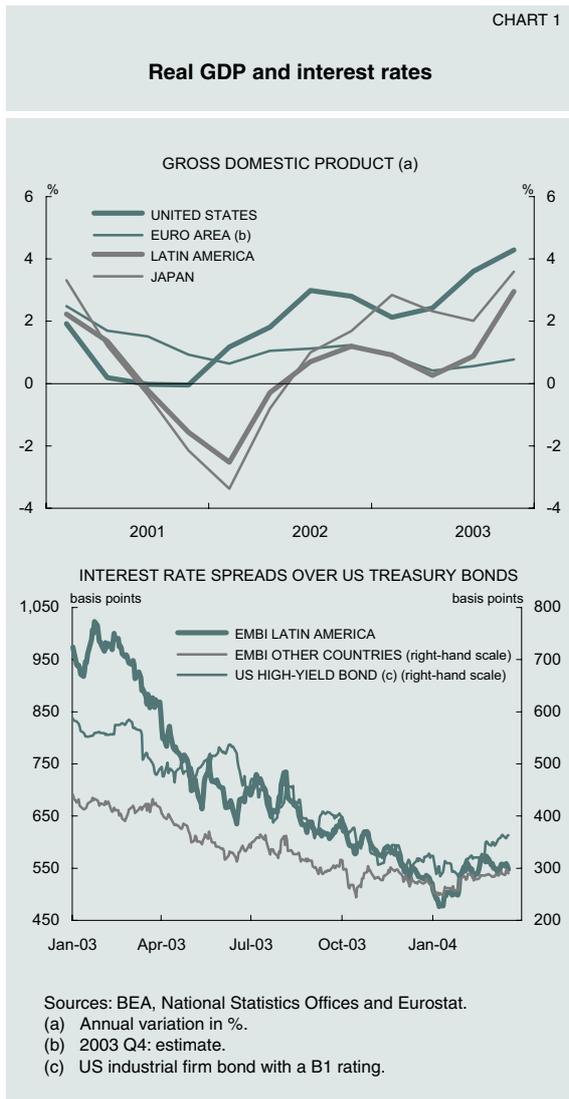

Half-yearly report on the Latin-American economy

1. INTRODUCTION

In early 2004 Latin America has enjoyed the most favourable financing conditions of recent years: a virtual absence of exchange rate pressures; current-account surpluses, in many cases; access to foreign capital markets under favourable terms; and sovereign spreads at similar levels to those prior to the 1998 Russian crisis. However, the region continues to exhibit high fiscal and financial vulnerability and faces uncertainty on certain fronts in the coming months. Doubts centre, first, on retaining international financial investors' favourable disposition to the area, following the high returns accumulated, when there is a possibility that US interest rates may rise in the coming quarters; and further, on regaining the ability to attract foreign direct investment, following the turbulence of recent years. Against this background, the pick-up in economic activity towards late 2003 placed the annual growth rate slightly below 3% in Q4. As a result, growth in Latin America for the year as a whole turned positive again (1.3%, against -0.2% in 2002), but this did not prevent the third consecutive annual decline in per capita income. The recovery is expected to firm during 2004, although the delay with which this is occurring in the two biggest economies - Mexico and, above all, Brazil - calls for an additional note of caution regarding the region's overall outlook.

During the second half of 2003, interest rates in the United States and in Europe, too, held stable at all maturities. In spite of expectations of a global economic recovery, supported by favourable data in the second half of the year particularly in the United States and Japan (see Chart 1), and of the growing US fiscal imbalances, there was no upward shift in the yield curve. This was due perhaps to the sound performance of inflation, which provided for a continuing accommodating monetary policy stance, and, in the case of the United States, possibly to the intense build-up of Treasury bonds by Asian central banks. The firming of the recovery and the search for returns in a less risk-averse environment marked by abundant liquidity exerted, by contrast, a notable effect on the corporate bond market, where spreads narrowed to the lowest levels since 2000 (see Chart 1). That was propitious during the second half of the year to stock markets, whose earnings doubled in relation to the first six months.

All these factors contributed to consolidating, in the second half of 2003, the improvement in Latin American financial markets while, at the same time, capital inflows were recovering in relation to 2002, albeit without attaining the levels of prior years. The narrowing of sovereign



spreads continued, in parallel with that of corporate junk bonds and with emerging regions' bonds, albeit at a more measured pace than in the first half of the year. Nonetheless, spreads have risen slightly since mid-January. Domestic equity markets in Latin America also benefited from this favourable situation, and some recorded the highest annual earnings among stock markets worldwide.

These favourable stock market and financial developments in the area contrasted somewhat with the course of economic activity, which only began to show clear signs of acceleration in most countries in 2003 Q4. Behind the delay in and gradualness of economic recovery is the economic adjustment made in recent years in a large number of countries and the tightening of macroeconomic policies that accompanied it. As financial market tensions were overcome and inflation progressively moderated, the monetary policy stance began to be eased, although this process has slowed in 2004 Q1. Conversely,

ly, fiscal policies remained restrictive, owing to the persistent vulnerability of public finances. In these circumstances, external demand was once again the driving force of growth in 2003. The marked rise in commodity prices and the increase in world demand in the second half of the year, against a backdrop of stable exchange rates, were conducive to prolonging the buoyancy of exports, which remains the case into 2004. Although domestic demand is expected progressively to replace this external momentum, the process may take some time due to the depth of the cumulative income adjustment in recent years.

2. ECONOMIC AND FINANCIAL DEVELOPMENTS IN THE AREA

2.1. Economic activity

In contrast to the marked weakness in the first six months, activity in the region quickened notably in 2003 Q4 (3% growth compared with the same period a year earlier), after remaining slack in Q3. GDP thus posted a rate of 1.3% in 2003 as a whole (see Chart 2). The rise was across the board but, as in the first half of the year, it was much sharper in the countries beset by economic crisis in 2002, namely Argentina, Uruguay and Venezuela, which ended the year with growth rates close to 10%. Excluding these countries, the year-on-year rate of increase of GDP in the area would have fallen to 1.5% in Q4 and annual growth in 2003 would have been cut by 0.6 pp.

Growth tended to quicken in most countries towards the end of the year, except in Peru, which was ahead in the cycle. There was sluggish growth in Brazil in the second half of the year: its year-on-year growth was negative in Q3 and practically zero in Q4, placing the rate for 2003 as a whole at -0.2%, the first negative rate since 1992. Argentina recorded the highest annual rate of growth for the year (8.7%), following heavy declines in the two previous years. Next came the countries with growth rates of between 4% and 3%: Peru, Colombia and Chile, in that order. Growth in Mexico was low at 1.3%, and Venezuela underwent a severe recession, with a fall in GDP of over 9%.

The pick-up in industrial output was not as sharp as expected, in the light of the firming of the world recovery. The related year-on-year rates turned positive during Q3, taking root towards the end of the year. There was an increase of 5.2% in December on a year earlier (which saw the year end with a rise of 1.1% in relation to 2002), although the slowdown evident in some of the early data for 2004 high-

TABLE 1

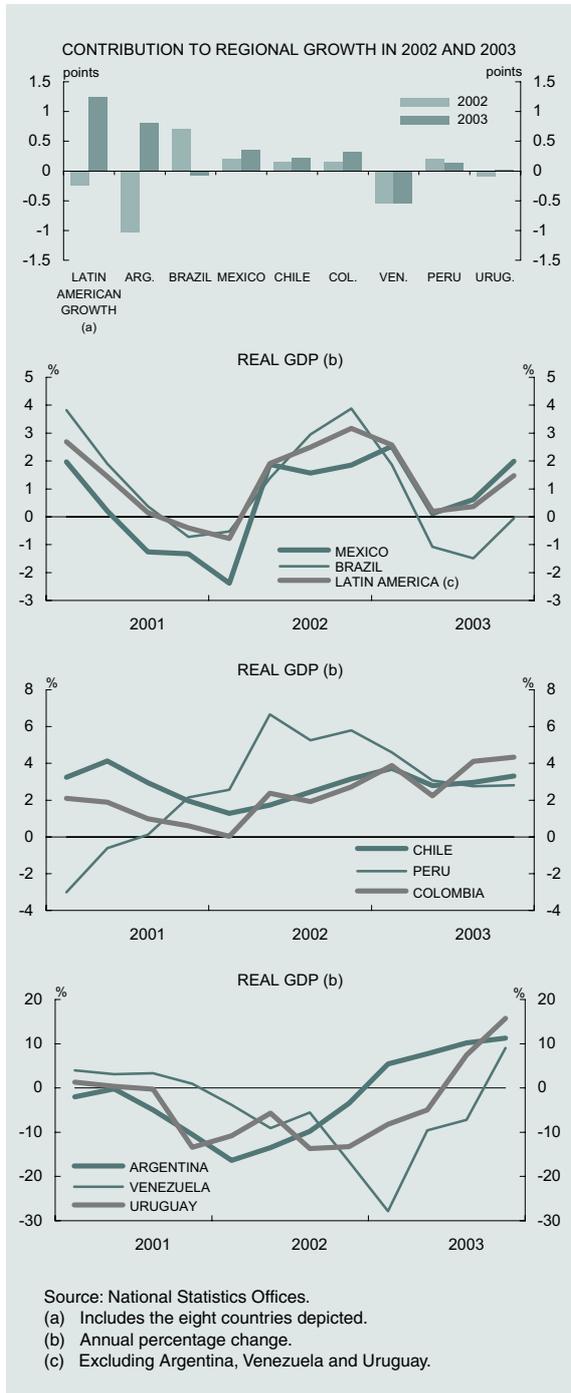
Latin America: relevant macroeconomic indicators

