Introduction

The pace of growth in Latin America continued to ease very gradually in 2005 Q4, and the year-on-year rate stood at 3.8%, almost 1.5 pp down on that attained mid-year. Over the year as a whole, GDP increased by 4.3%, marking a notable slowdown on the exceptional performance the previous year (5.8%). Nonetheless, the aggregate of the eight main countries somewhat distorts the overall assessment, since the two biggest economies (Brazil and Mexico, which jointly account for close to 60% of the region's GDP) were those that posted a lower growth rate, as can be seen in Chart 1. In this respect it should be stressed that, in addition to the two countries mentioned, only Venezuela and Uruguay – which grew at double-digit rates in 2004 – saw their growth rate fall during the year, while the other four countries posted growth equal to or higher than that of the previous year, with a persisting high rate of activity in Argentina. Another noteworthy factor in this growth ranking is the momentum entailed in recent years by the improvement in the terms of trade, which continues to operate. Indeed, as can be seen in the right-hand panel of Chart 1, Brazil and Mexico were two of the economies that benefited relatively less from this stimulus and those that least grew in average terms over the past three years. That said, other factors, such as the adjustment prompted by the previous crisis and the subsequent rebound, as in Argentina, also had a significant effect on economic developments in this period in some countries.

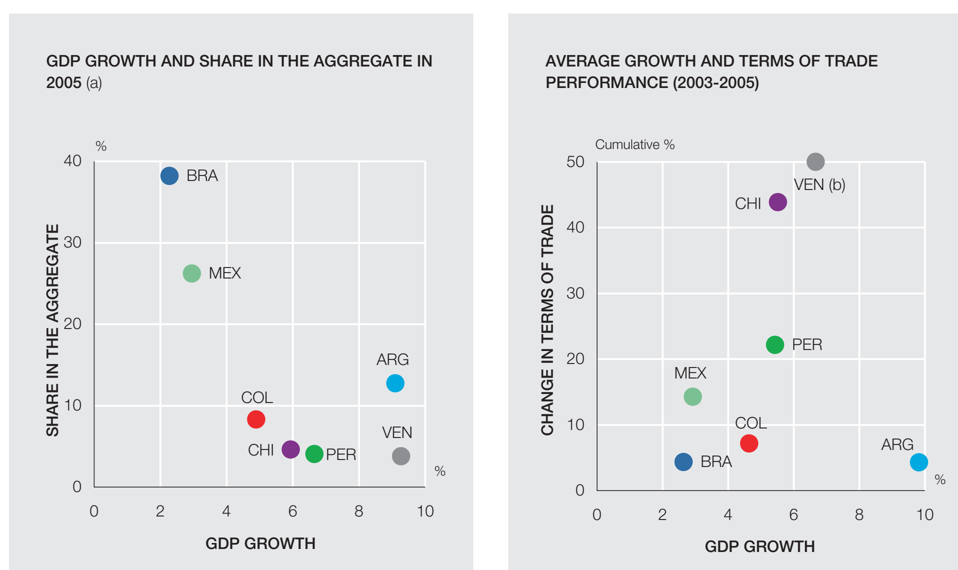
Activity during the second half of 2005 was underpinned by the firming of domestic demand, based on the sound performance of the labour market. Notwithstanding, inflation (underlying inflation in particular) continued on a downward path and enabled all the main countries with direct inflation targets to meet their end-year goals, in contrast to what happened in 2004. Public finances also performed satisfactorily, as the primary surplus widened and the total budget deficit stabilised at a rate not far off budgetary equilibrium in the area as a whole. The negative contribution of external demand to GDP growth gradually increased, despite the performance of exports remaining very positive.

Financial markets continued to perform very favourably in the second half of the year. There were strong gains on stock exchanges and a notable narrowing of sovereign yields, with these trends running into early 2006. The Latin American region outperformed other emerging regions, and a contributing factor here was the perception that some of the traditional sources of financial instability in the area are gradually abating as local markets gain in depth, as less resort is made to external financing and as the characteristics of public debt improve, through a very active management thereof. Net capital inflows were relatively scant in 2005 as a whole (compared with a slightly negative outstanding balance in 2004), but this was due to the fact that the notable increase in private flows was partly countered by a significant contraction in official flows. This reduction was attributable to the region's improved economic situation, but a key determinant was the early cancellation of the IMF loans by the Fund's two principal debtors, Brazil and Argentina. This repayment meant that, for the first time in many years, Latin America ceased to be the main recipient of the Fund's financial resources.

The outlook for the coming quarters remains positive, but not free from risks. Domestic demand is upheld by the high level of agents' confidence in a low-inflation environment (except in Argentina and Venezuela). In this setting, the favourable effects of the downward cycle of interest rates initiated in 2005 Q3 in the two main countries, Brazil and Mexico, should contribute to giving an additional boost to domestic demand, providing for a pick-up in activity in the area as a whole and greater convergence among growth rates. Further momentum might be

GDP GROWTH
Year-on-year change and percentage

CHART 1



SOURCES: National Statistics Offices and IMF

a. Share in Latin American aggregate based on PPP GDP.
b. Terms of trade in Venezuela increased by 90%

induced by a greater fiscal stimulus, typically associated with electoral phases, in which several countries remain immersed. However, this characteristic has been less marked than in past electoral episodes. Over the longer term, these favourable features should not mean the stagnation of reforms over the past year is forgotten.

Although there are no clouds on the horizon in Latin America in the short term, it should be stressed that the maintenance of favourable global financial conditions cannot be taken for granted. The persistence of a benign external environment has been pivotal in recent years for the firming of recovery in the area. The global economy has assimilated better than expected the adverse effects of dearer energy prices and the tightening of monetary conditions in the United States, but it is not proving capable of making headway in the correction of global imbalances, which became even deeper-rooted in 2005. The recent shift in the monetary policy stance in the euro area and Japan might have consequences through at least two interrelated channels: first, there might be some reduction in the hitherto abundant global liquidity in 2006 derived from the rise in interest rates in these economies; and second, the narrowing of their interest-rate spreads vis-à-vis the United States might impact the dollar and the perception of global risks, insofar as investors might refocus on the growing imbalances in the US economy. Both factors might prompt a more conservative attitude on the part of agents. And this, given how closely adjusted valuations in emerging markets are, might entail a reversal or, at least, some deterioration in the favourable conditions they have enjoyed in recent years.

