deficit accumulated over the previous 12 months rose from 1.7 percent to 2.6 percent of GDP between December 2022 and August 2023, a trend largely attributed to falling current revenues. Public debt is projected to reach 32.9 percent of GDP by the end of 2023. Given expectations of reduced economic growth and lower export prices, the fiscal deficit is forecast at 2.4 percent and 2.0 percent of GDP in 2023 and 2024, respectively, nearing the limits established by the fiscal rule.

The current account deficit is projected at 1.3 percent of GDP in 2023, influenced by less favorable terms of trade, weaker domestic demand growth, and reduced transportation costs. However, it is expected to narrow to 1.2 percent in 2024, due to a resurgence in inbound tourism and exports, coupled with a partial normalization of adverse weather conditions expected between the end of 2023 and the beginning of 2024. All along, the balance of payments is expected to remain sustainable, bolstered by long-term capital inflows.

In September 2023, the BCRP reduced its policy rate by 25 basis points to 7.50 percent. The BCRP highlighted that this move does not necessarily signal the onset of a rate-cutting cycle. As of September 2023, the real policy rate was 4.14 percent, which is above the estimated neutral real interest rate.

Furthermore, the BCRP holds FX reserves amounting to about five times the country's short-term liabilities and 30 percent of GDP. Additionally, Peru has access to contingent funds, notably USD 5.3 billion from a successor FCL with the Fund. Given its robust fundamentals and sizable FX reserves, Peru's external position ranks among the strongest in emerging market economies, allowing the authorities to effectively mitigate risks from external financial shocks.

Peru maintains solid macroeconomic fundamentals, marked by low debt ratios, one of the largest fiscal spaces in the LAC region, and significant external buffers. In a context of unprecedented challenges, the country's solid policy management over the past three decades is being validated.

URUGUAY

Recent economic developments

Uruguay's economy has been impacted by the effects of the most severe drought in the last century, contributing to a slowdown in growth in the second half of 2022 and into 2023. After growing by 5.1 percent and 4.9 percent in 2021 and 2022, respectively, economic activity in the second quarter of 2023 declined 1.4 percent with respect to the first quarter of the current year, when it had expanded by 1.3 percent. A pick-up in growth is expected in the third quarter with real output expected to grow by around 1.3 percent in 2023.

The labor market has continued to recover. The employment rate increased to 58.2 percentage points in July, up by 1.4 percentage points compared with the same month in 2022. Notwithstanding a significant labor supply increase, the unemployment rate decreased to 7.8 percent in July, down from 8.1 percent in the same month of last year. The underemployment rate was 9.6 percent, and the informality rate remains at a historically low level. Meanwhile, real wages are on a recovery phase, expanding 4.0 percent year-on-year in July.

Inflation decreased to 4.11 percent in August, well within the Central Bank's target range (3-6 percent) marking the lowest inflation rate in 18 years.

Macroeconomic and financial policies

The Central Bank of Uruguay (BCU) has continued to proactively respond to the shocks faced by the economy. In August 2023, the Monetary Policy Committee of the BCU reduced its policy rate by 75 basis points, to 10 percent, a level that is considered consistent with the contractionary phase of monetary policy and with the target range established for the 24-month monetary policy horizon. At the same time, the Monetary Policy Committee noted that future movements in the interest rate will continue to be conditioned by the evolution of inflation and, mainly, by inflation expectations in the monetary policy horizon. Working towards low and stable inflation remains the BCU's primary focus and the most critical component of the de-dollarization agenda. Going forward the BCU remains committed to continue advancing its de-dollarization strategy and rebuilding the Uruguayan peso markets, aiming to enhance monetary policy transmission.

The financial system remains sound, profitable, with low and stable non-performing loans, and strong liquidity indicators. The aggregate profit of banks represented a return on assets of 1.4 percent and a return on equity of 13.8 percent as of March 2023. The general delinquency of credit stood at 1.7 percent staying at minimal levels in historical terms, and the ratio of liquid assets to total assets stood at 55.5 percent. Stress tests of the banking system carried out by the Superintendence of Financial Services (SFS) of the Central Bank, showed that the banking system on average would withstand a severe recession scenario and the regulatory capital would remain above the minimum requirement.

The authorities have continued implementing sound macroeconomic policies which have strengthened the country's resilience to shocks and improved its credit standing. Three of the five credit agencies have upgraded the country's sovereign ratings over the last two years. Most recently, in June 2023, Fitch Ratings upgraded Uruguay's credit rating to "BBB", with a stable outlook.

For three consecutive years the authorities complied with the rules-based fiscal framework introduced in 2020. Notwithstanding the deterioration of the fiscal deficit in 2022 to close to 4 percent of GDP largely following a drop in tax revenues, the structural deficit is expected to stand below 3 percent of GDP in 2023. In April 2023, Uruguay's Parliament approved a reform of the pension system which is critical to the long-term sustainability of public finances. The reform improves the sustainability of the pension system through parametric modifications and stabilizes pension-related expenditures in terms of GDP.

The drought has required unforeseen additional budgetary resources to address the water deficit emergency in the metropolitan area. Amid a very challenging environment, targeted measures were deployed to ameliorate the impact of the severe drought. Among others, these include measures to improve access and the cost of credit for agricultural producers, especially smaller-scale producers, help address higher costs in supplementing livestock feed and the costs of electrical energy, and tax payment extensions and exemptions. Consequently, the authorities activated the legal safeguard clause under the fiscal rule, which allows to increase the net borrowing limit to an additional 30 percent under extraordinary circumstances. (One of the three pillars of the rule-based fiscal framework includes a legal cap to annual Government Net Indebtedness—GNI). As required by law, in July 2023, the Ministry of Economy and Finance appeared before Parliament to provide information on the evolution of the GNI and to report on the reasons as to why the safeguard clause was invoked. The new augmented limit for 2023 is now set at USD 2.860 million.

On debt management, the authorities have continued proactive strategies aimed at de-risking the debt portfolio while keeping borrowing costs contained. Liability management transactions, conducted in domestic and international markets, have sustained a robust debt maturing profile, thus reducing the rollover risk. Issuance of a new sovereign bond in nominal pesos in global markets. Most recently in July 2023, the Government issued a new sovereign bond in nominal pesos in global markets maturing in 2033. Simultaneously, it carried out a liability management exercise of short-term global bonds which also aimed to boost the liquidity of the newly established local-currency benchmark. Net debt of the Central Government stood at 54.4 percent of GDP in June 2023, a decrease of 1.2 percentage points of GDP from a year ago.

At the end of June 2023, Uruguay reached the highest ESG score among emerging market economies, which factors into the ESG-adjusted EMBI from JPMorgan.