	2001	2002	2003	2002				2003			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (y-o-y change) in %											
Argentina	-4,4	-10,8	8,7	-16,3	-13,5	-9,8	-3,4	5,4	7,7	10,1	11,3
Brazil	1,4	1,9	-0,2	-0,5	1,4	3,0	3,9	1,9	-1,1	-1,5	-0,1
Mexico	-0,3	0,7	1,3	-2,2	2,0	1,8	1,8	2,5	0,1	0,6	2,0
Chile	3,1	2,1	3,3	1,3	1,7	2,4	3,2	3,7	2,8	3,0	3,3
Colombia	1,4	1,8	3,7	0,0	2,3	2,0	2,6	3,8	2,3	4,1	4,4
Venezuela	2,7	-8,8	-8,9	-3,8	-9,1	-5,6	-16,7	-27,9	-9,6	-7,2	9,0
Peru	-0,1	5,1	4,0	3,2	6,3	5,1	4,7	6,0	3,6	3,5	2,9
Uruguay	-3,1	-10,8	2,5	-10,8	-5,5	-13,6	-13,1	-8,3	-4,8	7,1	15,7
LA - 8	0,4	-0,2	1,3	-2,5	-0,3	0,7	1,2	0,9	0,3	0,9	3,0
CPI (y-o-y change) in %											
Argentina	-1,1	25,9	14,8	4,2	23,3	36,0	40,3	35,7	14,5	5,2	3,7
Brazil	6,8	8,5	14,8	7,6	7,8	7,6	10,6	15,6	16,9	15,2	11,4
Mexico	6,4	5,0	4,6	4,7	4,8	5,2	5,3	5,4	4,7	4,1	4,0
Chile	3,1	2,9	2,8	2,4	2,2	2,4	2,9	3,8	3,7	2,7	1,1
Colombia	8,0	6,4	7,1	6,6	5,9	6,0	6,8	7,4	7,6	7,1	6,4
Venezuela	12,5	22,4	31,4	14,6	18,9	24,8	30,6	35,4	34,1	29,6	26,2
Peru	2,0	0,2	2,3	-1,0	0,1	0,3	1,4	2,8	2,4	1,9	1,9
Uruguay	4,4	14,0	20,0	4,6	7,1	18,9	25,0	27,9	26,3	15,0	10,7
LA - 8	5,8	9,2	11,1	6,1	8,3	10,0	12,1	14,0	12,2	10,0	8,0
Public-sector balance (% GDP)											
Argentina	-3,0	-1,5	0,4	-3,2	-2,0	-2,2	-1,3	-0,7	0,0	0,5	0,4
Brazil	-5,2	-10,5	-3,7	-4,9	-7,1	-8,9	-10,3	-10,2	-6,5	-3,7	-3,7
Mexico	-0,7	-1,2	-0,7	-1,0	-0,5	-0,6	-1,1	-0,6	-0,5	-0,6	-0,7
Chile	-0,3	-0,8	-1,4	-0,9	-1,3	-1,2	-0,8	-0,3	-0,5	-1,1	-1,4
Colombia	-4,3	-3,6	-2,8 (p)	-4,3	-5,2	-5,4	-3,6	-3,5	-2,0	...	...
Venezuela	-4,5	-1,0	-4,5 (p)	-5,8	-4,4	-4,0	-1,2	-1,4	-1,7	...	...
Peru	-2,4	-2,2	-1,8	-3,0	-2,8	-2,7	-2,2	-1,9	-1,8	-1,7	-1,8
Uruguay	-4,5	-5,1	-5,2	-4,9	-4,4	-5,2	-5,1	-5,1	-6,8	-5,8	-5,2
LA - 8	-3,2	-4,9	-2,2 (p)	-3,3	-3,9	-4,6	-4,8	-4,5	-3,3	-2,0	-2,0
Public debt (% GDP)											
Argentina	53,8	140,0	...	100,6	114,1	142,6	144,9	142,0	109,8	122,7	...
Brazil	52,6	56,5	58,2	54,3	57,3	62,5	55,5	55,0	55,6	58,1	58,2
Mexico	22,4	24,4	26,1	23,3	22,9	24,0	22,9	23,5	23,2	25,3	26,1
Chile	11,8	12,3	13,3	11,3	11,6	12,3	11,9	12,3	11,9	11,9	13,3
Colombia	44,3	50,5	...	43,8	44,3	48,1	47,6	51,3	50,0	...	...
Venezuela	46,4	47,1	77,6	45,5	46,5	50,3	59,5	54,4	58,9	66,7	77,6
Peru	46,1	47,0	46,6	47,4	41,6	46,8	46,6	47,7	42,1	46,3	46,6
Uruguay	54,0	97,4	...	82,4	86,0	97,9	97,4	98,4	100,4	104,9	...
LA - 8	40,8	51,7	...	45,9	48,1	54,0	51,8	51,3	48,4	...	...
Current-account balance (% GDP)											
Argentina	-1,7	9,8	5,7	-0,1	3,8	8,1	10,1	10,0	7,4	6,8	5,7
Brazil	-4,6	-1,7	1,0	-4,0	-4,4	-3,6	-1,9	-1,1	0,3	0,9	1,0
Mexico	-2,9	-2,2	-1,6	-2,6	-2,4	-2,5	-2,2	-2,1	-1,9	-1,8	-1,6
Chile	-1,8	-0,9	-0,8	-1,0	-0,8	-1,1	-1,3	-1,3	-1,5	-0,7	-0,8
Colombia	-1,5	-1,9	-2,7 (p)	-1,2	-1,3	-1,6	-1,9	-2,4	-2,1	-2,1	...
Venezuela	1,7	9,5	14,6	0,4	0,8	4,5	9,2	11,2	15,1	13,5	14,6
Peru	-2,2	-2,1	-1,8	-1,9	-1,8	-1,9	-2,1	-2,3	-2,3	-2,1	-1,8
Uruguay	-2,6	2,1	...	-4,1	-2,4	-0,3	2,1	1,2	1,9	1,4	...
LA - 8	-2,9	-0,1	1,1 (p)	-2,4	-2,1	-1,3	-0,1	0,2	0,8	1,0	1,1 (p)
External debt (% GDP)											
Argentina	52,2	136,9	112,1	115,9	130,7	143,9	141,6	133,7	101,0	107,9	112,1
Brazil	41,6	51,9	...	41,1	43,7	51,4	57,3	54,0	45,3	43,5	...
Mexico	23,1	21,6	...	22,7	21,5	23,1	21,7	23,9	22,2	23,6	...
Chile	56,2	62,2	62,7	56,7	53,6	62,2	62,7	60,9	56,6	58,4	62,7
Colombia	44,4	39,7	...	42,2	40,1	45,6	45,1	48,9	46,4	45,5	...
Venezuela	36,0	57,8	...	42,5	50,8	68,5	68,4	68,1	67,0	...	...
Peru	50,7	49,3	47,8	51,7	45,3	50,6	49,0	49,9	44,1	47,9	47,8
Uruguay	47,9	90,2	...	79,1	89,4	89,0	90,2	86,4	87,7	90,1	...
LA - 8	39,2	52,0	...	45,2	47,2	54,1	55,6	54,2	46,7	...	...

Sources: National Statistics Offices, IMF and own calculations.

CHART 2

Latin American real GDP



lights the uncertainty over the firming of activity in the region.

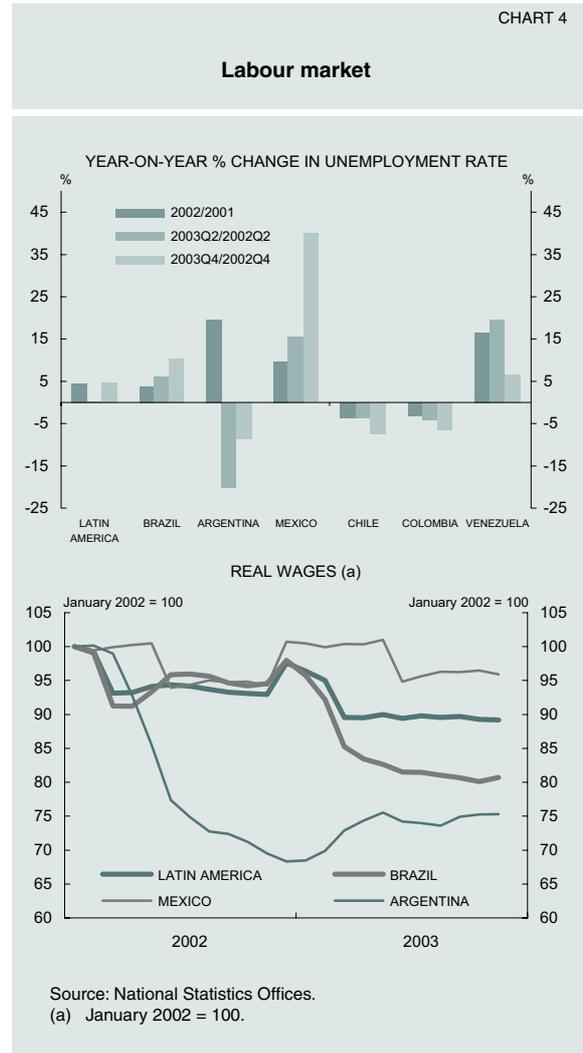
Following a prolonged period of slackness, domestic demand showed signs of picking up, especially in Q4, as indicated by the trend of retail sales (see Chart 3). Despite this, domestic demand contributed scarcely 0.6 pp to year-on-year growth for the area as a whole in the sec-