Economic and financial developments

EXTERNAL ENVIRONMENT

International economic and financial developments (see Chart 2) remained very favourable for emerging markets, in particular for Latin America, for the third year running. The growth of the world economy showed clear signs of dynamism, both in the second half of 2005 and in early 2006, accompanied by the spread of such buoyancy to a broader group of countries that had been lagging in recent years, such as the euro area and Japan. The extension of favourable growth expectations might have a notable impact on global liquidity conditions. In this respect,

GLOBAL MACROECONOMIC AND FINANCIAL INDICATORS

CHART 2

Year-on-year changes, percentages, basis points and indices

SOURCES: Bureau of Economic Analysis, Eurostat, Bloomberg and JP Morgan.

a. 2005Q4: estimate.
b. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore and Taiwan. Latest figure without Thailand.
c. MSCI index, in US dollars.
d. US B1 rated corporate bond.
e. Implied volatility of options traded in the CBOE, multiplied by 10.

monetary policies in both Japan and in the euro area are moving into a moderately tightening phase. In the first instance, this made for a change in monetary policy in March, which will entail the abandonment of zero interest rates in the medium term. Further, short-term interest rates in the United States continued to rise gradually, and were up to 4.75% in March (an increase of 1.25 pp since September); and expectations about the end of the upward cycle were progressively postponed, although they continue to be considered close in time. The persistence of a positive spread in interest rates between the United States and the rest of the developed countries was a determining factor of the course of the dollar, which appreciated in nominal effective terms during 2005 as a whole, although this overall result masks widely differing trajectories. Against the currencies of the emerging economies the dollar tended to depreciate, and against those of the industrialised countries it appreciated, although it stabilised against the euro in the second half of the year.

Despite these monetary policy developments, long-term interest rates, which directly influence the cost of financing in dollars on the emerging markets, did not change significantly until March this year, when they rose across the board, although this increase was less than 0.5 pp in the United States. The perception that inflationary pressures would be contained globally in the medium term, despite the persistent rise in energy prices, and other circumstantial factors – such as the demand of institutional investors, the recycling of petrodollars and the build-up of reserves in Asia – are what would explain this insensitivity of long-term interest rates to short-term monetary and economic developments and the resulting anomalous behaviour of the yield curve in the United States, which showed negative slopes in certain segments. This favourable perception tended to strengthen investor confidence, to the extent that the developed stock markets ended 2005 and started 2006 with notable rises. Last year was much more favourable in Europe (gains of around 20%) and, above all, in Japan (40%) than in the United States, where gains were confined to 3% in the case of the Dow Jones index.

In these circumstances the emerging markets continued to perform exceptionally, especially in Europe and Latin America. This was underscored by the forceful narrowing of sovereign yields, which have continued diverging from the yields on private junk bonds in the United States (which are considered a sound indicator of the predisposition to risk on markets), with which they had traditionally run in parallel. Such divergences would be attributable to the greater attractiveness of emerging markets, due in the cases of Asia and Eastern Europe to the prospect of continuing strong growth and, in Latin America's case, to the marked reduction in financial vulnerability in recent years. The EMBI spread narrowed by 32 bp in 2005 Q4 and by a further 39 bp in Q1, taking it to 191 bp at end-February; in March, however, it rebounded slightly as a result of the correction in long-term rates in the developed countries. This figure marked a historical low, which was also attained in many Eastern European and Latin American countries, while the behaviour in Asia was somewhat less exceptional. The index of emerging stock markets rose by somewhat over 50% in 2005 (although the rise was more limited on the Asian stock exchanges) and continued to post gains at a sound rate in the opening months of this year.

ECONOMIC ACTIVITY AND DEMAND

During the second half of 2005, regional growth held stable at a moderate rate, following the strong expansion the previous year. Year-on-year growth in the eight main economies as a whole stood at 3.8%, in both 2005 Q3 and 2005 Q4 (see Chart 2 and Table 1), compared with an average rate of 4.5% in the first half of the year and some way below the growth of 5.8% for Latin America in 2004. Nonetheless, as can be seen in Chart 3, the quarter-on-quarter rates reflect the stability of the growth rate in the second half of the year, with an average figure of 0.8%, compared with 0.7% in the first six months. Some higher frequency indicators, such as industrial output or retail sales, which are reflected in Chart 4, held on a moderate path to the end of the year and into the beginning of 2006. That would point to a potential further slowdown in activity, especially in domestic demand. However, the improvement in consumer confidence and other factors would be conducive to activity holding up in the coming quarters, as indicated elsewhere in this report.

Notable among the countries in the area (see Chart 3) was the ongoing robust growth in Argentina and Venezuela following four and three years, respectively, of close to double-figures increases in output, as well as in Peru and Chile, where the growth rate quickened once more in Q4, and in Colombia, where activity was also very buoyant in recent quarters. A common denominator in several of these economies is the notably favourable impact of changes in the terms of trade (see Chart 1). Conversely, the growth rates in Mexico and Brazil have eased off notably, although there was something of a pick-up in the latter economy in the final quarter, following a negative quarter-on-quarter growth rate in Q3.

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

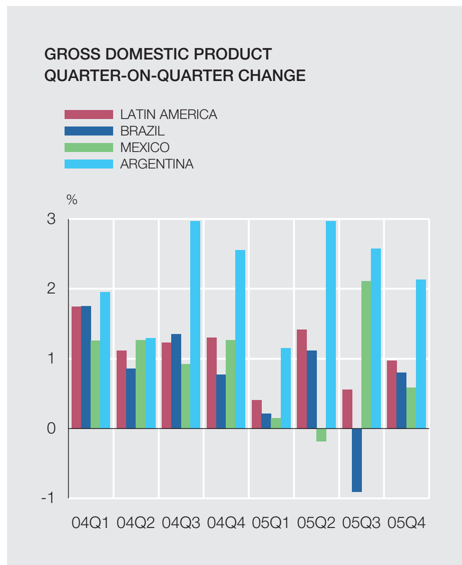
	2003	2004	2005	2004				2005			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q2
GDP (year-on-year change)											
Latin America (a)	2.1	5.9	4.3 (b)	6.0	5.2	5.9	5.8	3.9	5.2	3.8	3.8 (b)
Argentina	8.8	9.0	9.2	11.3	7.1	8.7	9.3	8.0	10.4	9.2	9.1
Brazil	0.5	5.0	2.3	4.1	5.1	5.9	4.8	2.7	3.9	1.0	1.4
Mexico	1.4	4.4	3.0	3.6	3.7	4.5	4.8	2.4	3.3	3.4	2.7
Chile	3.3	6.1	6.4	4.7	5.3	7.0	7.3	6.6	7.2	5.8	5.8
Colombia	4.0	4.2	5.2 (b)	3.5	4.5	2.9	5.4	4.0	6.2	5.6	3.8 (b)
Venezuela	-7.7	17.9	9.3	35.0	14.3	14.2	12.1	6.6	10.7	9.5	10.2
Peru	3.8	4.8	6.7	4.8	3.2	4.7	6.6	6.4	6.2	6.3	7.7
Uruguay	2.5	12.4	6.6	14.9	12.0	12.6	10.0	6.4	7.7	6.0	6.1
CPI (year-on-year change)											
Latin America (a)	10.9	6.0	6.3	5.6	5.2	6.3	6.5	6.4	6.6	6.0	6.0
Argentina	14.9	4.4	9.6	2.4	4.1	5.4	5.7	8.2	8.8	9.8	11.7
Brazil	14.8	6.6	6.9	6.8	5.5	6.9	7.2	7.4	7.8	6.2	6.1
Mexico	4.6	4.7	4.0	4.3	4.3	4.8	5.3	4.4	4.5	4.0	3.1
Chile	2.8	1.1	3.0	0.0	0.5	1.5	2.3	2.3	2.8	3.3	3.8
Colombia	7.1	5.9	5.1	6.2	5.7	6.0	5.8	5.2	5.0	4.9	5.1
Venezuela	31.4	21.7	16.0	24.0	22.4	21.5	19.5	17.0	16.3	15.3	15.2
Peru	2.3	3.7	1.6	3.0	3.4	4.4	3.8	2.2	1.8	1.2	1.3
Uruguay	19.4	9.2	4.7	9.3	9.2	10.0	8.1	5.6	4.5	3.9	4.8
PUBLIC SECTOR BALANCE (% GDP)											
Latin America (a)	-2.0	-0.6	…	-1.7	-1.0	-0.9	-0.6	-0.6	-0.9	-1.2	…
Argentina	0.4	2.5	1.8	1.1	2.0	2.7	2.5	1.2	1.5	1.2	1.8
Brazil	-3.6	-2.5	-3.1	-3.3	-4.0	-2.8	-2.5	-2.4	-2.1	-2.4	-3.1
Mexico	-0.7	-0.3	-0.1	-0.4	-0.7	-0.2	-0.3	-0.5	-0.5	0.0	-0.1
Chile	-1.4	2.2	4.8	-0.6	0.8	1.6	2.2	3.1	3.9	4.5	4.8
Colombia	-2.6	-0.6	…	-2.3	-0.7	0.3	-0.6	0.0	0.1	…	…
Venezuela	-4.3	-1.9	0.2	…	…	…	…	…	…	…	…
Peru	-1.8	-1.3	-0.6	-1.5	-1.0	-1.1	-1.3	-1.1	-0.5	-0.3	-0.6
Uruguay	-4.6	-2.5	-1.6	-3.9	-2.0	-2.4	-2.5	-2.1	-2.2	-1.9	-1.6
PUBLIC SECTOR DEBT (% GDP)											
Latin America (a)	54.4	50.9	…	53.6	50.1	50.8	50.2	50.5			…
Argentina	141.0	119.9	…	133.0	111.0	120.7	120.2	121.6	66.2	…	…
Brazil	57.2	51.7	51.9	55.6	54.2	52.0	51.7	51.3	51.4	51.5	51.9
Mexico	24.7	23.3	20.8	23.5	23.8	23.2	21.6	22.7	21.6	22.6	20.8
Chile	13.3	10.9	…	13.4	12.0	12.0	10.4	10.3	8.9	7.5	…
Colombia	50.9	47.5	…	48.7	47.5	46.4	43.8	47.1	45.1	41.1	…
Venezuela	56.9	53.5	48.7	43.1	45.1	49.8	53.5	47.6	49.2	50.4	48.7
Peru	47.7	45.0	37.2	45.8	40.2	42.6	42.3	41.9	36.0	38.1	37.2
Uruguay	108.3	100.8	…	94.6	96.0	101.5	118.6	99.4	102.1	103.8	…
CURRENT ACCOUNT BALANCE (% GDP)											
Latin America (a)	0.8	1.2	…	1.1	1.2	1.2	1.2	1.2	1.5	1.4	…
Argentina	6.1	2.2	…	4.6	3.1	2.7	2.1	1.8	1.5	2.3	…
Brazil	0.8	1.9	1.8	1.0	1.5	1.7	1.8	1.9	1.7	1.6	1.8
Mexico	-1.5	-1.1	-0.7	-1.2	-0.9	-0.8	-1.0	-1.2	-1.1	-1.0	-0.7
Chile	-1.5	1.5	…	-0.5	0.9	1.2	1.5	1.1	0.7	-0.2	…
Colombia	-1.7	-1.0	…	1.2	-1.3	-1.2	-1.0	-0.7	-0.6	-1.5	…
Venezuela	13.4	13.7	22.4	15.9	14.3	13.6	13.7	14.4	16.9	20.4	22.4
Peru	-1.7	0.0	1.3	-1.1	-0.8	-0.2	0.0	0.2	0.7	0.9	1.3
Uruguay	0.5	-0.8	…	-0.2	-0.2	-0.6	-0.8	-1.1	-1.0	-1.5	…
EXTERNAL DEBT (% GDP)											
Latin America (a)	46.7	42.7	…	45.3	42.2	43.4	40.6	39.6	30.4	28.9	…
Argentina	119.8	112.3	…	121.4	101.4	110.8	107.4	107.5	62.2	62.4	…
Brazil	40.1	33.3	…	38.7	37.9	35.3	31.7	29.8	25.5	22.6	…
Mexico	22.1	20.5	15.4	21.2	21.5	21.5	19.1	19.9	17.6	17.3	15.4
Chile	54.8	46.7	34.6	47.9	46.1	48.0	43.6	42.8	40.5	39.7	34.6
Colombia	44.9	41.3	…	42.6	41.2	38.7	36.3	34.3	31.2	28.0	…
Venezuela	48.3	44.1	41.2	39.5	42.0	41.6	43.4	36.9	40.1	39.5	41.2
Peru	48.3	45.3	35.7	47.2	42.1	43.7	42.5	42.4	36.3	36.7	35.7
Uruguay	98.0	87.6	…	85.3	81.9	85.6	87.6	84.5	84.8	84.7	…