ond half of 2003. Highly influential here was the stagnation in Brazil and Mexico. Also notable were the divergences in regional behaviour in respect of the domestic demand components. Private investment, which as a percentage of GDP has fallen over the region as a whole by almost 3 pp since 1998 (to below 16%), led the pick-up in domestic demand in the second half of the year in countries such as Colombia and, to a lesser extent, Brazil, where consumption remained very depressed throughout the period. Paradoxically, in other countries with better prospects of stability such as Chile and, above all, Mexico, the pace of the recovery in investment was relatively slow, and private consumption was the most dynamic domestic demand component. The easing in monetary policies throughout last year and improved consumer (see Chart 3) and business confidence, which rose across the board, should contribute to accelerating the momentum of domestic demand. Yet a high degree of wariness remains when it comes to addressing new investment plans and taking on labour. Only in the second half of the year did the labour market begin to show a muted improvement in some countries (see Chart 4), although the limited quality of the region's labour statistics hampers analysis. On one hand, although the aggregate unemployment rate initiated a slight reduction in 2003 Q4, the change compared with a year earlier was positive and slightly greater than that of the previous year, as the sound performance of Argentina was offset by rises in unemployment in Brazil and, above all, in Mexico. On the other, the marked loss of the purchasing power of wages, intensified by the inflationary surge between 2002 and 2003 Q1, was checked in the second half of the year. That said, real wages in the region at the end of the year were still 10% below those recorded at the outset of 2002, due above all to their far-reaching deterioration in Brazil and Argentina.

External demand thus remained the main underpinning of activity over the year as a whole, although its contribution to year-on-year GDP growth in the second half of the year was substantially lower than in the first six months (estimated at 1 pp compared with 2.8 pp in the first six months -- see Chart 3). The prolongation of external momentum in the second half of the year is, in any event, notable. The basis for this was the highly favourable performance of commodity prices - extensive to all the main components (see Chart 5) - and the strengthening of world growth. Further, the weakness of the dollar against the rest of the developed countries, set against the stability of the Latin-American currencies vis-à-vis the dollar, mitigated losses in competitiveness. All these developments were favourable to exports; after



temporarily declining in Q3, the growth rate of exports quickened to over 11% year-on-year in 2003 Q4, signifying an annual average increase of a similar amount to that in 2002. Exports showed sustained resilience in Brazil, where they continued growing at a year-on-year rate of over 25% at the end of the year. This buoyancy was in contrast to the delay with which Mexico harnessed the momentum of the US economy,



although this delay has been slowly corrected in recent months. There was a gradual though moderate acceleration in import growth across the region (9.4% in 2003 Q4, and 2.6% in the year as a whole). This allowed a comfortable and growing trade surplus of close to 5% of GDP in 2003 to be sustained throughout the region. Of the main countries, only Mexico and Colombia closed the year with a small trade deficit, while the surplus in Chile and Brazil amounted to around 5% of GDP; in Argentina it exceeded 13% of GDP, although a turnaround was apparent in the second half of the year.

During the coming quarters the composition of Latin American growth is expected to shift towards domestic demand, although this is taking place more slowly than anticipated. It is also likely that the current-account balance is about to reach, if it has not done so already, a turning point. In any event, the profile of the current-account balance continued to improve in the second half of the year, in parallel with the trade balance (see Chart 5), providing for a current-account surplus of 1.1% of GDP for the area as

CHART 6

Sovereign spreads



a whole in 2003, for the first time since 1988. Although the trade surplus made the main contribution to this improvement, the other components also contributed favourably, as Chart 5 shows. The income balance - which includes interest payments on external debt - worsened by only 0.1 pp of GDP, which reflects lower financing costs and the particular situation of the Argentine debt default. The balance of transfers, for its part, made a more sizable contribution (0.32 pp), which was particularly notable in Mexico and Colombia owing to the increase in

emigrants' remittances. Among the main economies in the area, only Colombia posted simultaneously a current-account deficit (-2.7% of GDP) and a deterioration therein, due above all to the worsening of the income balance. In the remaining countries, greater domestic absorption will not foreseeably give rise to worrying external imbalances in the short and medium term, in view of the comfortable position from which they are departing. This is particularly important in a region in which such imbalances have repeatedly curtailed the duration of expansionary phases.

2.2. Financial markets and external financing

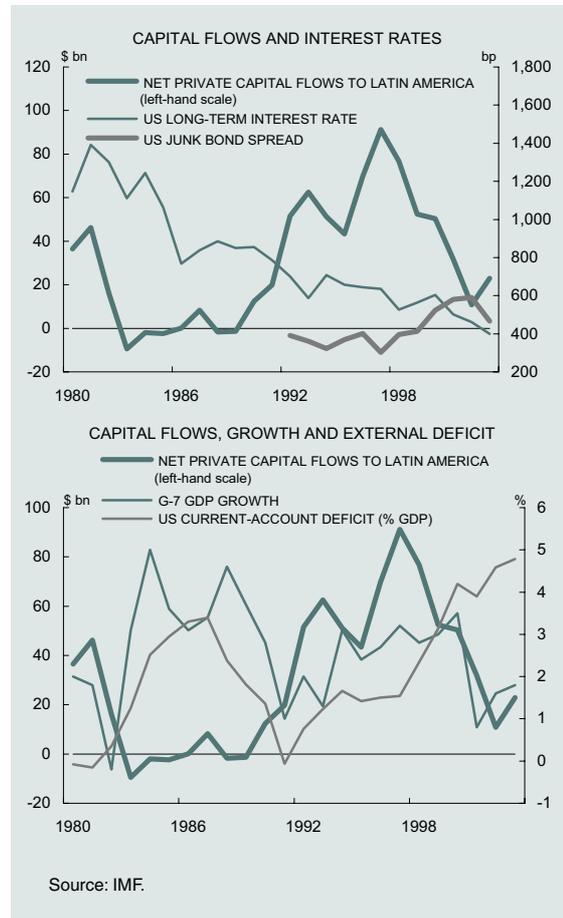
The sound performance of the external position coincided with international investors' continuing favourable perception of Latin American assets, which has seen the year close with a very favourable result for the financial markets. Sovereign spreads thus continued to narrow during the second half of the year (see Chart 6), albeit at a more tempered rate than in the first six months: a 25% decline compared with 31% in the first half of the year for the region's aggregate differential. In Venezuela and Peru the decline accelerated notably in the second half of the year.

The narrowing of differentials was across the board in all emerging markets (as the substantial increase in correlations between their spreads reveals), encompassing credit-rated and speculative issuers virtually indistinctively. The bonds of the Latin American countries with the biggest sovereign spreads benefited from this to a greater extent, as Chart 6 shows. Significantly, there was a marked contrast between the strong fall in differentials and the stability of ratings in most countries. Only Argentina, Venezuela and, in February this year, Ecuador saw their ratings upgraded by the main agencies.

These features reflect the significance of external (or push) factors in determining capital flows towards the region in 2003. Box 1 analyses these factors in greater detail, together with domestic (or pull) factors. Of particular note were the ample liquidity worldwide and the lower risk-aversion of financial markets, which prompted a search for assets with a higher return. The forceful inflow of funds to emerging markets was also conducive to less discrimination between countries, arising in part from the prominent role played by non-specialist investors last year. Adding to this was the better position of the economies in the region where, generally, price stability and fiscal discipline were safeguarded, exchange rates were more com-

Determinants of and outlook for capital flows to Latin America

The year 2003 saw the downward trend in capital flows to Latin America since 1998 cease. To assess whether this recovery is transitory or will firm, it is worth describing and analysing the explanatory factors identified as relevant in determining capital flows to the region. Two types of factors can be distinguished: push factors, related to the economic and financial conditions of the countries from which the flows stem (the developed countries and, in the case of Latin America, the United States in particular); and pull factors, related to the risk/return characteristics of investment in the recipient country. A third factor – degree of financial integration – might be added; this determines the readiness with which capital is transferred, and during the nineties it experienced a strong boost in Latin America and worldwide, prompted by the process of capital account liberalisation. While the evidence is not conclusive concerning the relative significance of these determinants, there is some consensus that the push factors determine the scale of the flows, while the pull factors influence their geographical distribution. The theoretical and empirical bodies of literature have identified the following as the main push factors: the business cycle in the developed countries; the degree of risk aversion, since emerging countries' assets are perceived as high-risk; the level of interest rates in the developed countries, as they determine liquidity and the search for alternative investments; and the external financing requirements of the industrialised countries, since to some extent they compete for foreign capital. The most salient pull factors in macroeconomic terms are Latin America's growth differential vis-à-vis other regions and the degree of macroeconomic stability and vulnerability. These two factors would proxy for the dimension of investment risk. Notable among structural factors are: structural reform processes, the degree of regional integration, and the development and stability of the institutional framework of the recipient country. These factors are particularly relevant for attracting foreign direct investment flows, the biggest component of total flows in Latin America since the mid-nineties (see adjoining chart), and which, since the end of the decade, have fallen to less than half the total to scarcely \$30 billion (the estimate for 2003).