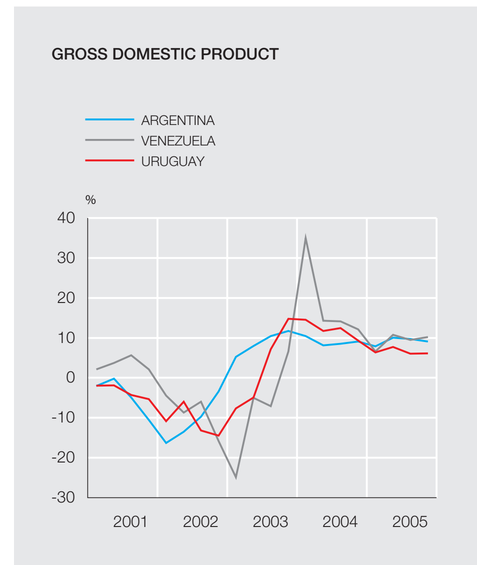
SOURCES: IMF, Banco de España and national statistics.

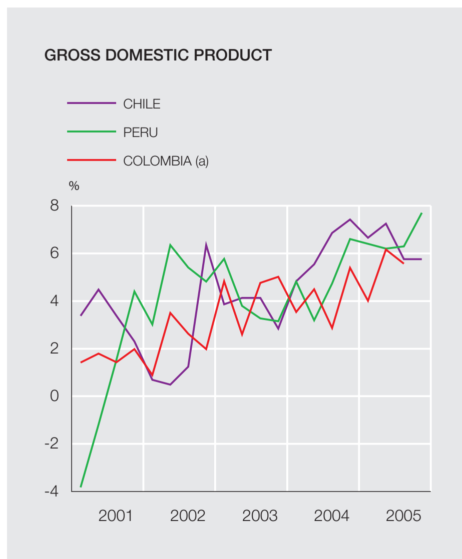
a. Aggregate of the eight represented countries.
b. Estimation.

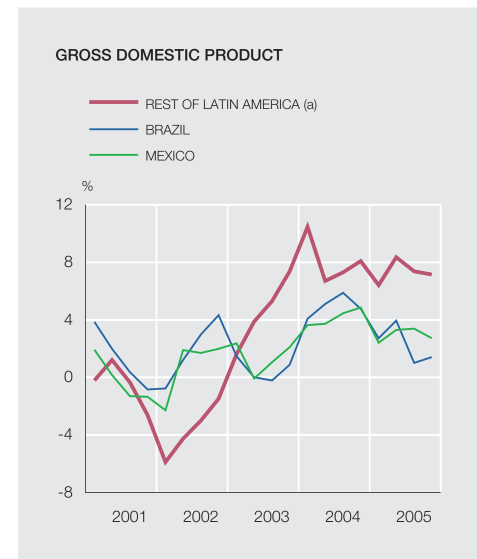
GDP IN LATIN AMERICA
Year-on-year change, unless otherwise indicated

CHART 3









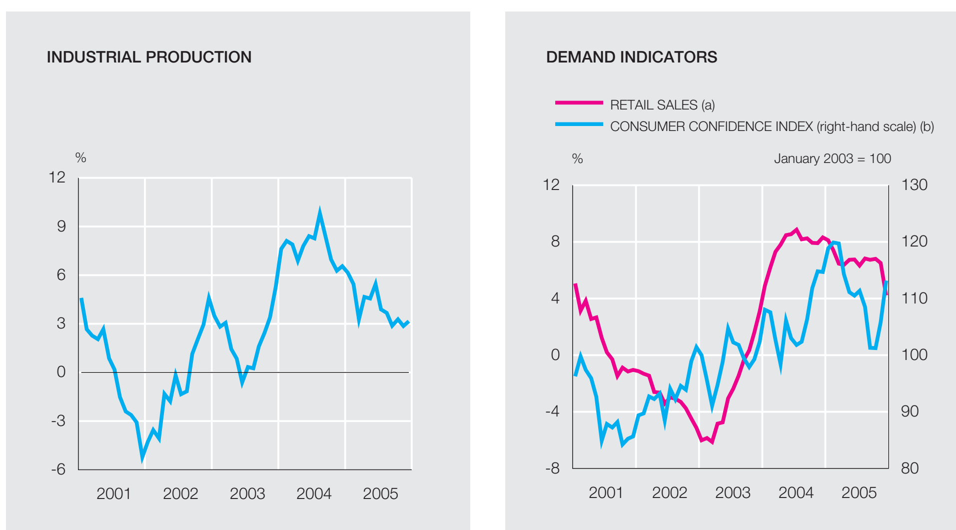
SOURCE: National Statistics.

a. 2005Q4: estimate

Domestic demand remained strongly buoyant in most countries (Brazil being the main exception), and contributed around 5 pp to growth in the last two quarters of the year (see Chart 5), in line with the first half of 2005. Private consumption remained robust, and picked up in Mexico. The real and financial factors upholding this dynamism recently continued to operate. The sound behaviour, in general, of labour markets (see Chart 6) was an important factor, given the improvement in labour income and the underpinning provided to consumer confidence. Unemployment declined in all the countries and the aggregate unemployment rate – which should be viewed with caution given the heterogeneity of measures from country to country – fell gradually during the year, marking a decline of 1 pp (to 7%) compared with 2004. The pace of employment creation stabilised in the area as a whole during the year, with an increase of 3.7% recorded in relation to 2004. Notable here was the increase in Mexico, at over 4%, and the slowdown in Brazil in the second half of the year. On the positive side, these developments contributed to reducing the proportion of informal employment. Real wage income trended

SUPPLY AND DEMAND
Year-on-year change and level

CHART 4

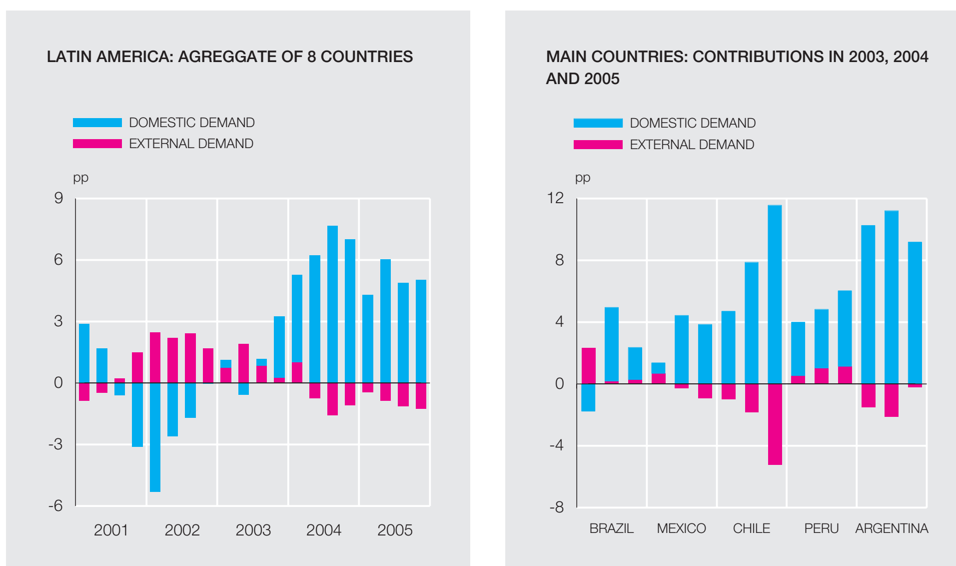


SOURCES: National statistics office.

a. Seven biggest economies, excluding Peru.
b. Argentina, Brazil, Mexico, Chile and Peru.

CONTRIBUTIONS TO GDP GROWTH
Percentage points

CHART 5



SOURCES: National statistics.

somewhat more moderately than in previous years (gains of over 2% were posted), with the exception of Argentina and Venezuela, where growth was 10% and 17%, respectively. Investment also performed favourably, with growth of around 6.4% in 2005 in relation to the previous year; the only notable exception was Brazil, where investment scarcely grew. Nonetheless, the downward interest rate cycle that began in the second half of the year in the region's two biggest countries should see the strength of investment take root and, in particular, a recovery in Brazil, along with a further boost to credit to the private sector, the growth of which quickened in the second half to a real rate of close to 17% at the close of the year in the area as a whole.

LABOUR MARKET
Indices and year-on-year changes

CHART 6

SOURCE: National statistics.

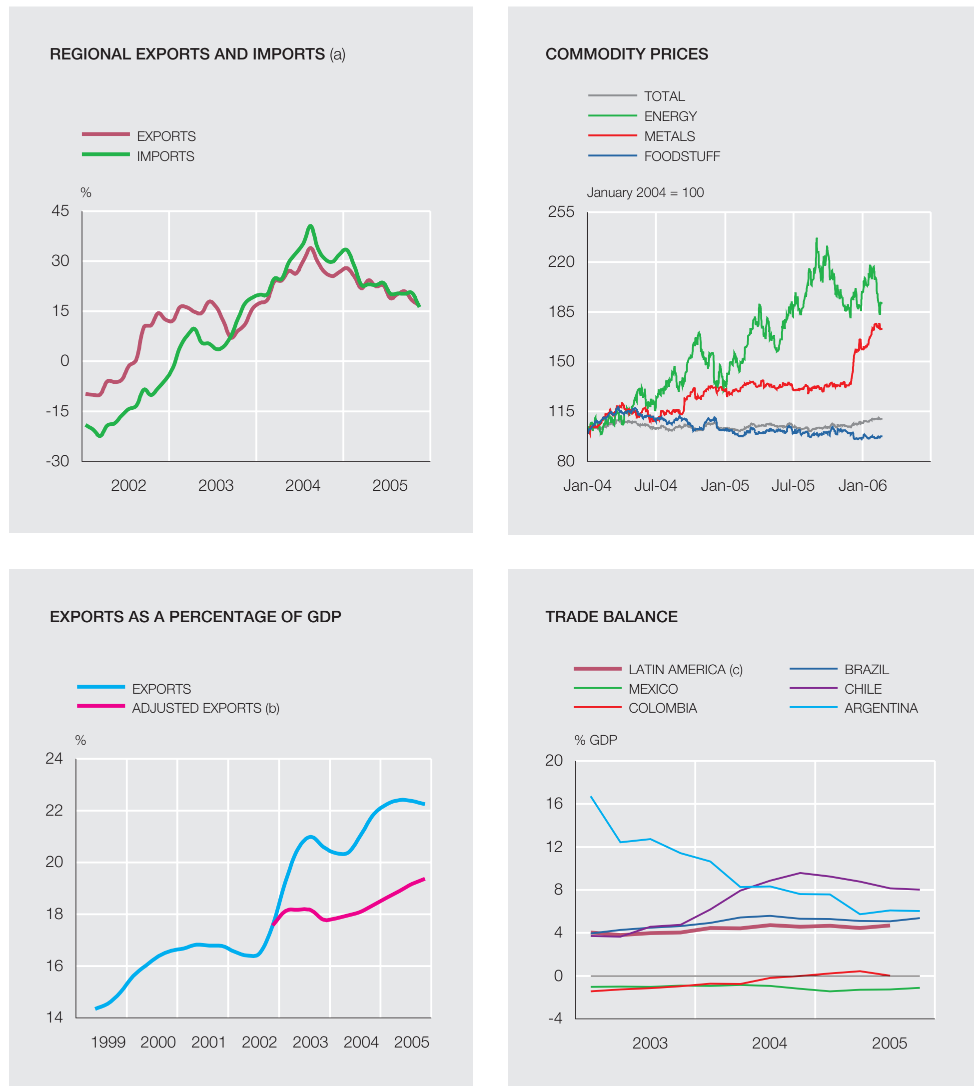
The fact domestic demand is holding up is particularly timely since the negative contribution of external demand increased progressively, subtracting 1.3 pp from GDP growth in Q4 (around 1 pp over the year as a whole). As can be seen in Chart 7, the behaviour of exports and imports was similar, since both continued to slow gradually in parallel. At the end of the year, and in dollar terms, they had grown by around 16%. Nonetheless, at the start of 2006 exports have perhaps started to move on a quickening trend. Conversely, imports have broadly stabilised, in keeping with the moderation of domestic demand. It should be clarified that the sound foreign trade performance is consistent with a growing negative contribution of external demand and with a continuing trade surplus since, in National Accounts terms, exports and imports are calculated in national currency and deflated by their prices. These prices, namely the terms of trade, have tended very favourably in recent years owing to the strong increase in commodities prices, although the behaviour of the latter has been divergent in recent quarters. The prices of agricultural commodities, which are an important component of Brazilian, Argentine and Colombian exports, have undergone cuts in recent quarters, while energy raw materials are holding in a very high price range and metals (which are beneficial for Chile in particular) enjoyed a very marked rise at the end of last year. In any event, the prolonged dynamism of exports in recent quarters should be attributed to the increase in exported volumes (see Chart 7). However, this volume increase is also closely related in most countries to a rise in global demand for commodities.