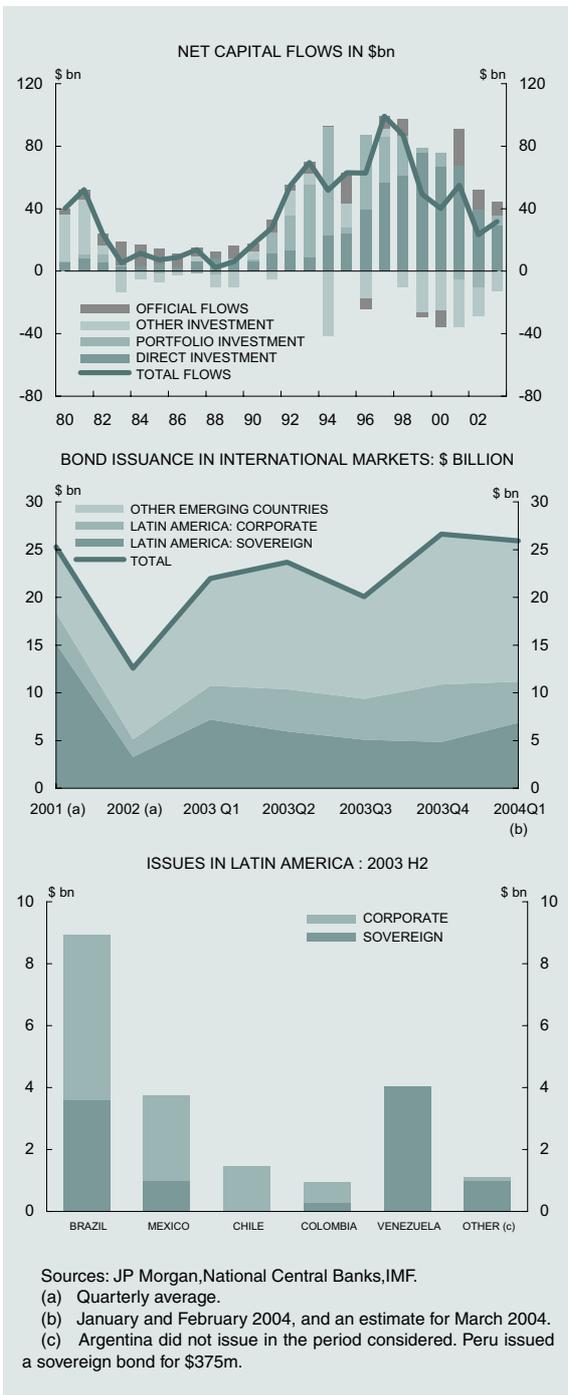
Source: IMF.

The two panels in the accompanying chart depict the relationship between the push factors identified and private capital flows to Latin America since the eighties. In the strong fall-off in flows between 1998 and 2002, the business cycle and risk-aversion (measured by the yield spread between US junk bonds and Treasury bonds) and the growing US external deficit would have performed as expected. The pull factors have also played a relevant role, as inferred by the sharper fall in flows in Latin America than in other emerging regions. This is possibly related to investors' worsening perception of legal security and institutional stability, in the wake above all of the events in Argentina in recent years. Other pull factors bearing adversely on capital flows, such as economic volatility, economic stagnation and also stalling reforms, have a sizable endogenous component, since the fall-off in flows has prompted a strong economic adjustment and has hindered sustaining the pace of reform.

The pick-up in private capital flows in 2003 may likewise be interpreted as the reversal of most of the foregoing factors, at the same time as ample global liquidity conditions remained in place. The prolongation of a propitious external environment and the pick-up in growth in the region should contribute to the recovery in flows firming. Nonetheless, even in this favourable scenario, flows will not foreseeably resume the high levels seen in the mid-nineties (\$70 billion on average in the region), since direct investment flows, which underpinned that earlier expansion, are hardly likely to regain their previous momentum. True, there is recent empirical evidence that prior direct investment exerts a carry-over effect on future investment and that, given Latin America's dependence on external financing, the region's countries will strive to retain their attractiveness to foreign investment. But other structural and institutional factors will probably be dominant. First, investors' perception of political risk has increased, which will give rise to greater caution when undertaking investment projects. Further, other investment destinations among the emerging countries, such as China or the central and eastern European countries, have become relatively more attractive in recent times. And finally, given the unpopularity of reforms, governments' appetite for privatisation has also waned. The limited estimates available for 2004 (IMF, IIF) would support this diagnosis, since they point to moderate growth of direct investment flows (between 10% and 30%). This increase would enable capital flows to settle at around \$40 billion this year, but direct investment flows would be far from those seen in the second half of the nineties.

CHART 7

External capital flows



and there has been a slight widening of differentials in 2004 Q1.

Better financing conditions were accompanied by a notable recovery in net capital flows to Latin America. A level of over \$30 billion was attained in 2003, compared with \$23 billion in 2002 (see Chart 7). This pick-up was sharper than in other emerging regions. The breakdown by component of these flows provides, however, a less favourable reading. Approximately one-quarter of net inflows were official flows, largely related to support by multilateral agencies to the economic programmes adopted to tackle the bouts of instability in recent years. Conversely, bank loans - included under the heading of *Other investment* - continued to show net outflows, albeit in more moderate amounts than in previous years. Of greater concern was the fourth consecutive annual reduction in net direct investment flows, which stood slightly below \$30 billion, since their previous high levels had provided capital flows to the region with a basis of stability. Finally, portfolio investment - which includes bond issues and equity investment - posted a net inflow for the first time since 2000.

The availability of external financing was also reflected in an increase in Latin American bond issues on global markets, accounting for almost half the total for emerging economies, a similar proportion to that of the previous year. Gross issues amounted to \$41 billion in 2003, distributed in a relatively uniform manner over the year as a whole (see Chart 7). This figure is almost twice that for 2002 and, though it is notably below that of previous years, it should be borne in mind that Argentina was then a very active player in the primary bond market, from which it is now absent. During the second half of the year, the main issuer was Brazil (\$8.9 billion), although there was a notable \$4 billion issue by Venezuela in relatively good conditions despite its precarious internal situation. The split between sovereign and corporate debt showed a slight predominance of the former (56% of the total), although the proportion of corporate debt increased notably in relation to prior years and, in 2003 Q4, even exceeded sovereign debt. The year 2004 has started with issues - especially of sovereign debt - showing renewed vigour. That has allowed countries such as Chile or Mexico to cover their issuance programme for the entire year, with Brazil having covered more than half of its scheduled issue.

petitive, external positions improved and the adverse effects of the earlier strong adjustment on activity gradually faded.

In any event, the current low levels of spreads make it more difficult for them to continue narrowing. Indeed, following the minimum levels observed in mid-January, the market has started to become more sensitive to bad news

Like the debt markets, stocks in the region performed well, although here most earnings were recorded in the second half of the year (see Chart 8). The Latin-American indices ended the year with rises far above those of the industrialised countries and sharper than those of