FINANCIAL MARKETS AND EXTERNAL FINANCING

The squeeze on sovereign yields was further accentuated after the summer, and the regional EMBI index reached successive lows, narrowing to 220 bp in February 2006, some 125 bp below the September level (see Chart 9). There was a moderate rise in March, in line with the increase in long-term rates in the developed countries. It is notable that all sovereign yields have narrowed further and significantly, with the exceptions of Peru, Chile and Argentina (although in the latter two cases this was mainly due to the recomposition of the index) and that it was in those countries with the widest yields that they narrowed most. This is the case of Venezuela, whose yield stands at below 250 pp (1.5 pp less than in September), and Ecuador, which regained access to international markets for the first time since its 1999 default, with 560 bp, 185 bp below the September level. Brazil, Colombia and Mexico also saw sizeable reductions to 220 bp, 160 bp and 115 bp, respectively,

EXTERNAL ACCOUNTS AND THEIR DETERMINANTS
Year-on-year changes, indices and percentage of GDP

CHART 7



SOURCES: National statistics office and Banco de España.

a. Quarterly moving average.
b. Exports at 2002 prices as a percentage of real GDP in US dollars.
c. Aggregate of 8 countries

which in relation to September 2005 means 30% less in the first two cases and 15% less for Mexico.

Stock markets performed very favourably in the second half of the year. The local-currency regional index rose by 30%, ending the year with an increase of 32%. In any event, the behaviour of stock markets was not fully uniform. Brazil, Mexico, Colombia and Venezuela saw practically continuous rises from September; the first three countries posted respective gains of 36%, 38% and 115%, in local currency, for the year as a whole, while Venezuela recorded a decline of 9%. Chile and Argentina showed greater volatility in Q4 but nevertheless ended the year with annual rises of around 10%. Stock markets began strongly in 2006, with the overall index posting a rise of 11% to February; since then, however, there has been a correction and consolidation, with markets at a high level. The correlative to this was the improvement in the credit ratings of several countries in the region: Brazil, upgraded by two different agencies, in October and March; Venezuela, in November and January, also by two different

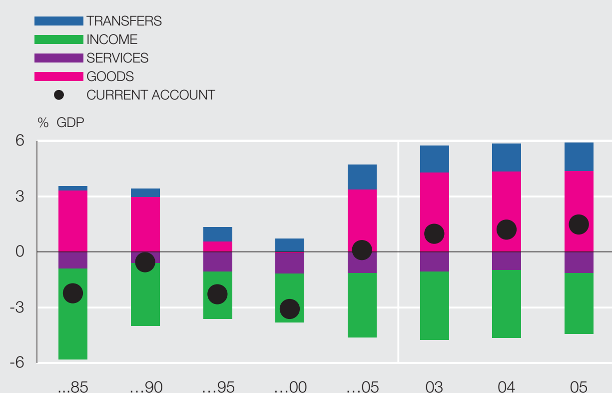
In 2005, for an unprecedented third year running, Latin America[1] recorded a positive current account balance. In the past, growth rates like those of the last three years would have entailed a current account deficit of at least 3% of GDP.

The main factor explaining this change in pattern over the last three years is the behaviour of the trade balance, which has moved from a relatively balanced position in the 1990s to large surpluses, for the first time since the late 1980s. In fact, at over 4% of GDP, the surpluses recorded in 2003-2005 were even larger than those of the 1980s, which were only slightly over 3% of GDP. The key to the good trade balance figures is the improvement, in recent years, in the terms of trade of the countries of the region, as a consequence of the rise in the prices of raw materials, which make up a significant proportion of Latin American exports. During the period 2003-2005, the terms of trade for the area as a whole improved by 13.5%, with much larger increases in some countries, such as Venezuela and Chile. In fact, isolating this improvement in the terms of trade and calculating the trade balance on the basis of the 2002 terms of trade reduces the surplus to 2% of GDP in 2005, 2 pp less than it actually was, which means that at end-2005 there would have been a deficit on current account of close to 1%. Moreover, this calculation only eliminates the price effect, not the quantity effect arising from the greater global demand for raw materials. All this goes to show that the improvement in Latin America's external position and degree of openness is more a consequence of external circumstances than of structural progress in its export capacity or external openness.

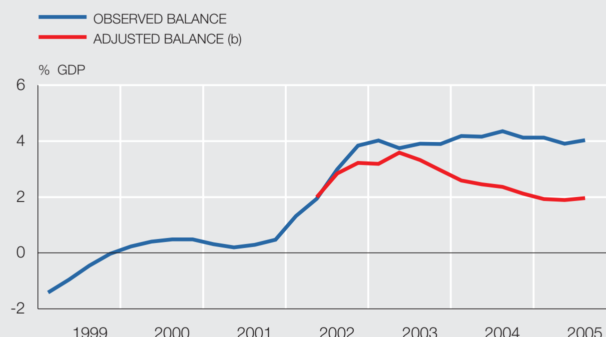
As regards the other components of the current account balance, the services account has recorded a relatively constant deficit, of around 1% of GDP. The growing transfers surplus arising from higher remittances, which have doubled over the last 10 years to around 1.5% of the region's GDP, has been offset in recent years by an increase in the

1. The calculations for the region include Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela.

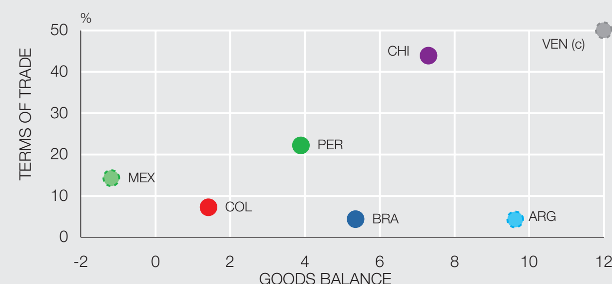
LATIN AMERICAN CURRENT ACCOUNT AND ITS COMPONENTS (a)