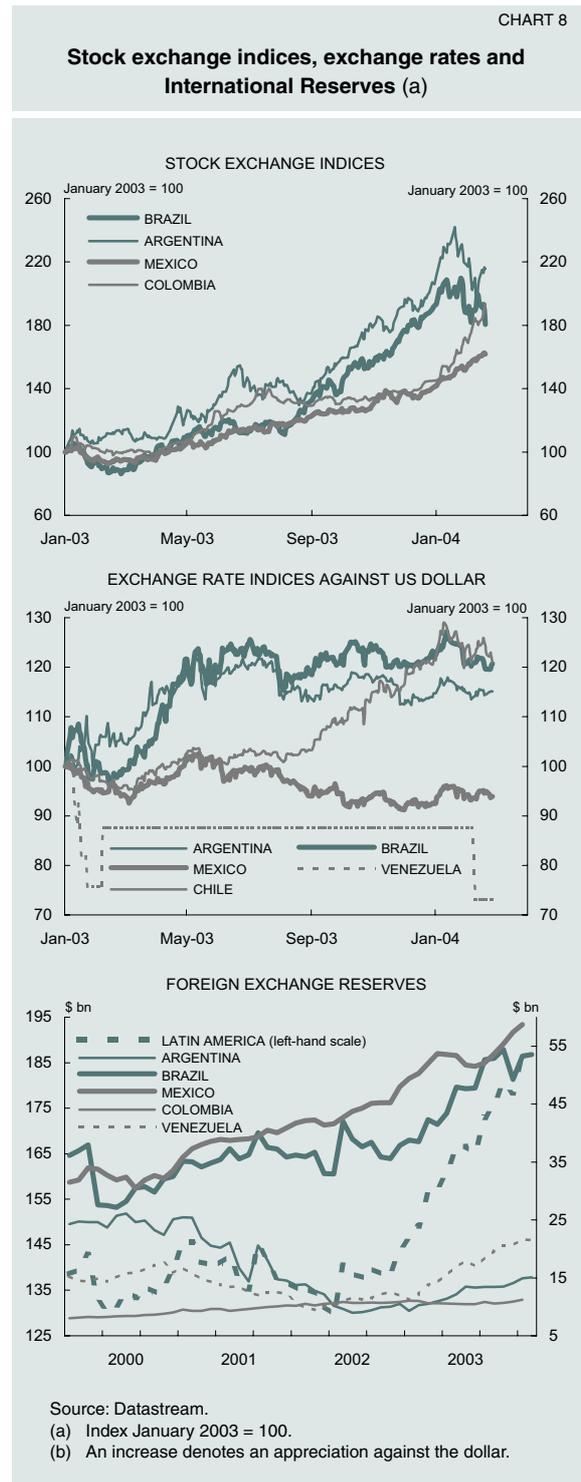
most emerging markets. The rise in the weighted index for the area as a whole was 67.1%, two-thirds of which was in the second half of the year. Most markets saw increases close to or higher than 50%. The indices virtually doubled in Brazil and Peru, and Argentina and Venezuela posted even higher increases (120% and 195%, respectively). Supporting these rises was the return of foreign investors, especially in Brazil (with net foreign inflows of almost \$3 billion) and Chile. However, the rising trend on stock markets has ceased during 2004 Q1 in countries such as Brazil, Chile and Argentina, further to doubts about foreign investors maintaining favourable sentiment towards the region.

2.3. Macroeconomic policies

Greater capital inflows prompted upward pressure on most of the countries' currencies, which was countered by an active intervention and reserves-building policy (see Chart 8). Exchange rates were thus notably stable in the second half of the year, in contrast to the appreciations seen in the first six months. For 2003 as a whole, there was an appreciation across the board against the dollar (8.6% for the regional aggregate), but one which was much more moderate in terms of the nominal effective exchange rate (1.1%) owing to the weakness of the dollar against the rest of the main currencies. Two currencies must be excluded from this general picture: the Chilean peso, which appreciated by 9.8% against the dollar in the second half of the year, making for an annual appreciation of over 20%; and the Mexican peso, which depreciated as from May and hit a low against the dollar in October, ending the year with a depreciation of 5%. Finally, the Venezuelan bolivar was devalued in February, against the backdrop of strict exchange controls.

The increase in foreign reserves (over \$34 billion) was notable in the region as a whole, allowing historical maximum levels to be regained. The countries that benefited most were those that had undergone the biggest erosion during the foreign exchange turbulence of previous years: in Brazil and Argentina, currency reserves climbed by \$4.7 billion and \$10.4 billion, although their levels are still below those reached prior to the Russian crisis. Mexico and Venezuela, meantime, also posted very notable increases (\$8 billion and \$9.3 billion), continuing the rising trend of recent years. Conversely, reserves in Chile and Colombia held stable, reflecting less intervention on the foreign exchange markets.

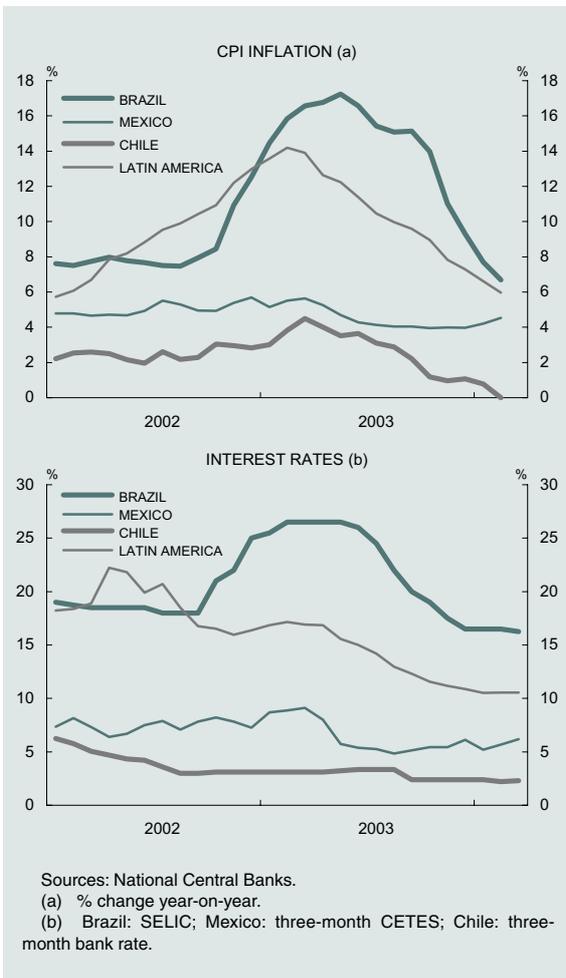
The stability of the exchange rate and the lagged effects of previous appreciations contrib-



uted to inflation continuing to perform favourably in the second half of 2003 (see Chart 9). The year-on-year rate for the region as a whole stood at 8% in Q4, the lowest figure since early 2002. Despite this favourable trajectory, average inflation in 2003 exceeded that of the previous year (11% against 9.1%), one of the highest figures among the emerging regions. Of the countries with direct inflation targets, only Chile and Peru comfortably met theirs. Inflation in

CHART 9

Inflation and interest rates



Mexico stood right at the upper limit of the target range (4%), and Brazil and Colombia exceeded it (9.3% and 6.5%, respectively). There was also a notable downturn in inflation in Argentina which, against all expectations, ended the year with one of the best figures for the region (3.7%). And it has continued to fall in early 2004, despite robust activity. In contrast, Uruguay and Venezuela ended the year with double-digit inflation rates (10.9% and 26.9%, respectively). In the opening months of 2004 inflation has shown greater downward stickiness and has even risen in year-on-year terms in some countries such as Mexico. While results have not been outstanding and targets have been exceeded in a number of cases, the assessment of recent inflation developments in Latin America is relatively favourable if regard is had to the previous exchange rate adjustment most of the countries underwent. The notable ability to cushion the pass-through of previous exchange rate depreciations to final prices - assisted also by greater rigour in combating infla-

tion and by the environment of productive slackness - may have in turn enhanced the reputation of the monetary authorities.

In general, inflation and exchange rate developments allowed interest rates to continue to fall throughout the second half of 2003, albeit at more moderate rates than at the start of the year. Brazil was an exception here, since the downward cycle only began in June but was very intense, meaning that the SELIC rate fell by 10 pp in the period to the end of the year. In Argentina, one-month interbank rates fell to very low levels of around 4.5%, signifying a decline of 11 pp. In Chile easing continued apace in 2004 Q1, which placed rates below 2%, while in Mexico monetary policy was tightened through the raising of the short-term rate in February 2004.

With regard to fiscal policy, the results for the year were favourable (see Chart 10): the declining trend of deficits firmed and primary surpluses were obtained in most countries. The total deficit for the region thus contracted in 2003 to 2.2% of GDP, against 4.9% the previous year. Contributing to this improvement in equal measures were the decline in financing costs and the increase in the primary surplus, which stood at 2.8% of GDP, up 0.6 pp on 2002. The performance of tax revenue contributed to this outcome, albeit to a lesser extent than the previous year, and, moreover, it progressively lost steam as the year unfolded (the increase in nominal terms on 2002 was 13.3%, but year-on-year growth fell to 3.3% in Q4). Tax-raising difficulties in the region are deep-seated and related to the narrow tax base and to the structural problems of tax systems. In these circumstances, certain regionally rooted and unorthodox taxes have been retained and even extended, such as bank debit taxes (see Box 2), which impair the development of the financial system. Some countries ran primary surpluses. This was due in some cases to robust economic expansion (Argentina), but in others to notable expenditure restraint, as in Mexico and Brazil, where spending was cut in real terms. The Brazilian primary surplus (4.3% of GDP) exceeded the IMF programme target, and Mexico drew closer to a balanced budget. Chile was one of the few countries where public finances worsened, a development due to a counter-cyclical fiscal policy. This was in marked contrast to the other countries, which had to keep a tight fiscal stance as they did not have the room for manoeuvre to pursue counter-cyclical measures.

Unlike what usually happened in the past, the greater availability and lower cost of external financing did not translate last year into looser fiscal stances. The greater commitment

Bank debit taxes in Latin America

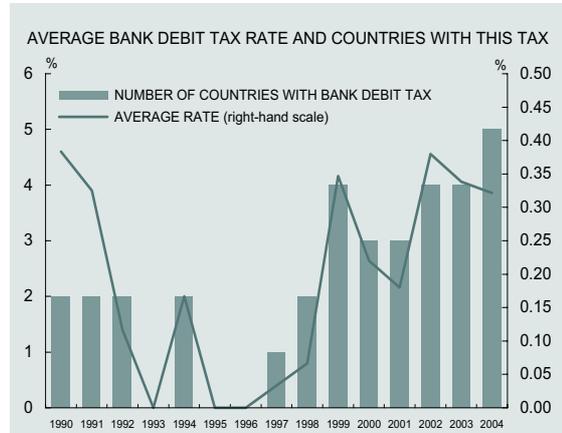
Fiscal difficulties in Latin America in recent years have led to renewed resort to bank debit taxes (BDT)¹. As the accompanying chart shows, a growing number of countries in the region have introduced these taxes, to the extent that currently, among the seven main economies, only Chile and Mexico do not levy them (see adjoining table). Another regularity observed in recent years is that these taxes tend to last and in some cases have even become a quasi-permanent tax, despite the fact the tax authorities usually declare them to be an exceptional measure on introduction, in response to pressing tax-raising needs. The widespread application of these taxes and their durability should be viewed with caution given their adverse effects on financing costs and on financial intermediation, aspects which tend to embed some of the structural problems of the Latin American economies.