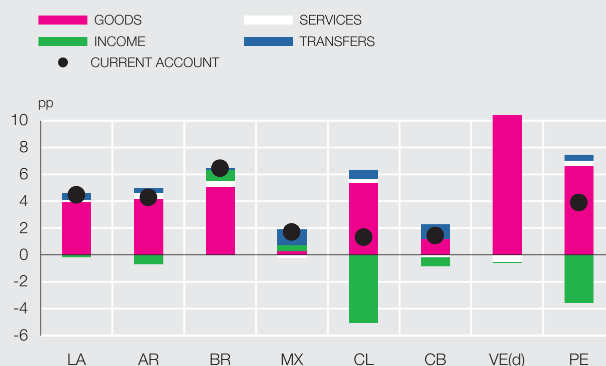
LATIN AMERICAN TRADE BALANCE



AVERAGE GOODS BALANCE RELATIVE TO GDP AND TERMS OF TRADE (2003-2005)



CHANGE IN COMPOSITION OF CURRENT ACCOUNT BALANCE RELATIVE TO GDP (2001-2005)



SOURCES: National statistics.

a. 2005: estimate made in the absence of the Q4 figure.
b. Trade balances using terms of trade relative to real GDP in US dollars.
c. Venezuela showed a 90% increase of the terms of trade and an average goods balance equal to 22% of GDP in the period.
d. Venezuela recorded a change in the current account of 17.1 GDP percentage points, and a contribution of the trade balance of 17.6 GDP percentage points.

income deficit (which includes debt interest payments, repatriated profits, etc), although it was less pronounced last year. Comparing the situation of the last three years with that of the 1980s, the current account was in deficit in those years because, despite the surpluses on goods trade of close to 3% of GDP, the income deficit was larger and there was only a very small surplus on the transfers account. In fact, the increase in the transfers surplus due to the increase in remittances is one of the most significant changes in the Latin American current account over the last 25 years which, given its upward trend and the fact that it is not pro-cyclical, has made the external position of the area more robust. Developments in the income account have been more volatile, since they depend on both financing costs and the rate of return on investments. However, the reduction in net financial liabilities in recent years (linked precisely to the accumulated current account surpluses and exchange rate appreciation) also improves the short and medium-term outlook.

Country by country, it can be seen that in all of them, except Mexico, there have been radical improvements in recent years in their current account balances, linked to the adjustment prompted by the economic crises and exchange rate appreciation (Argentina and Uruguay), to the increase in the prices of the main raw materials they export (Chile and Peru) or to both factors (Venezuela). In Mexico, by contrast, there was no recovery in the trade balance, despite the improvement in the terms of trade linked to the price of oil. This fact is related to the loss of competitiveness of export products in the US market (where around 90% of them are sold), especially relative to those of Asian countries.

Developments in the income balance in certain countries, like Chile and Peru, have also been notable, with a deterioration linked to the repatriation of profits arising from mining firms that have also contributed to the strong trade surplus in these countries. Meanwhile, there was an increase in the transfers surplus in countries such as Colombia, Mexico and Peru, but also in others, like Ecuador, Bolivia, and in many Central American countries. This has been a significant factor behind developments in the current account balance over the last five years. In fact, in Bolivia, Colombia and Ecuador the transfers surplus stands at close to 5% of GDP, and without it their external accounts would be in serious difficulty.

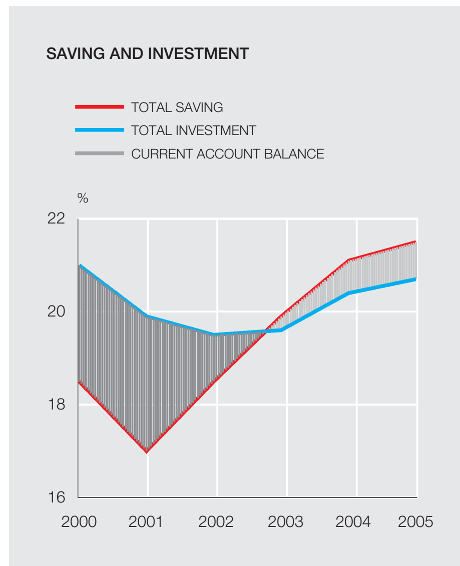
agencies; Mexico, in December, and Argentina, in March. Likewise, a substantial number of countries forecast a brighter outlook, with only Ecuador revising it downwards.

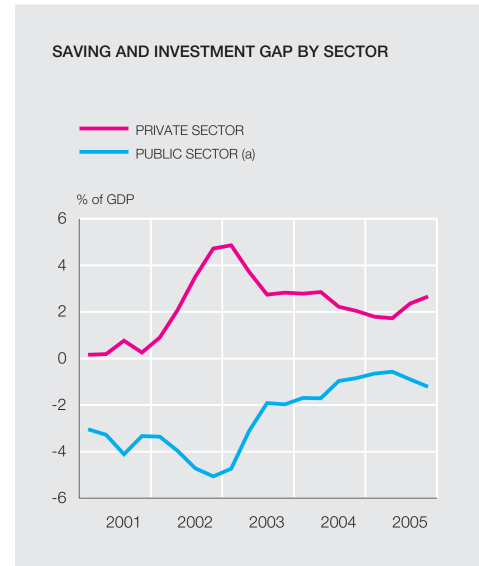
The favourable external environment and sound economic and financial conditions are being harnessed in this recovery phase to pursue increasingly active debt management policies with a view to reducing the vulnerability of these countries' financial positions. These policies have taken the form of numerous initiatives in recent quarters: the repurchase of all Brady bonds (previously undertaken by Mexico and to be concluded in April by Brazil) and other external debt; the issuance of local-currency external debt (Colombia and Brazil); the progressive cancellation of dollar-indexed debt in Brazil, completed in February; and, finally, a series of tax and regulatory measures, announced by Brazil and Chile, aimed at promoting the participation of non-resident investors in the domestic public debt market. Box 2 analyses in detail the impact of these policies on the notable reduction in exchange rate-linked debt witnessed in the region in recent years.