BDT chiefly tax the withdrawal of bank deposits and, in certain cases, other financial transactions such as the clearing of cheques, transfers, etc.. BDT are attractive to the tax authorities mainly because of their low administration costs, their high tax-raising potential (due to their broad tax base and the difficulties of evasion) and the ease with which they can be applied, since it is financial institutions that collect them. Moreover, in economic policy terms, one of their advantages is that of scant visibility and the dispersion of those paying them, which discourages the formation of sufficiently organised lobbies opposing them. These features account for the notable resort to BDT in countries with relatively undeveloped tax systems, as is the case in Latin America, where their application has significantly and instantly helped raise short-term tax takings. Thus, in countries in which these taxes were levied in recent years applying a rate of between 0.40% and 0.75% on the total transaction amount, the takings totalled between 1.35% and 1.75% of GDP, which accounts for more than 10% of tax receipts in countries such as Colombia and Venezuela.

However, BDT have high costs. There are problems in that a multistage cumulative tax is involved and that it is not equitable; in addition to not being progressive (a feature shared with *ad valorem* taxes), it is the higher-income agents who can most easily elude BDT. Further, BDT can alter the relative attractiveness of different saving instruments. But their main disadvantage is that they bear on the core of the economy's financial mechanism, namely bank deposits, which adds a distorting element to them that far exceeds their scope of application. The distortion arises both via a price effect and a quantity effect. Regarding the former, there is evidence that depositors pay a large portion of BDT receiving lower interest on their savings, but another portion falls on borrowers, increasing the interest rate on bank credit.² This may also entail higher financing costs for governments, which diminishes the net fiscal impact. As to the quantity effect, BDT: a) promote the use of cash to the detriment of bank deposits, lessening the fiscal authorities' control over the economy; b) heighten the competitive advantage of offshore financial centres or of investment in ADRs; c) encourage the shifting of financial operations to another country; and d) offer an incentive for corporate vertical integration to promote self-financing. As a result of the foregoing the introduction of BDT reduces financial intermediation, a cause for particular concern in Latin America in view of the low prominence of banks in the region. Moreover, given the positive externality exerted by the financial system on economic development, the adverse effects of these taxes in the form of financial disintermediation feed through to the economy as a whole.

Following the inauspicious experience in Argentina and Peru in the early nineties, it has been sought to reduce the harmful effects of BDT in recent years, complementing their application with additional measures. These include certain restrictions on the use of cash to prevent tax avoidance and financial disintermediation. In this way the progressive decline in tax revenue has been successfully tempered, a feature common to the experience of the countries in the region with this type of tax.

To conclude, BDT have been used as a tax-raising vehicle at times of fiscal difficulty. Despite their adverse effects, especially in the long run, BDT have proven relatively more successful when financial intermediation is high, the tax rate low, there is no great tradition of investment in offshore financial assets and there are mechanisms to combat evasion. All such conditions appear to be met, for instance, in Brazil. In any event, from a fiscal perspective it is a relatively inefficient tax and, from an economic viewpoint, it is harmful for the development of the financial system and for the efficient allocation of resources.



Source: Banco de España.
(a) Bank debit taxes

Current BDT in Latin America (a)

	Year of implementation	Current tax rate
Brazil	1997	0.38
Colombia	1999	0.30
Argentina	2001	0.60
Venezuela	2002	0.75
Peru	2004	0.15

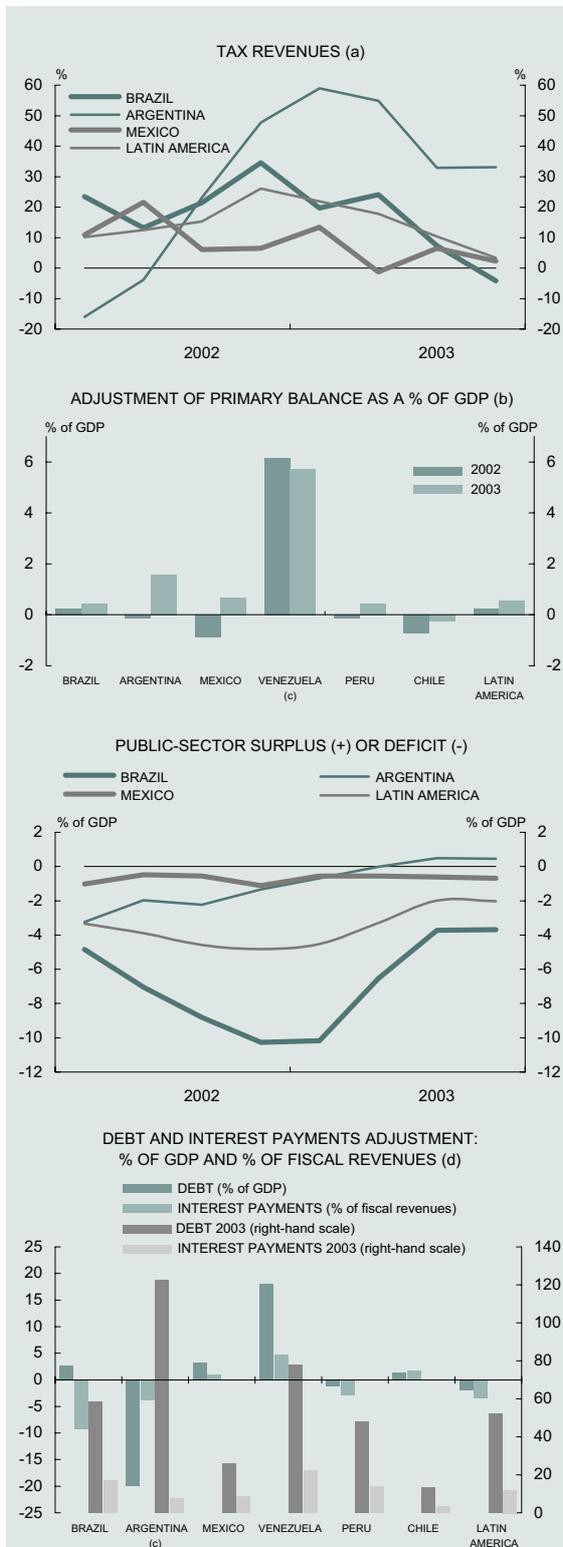
Source: Banco de España.
(a) Bank debit taxes.

(1) This type of tax is a sub-group under the more general heading of taxes on financial transactions (TFT), which also include taxes on securities transactions in the fixed-income and equity markets and taxes on currency operations (Tobin-type taxes).

(2) Albuquerque ("Os Impactos Econômicos da CPMF: Teoria e Evidência", Trabalhos para Discussão n.º 21, Banco Central do Brasil, 2001) calculates that, for Brazil, with a tax rate of 0.38%, the interest rate on credit increases by 2.7 percentage points.

CHART 10

Public sector



Source: National Statistics Offices.
 (a) Year-on-year change.
 (b) Change in primary balance: % GDP 2002Q4 / 2003Q4.
 (c) 2003Q2.
 (d) 2003Q3.

to fiscal discipline seen recently would be behind this change in attitudes, but the persistent vulnerability of public finances also acted as a deterrent. Indeed, although there was success in improving the maturity profile and the structure of debt, and although interest payments as a proportion of revenue declined in 2003 compared with the previous year (see Chart 10), the public debt/GDP ratio increased in most countries. In the region as a whole, the debt ratio rose by almost 4 pp if Argentina - where there was a marked contraction in debt (partly under suspension of payments) - is excluded. This downward stickiness of high public debt levels highlights the need for a prudent fiscal policy stance to be maintained in the coming years.

2.4. Reform and trade integration

After several years of stagnation, or in some cases recession as in Argentina and Venezuela, there was a timid re-launching of the reform process in 2003, albeit unevenly across the region. The vulnerability of public finances placed fiscal reform at the heart of government initiatives, the results of which differed greatly. While in Brazil the reform of the social security system was approved, along with incomplete plans for tax reform, attempts at tax reform in Mexico and Colombia were respectively rejected in parliament and at the polls.

In any event, the focus of the reforms currently reflects notable differences from those pursued in the nineties. Visibly, there is greater emphasis on the social aspects of reform and greater concern for the control of liberalisation processes, along with a tendency to tighten the regulatory framework of privatised services.

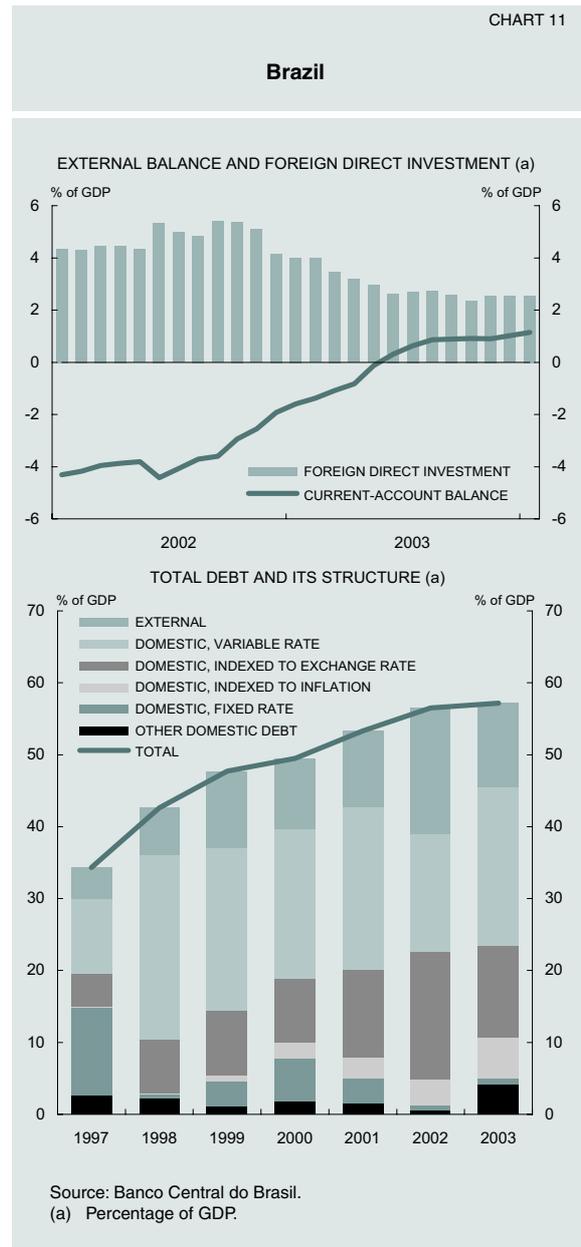
One of the pillars of the structural policies is trade integration, where there were also significant developments during 2003. First, the Mercosur agreement was reactivated. This saw the bolstering of certain initiatives, in particular integration with the Andean community, and the extension of agreements with other countries both within and outside Latin America. Further, negotiations continued on the FTAA (Free Trade Area of the Americas), although there was very limited progress. The stagnation of the process means the entry into force of the agreement on schedule (2005) will be difficult, at least under the previously agreed single undertaking formula. That suggests the FTAA may be set up under a lax framework in which the different countries move forward in the process of integration at different speeds. These obstacles arose in parallel with, and probably even reinforced, the headway in bilateral agreements with the United States. Notable among these were the entry

into force of the agreement with Chile, progress in the negotiation of the CAFTA (Central American Free Trade Agreement) and an interest in entering into agreements with the Andean countries, which benefited from the extension of the preferential tariff arrangements.

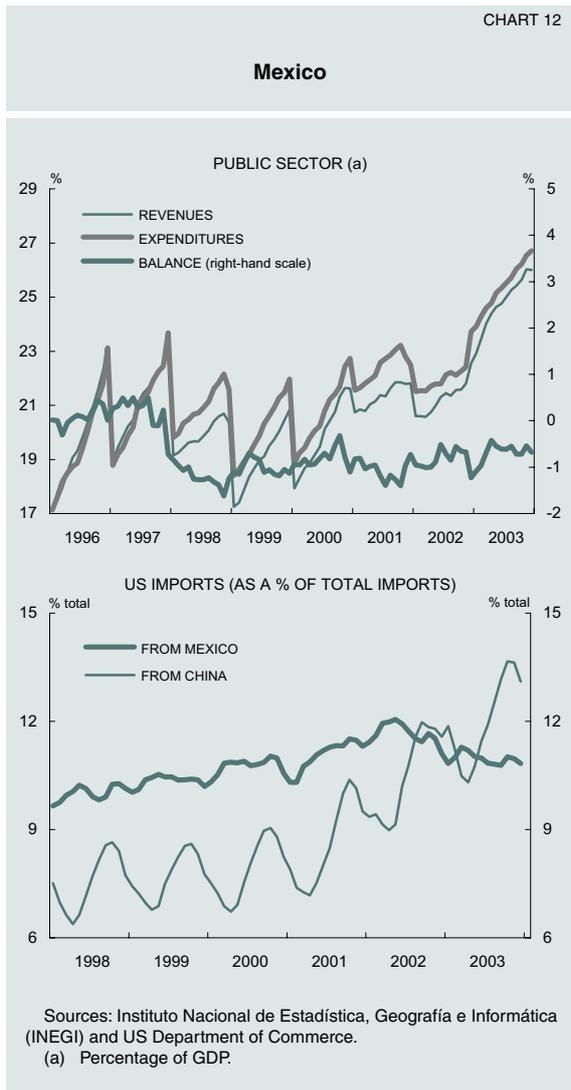
3. DEVELOPMENTS IN THE MAIN COUNTRIES

In *Brazil*, the impact of the adjustment and of economic policy tightening on activity lasted longer than expected. Consequently, Q4 ended with a 0.1% decline in GDP in year-on-year terms, placing growth for the whole of 2003 at -0.2%. That reflects the adverse behaviour of domestic demand, since private consumption shrank by 3.3% due to the reduction in wage income and high unemployment (see Chart 4), and investment declined by 6.6%. Such sluggish activity was not offset by the vigour of the external sector, despite the fact the year closed with a trade surplus of 5.9% of GDP. The momentum of exports, which grew by 22.6% on average in 2003, made for a current surplus of 0.8% of GDP. That offset the reduction in financing flows, particularly foreign investment (-39%), as can be seen in Chart 11.

In respect of demand-side policies there was a sharp easing of monetary policy in the second half of the year, entailing a 10.25 pp cut, down to the current rate of 16.25%. This easing came about in step with the decline in inflation and its associated expectations, which were both assisted by the weakness of demand and the appreciation of the real. Despite this, the December inflation figure was 9.3%, meaning the annual target set (8.5%) was exceeded for the third year running. The downward cycle of rates was interrupted in early 2004, but resumed in March. In the fiscal realm the authorities achieved a primary surplus of 4.3% thanks to the moderation of expenditure, since tax revenue underwent a real decline of 2%. Despite fiscal discipline and the appreciation of the real, a high interest burden and scant nominal growth led to a rise in the public debt ratio (see Chart 11) from 55.5% to 58.2% of GDP. Further, the authorities achieved their aim of reducing the weight of dollar-indexed debt. The financial markets continued to trend favourably in the second half of the year, which resulted in a marked reduction in risk premia and a notable increase in bond issues, which reached record figures in January. That said, spreads rebounded moderately as from mid-January. The progress in structural reforms was also positive since, despite difficulties, the definitive approval of the social security reform and of the first stage of the tax reform was achieved.



In *Mexico*, a pick-up was finally seen in 2003 Q4, enabling a year-on-year GDP growth rate of 2%. Annual growth for 2003 was thus 1.3%. During the second half of the year the contribution of domestic demand outpaced that of external demand (see Chart 3). Among the domestic demand components, consumption and investment in construction exhibited the best results, while investment in capital goods remained weak. The recovery was accompanied by a favourable turnaround in manufacturing output and in non-oil exports, a somewhat delayed response to the pick-up in US industrial output (see Chart 12). Nonetheless, the share of Mexican products in US imports declined further, which prompted intense debate on Mexico's loss of competitiveness against the emerging Asian economies, in particular China. In any



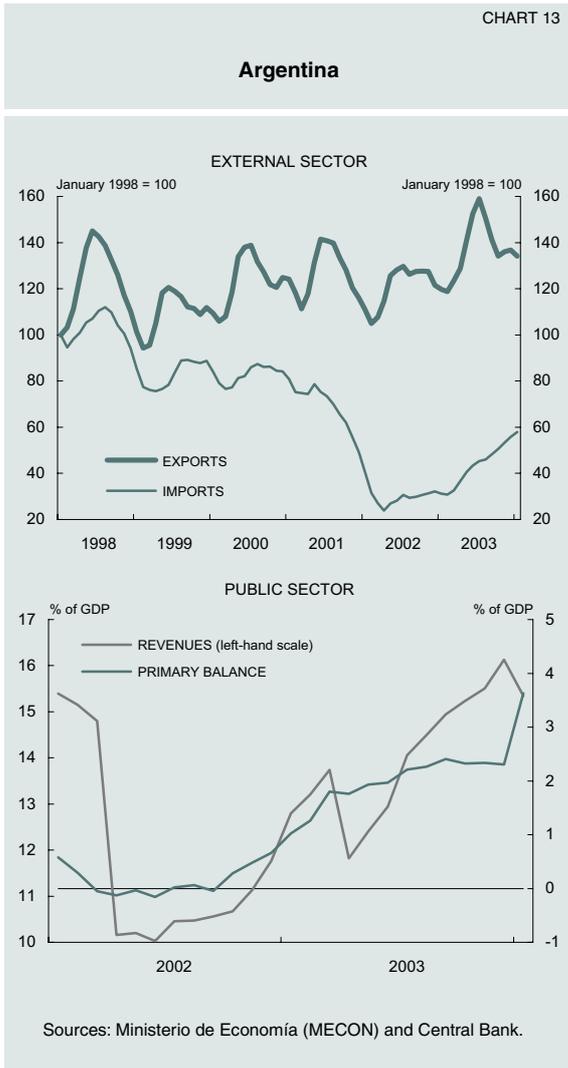
event, compared with the previous year the current-account deficit narrowed by 0.7 pp to 1.5% of GDP, thanks partly to the rise in emigrants' remittances, which increased by 35.2% in annual terms to somewhat over \$13 billion.

Turning to prices, annual inflation at the close of 2003 was at the upper limit of the target range adopted by the Mexican central bank. However, much of the reduction in inflation was due to transitory components, since underlying inflation rose slightly. Since early 2004 the increase in non-core inflation, along with the greater resilience of the recovery and wage behaviour, led the central bank to tighten monetary policy in mid-February and March, after having held it unchanged for most of the previous year. On the financial markets both equity and bonds performed favourably, placing their prices at an all-time high in early 2004. Both general government and, above all, the corporate sector took advantage of this favourable environment to raise \$2.3 billion on the debt markets. The Mexi-

can peso, for its part, exhibited marked volatility during the second half of the year. In November it hit a low for the year (entailing a depreciation of 9% on end-2002), but picked up thereafter. On the fiscal front the figures were favourable, and public finances posted their best result since 1996 (a deficit of 0.7% of GDP). However, the fiscal and energy reforms were at an impasse in the second half of the year.

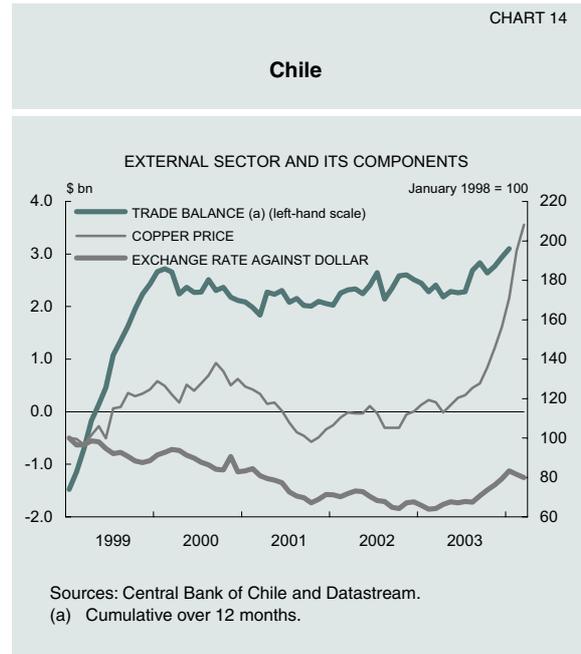
The recovery in activity in *Argentina* gained fresh momentum in the second half of 2003, and this would have run into 2004 on the latest data. Year-on-year growth was 11.3% in Q4, while the year ended with a GDP increase of 8.7% in relation to 2002. Growth continued to be domestic demand-led, and both private consumption and investment sustained notable growth in Q4 (11.8% and 48.7%, respectively). In step with this momentum, imports were very robust (52%), though they are still far removed from pre-crisis levels (see Chart 13). Meanwhile exports slowed (7.4%), meaning the net contribution of the external sector to growth was -2.4 pp of GDP. The trade surplus for the year was 12% of GDP and the current-account balance was 7.5% of GDP, although both turned down in the second half of the year. The fiscal performance, underpinned by the favourable course of tax revenue (40% in the year), complied with the targets agreed upon with the IMF, although the surplus revenue at the end of the year was partly earmarked for restoring wage income in the public sector (see Chart 13). The general government primary surplus stood at 3% and the total surplus at 0.5%, although regard should be had when assessing these favourable fiscal results to the fact that much of public debt is in default status. Buoyant production in several industries and the freeze on credit meant that economic expansion did not feed through to prices, which held stable in the second half of the year and ended 2003 having increased by 2.7%. This provided for the continuing downward trend in interest rates, in step with the vigorous expansion of the monetary base, although the yield curve assumed a marked positive slope. The monetary expansion was supported by the replenishment of reserves, while the exchange rate held very stable throughout the second half of the year.

The performance of the rest of Argentina's financial markets was uneven. The stock market trended favourably and the Merval index posted earnings exceeding 40% in the second half of the year. By contrast, the sovereign spread included in the EMBI stood at a higher level than that of the previous six months owing to the announced rescheduling of debt in September, which established a partial acquaintance of 75%. Although after some setbacks the IMF



approved the first two revisions of the agreement reached in September, the international community's relations with Argentina remain difficult, mainly because of problems tied to the foreign debt rescheduling process.

The growth rate in Chile also rose slightly in the closing months of 2003 following a period of lower growth in Q2 and Q3. The year-on-year rate in Q4 was 3.3%, meaning the economy also grew by 3.3% in relation to 2002. This acceleration came about due to the greater momentum of consumption, while investment was somewhat lacklustre. Despite the recent increase in imports and the recent exchange rate appreciation, the rise in export prices, especially in mining items, meant there was a record trade surplus of almost \$3 billion (see Chart 14). Given the absence of price pressures (inflation stood at 0% in February 2004) and the favourable course of the exchange rate, the central bank cut its official interest rate by 1 pp to a historical low of 1.75%. In sum, the combination of a brighter external environment and a favoura-



ble series of domestic factors (improved confidence indicators, the favourable trend of employment and real income gains) points to buoyant activity foreseeably taking root in 2004.

Activity in *Colombia* regained momentum during the second half of the year. GDP growth in Q4, which rose to 4.3% year-on-year, dispelled the uncertainty derived from the slowdown experienced at the end of the previous six-month period. Annual growth thereby climbed to 3.7%, the highest rate since 1995. Construction, one of the most buoyant sectors in recent years, and mining were the driving force behind this pick-up. The effects on the labour market were appreciable: the unemployment rate dipped to 14.1%, a similar rate to that of 1997, while the rate of job destruction diminished. Inflation stood at 6.5%, 0.5 pp up on the central bank's upper target limit, but substantially below the figure forecast in early 2003. Underpinning this performance was, among other factors, the appreciation of the Colombian peso. Against this background, the central bank cut its interest rate to 6.75% in February 2004, intervening actively on the foreign exchange markets to check the appreciation of the peso. The increase in commodity prices and the narrowing of sovereign debt spreads made for a sustainable external position, although the current-account deficit widened to 2.7% of GDP. The fiscal imbalance, by contrast, improved in relation to the previous year (2.9% on provisional estimates, against 3.9% in 2002), although the target initially agreed with the IMF was once again exceeded. Also notable in connection with the fiscal realm was the non-approval of the referendum on tax reform (and on

other policies), which made the adoption of alternative adjustment measures necessary.

In *Venezuela*, activity during Q4 rebounded significantly in relation to the previous quarters, with GDP growth of 9% year-on-year. Even so, GDP in 2003 as a whole shrank by 9.2%, the worst recession recorded in the country's history, owing to the effects of the general strike in late 2002, the grinding to a halt of the oil industry and the introduction of exchange controls. The impetus to activity was from external demand, assisted by a rise in oil prices on international markets. Despite strict price controls being set in place, inflation held at a rate of over 20%. The central government accounts recorded a favourable result in 2003 Q3. By contrast, monetary policy management was hampered by the delays in currency delivery to importers and the confrontation between the Venezuelan central bank and the Government, brought on by the latter requesting the transfer of a portion of the country's reserves to finance agricultural projects. In February the official exchange rate was devalued by 16.6%, although the new rate is still higher than that prevailing on the parallel market. Despite persistent political uncertainty, the country's improved economic outlook and its sustainable external position allowed access to international debt markets, where over \$5 billion were placed between the second half of 2003 and 2004 Q1.

Peru grew at a satisfactory rate during 2003, prolonging an expansion that has lasted for 22 months despite its recurring domestic political problems. Nonetheless, in the last six months of the year activity slowed to a growth rate of around 3%, prompted by the moderation of private consumption growth. Inflation ended the year at 2.5% (the target set by the central bank), providing for a continuing downward interest rate path. Despite setbacks in the approval of several tax regulations, public finances at the end of 2003 showed a primary surplus of 0.2%, and the debt ratio stabilised at below 47%.

In *Uruguay*, growth of 15.7% was posted in 2003 Q4, driven by the pick-up in both domestic demand and external demand. As a result, annual growth rose to 2.5%, far higher than expected. Inflation continued on a downward path and ended the year at 10.2%. Financial variables improved thanks to the favourable external setting and a stable domestic environment. The spread on sovereign debt thus narrowed to around 600 bp, while peso deposits grew by 30% over the six-month period. *Ecuador* has recently benefited from a sovereign upgrade, although the growth of its economy slowed. Conversely, there was a serious political crisis in October in *Bolivia*, and banking problems persist in the which has led to successive sovereign downgrades.

24.3.2004.