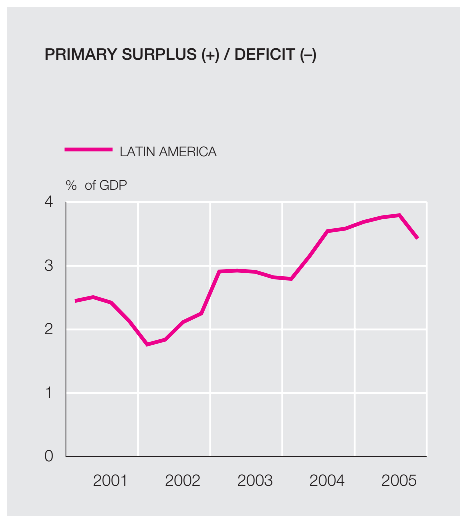
In this context it is worth mentioning the early cancellation by Brazil and Argentina of IMF financing, for amounts of $15.5 billion and $9.9 billion, respectively, since this also contributes to drastically reducing the external debt ratio. Nonetheless, the motives for this decision largely lie outside the scope of debt management and may even have a different interpretation in each of the countries. While in Brazil's case the decision was favourably interpreted by the markets, set against the improvement in the country's economic fundamentals and the credibility of its economic policies, in Argentina's case – which had a more adverse impact on the financial indicators – the severance from the IMF was related to the Argentine authorities' wish to follow through with policies different from those that the conditions attached to IMF financing entailed. In any case, the repayment of the loans has reduced the IMF loans portfolio by almost half, and the share of Latin America therein is now scarcely 8%, compared with 33% on average over the past decade (see Chart 10).

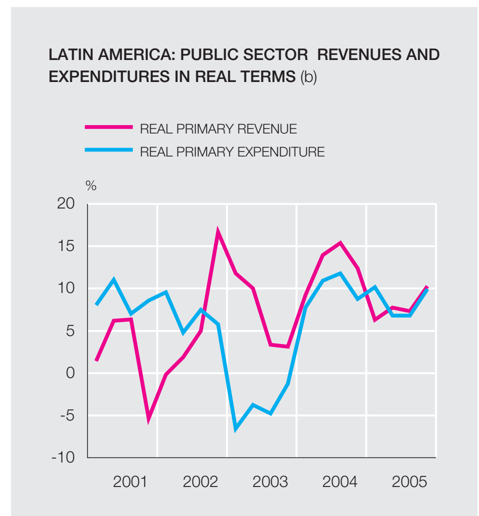
INVESTMENT AND SAVING IN LATIN AMERICA
Percentage of GDP

CHART 8









SOURCES: IMF and national statistics.

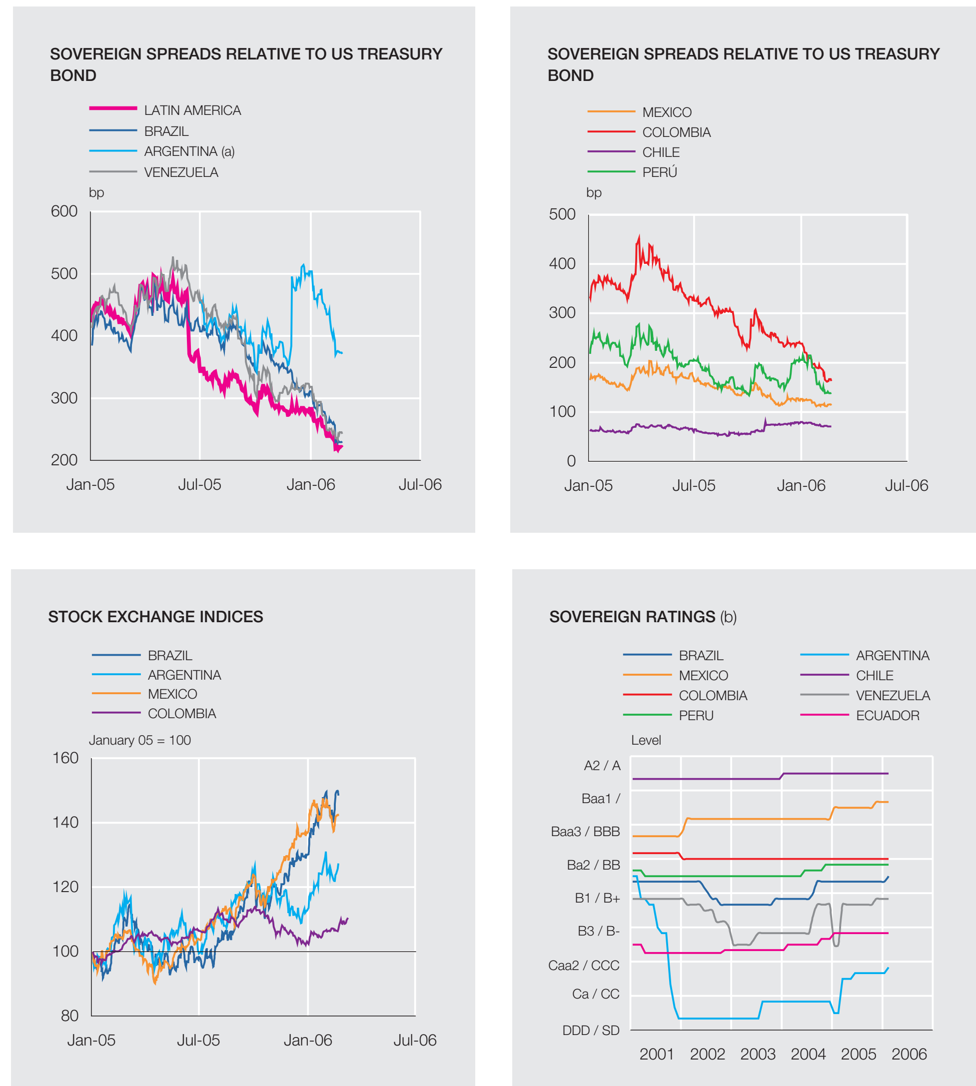
a. Calculated as budget balance.
b. Deflated by CPI.

These developments on Latin American capital markets were a determining factor of capital flows. Preliminary figures indicate that total net inflows were positive (exceeding $10 billion), compared with net outflows (–$1.5 billion) the previous year. However, the total figures (see Chart 10) fail to reveal the scale of the changes between private and official flows. Net private flows tripled in relation to the average for the four previous years, while net official flows amounted to –$24 billion. Bearing on this latter figure were, essentially, the cancellation of IMF loans (although the repayment by Argentina is not included as it was computed in January – see the related panel in Chart 10) and, also, the recovery in the region's economies.

The breakdown of private flows by category is also revealing. First, there was a forceful rebound in portfolio flows, which would have comfortably exceeded $20 billion, following four years of decline. This rebound is consistent with the strong inflow of foreign capital into the region's stock markets, but in principle it might clash with Latin American sover-

SOVEREIGN SPREADS AND STOCK EXCHANGES
Basis points and indices

CHART 9



SOURCES: JP Morgan.

a. On 11 and 13 June 2005 the new Argentine bonds derived from the restructuring of the debt were included in the EMBI+.
b. Simple mean of the ratings of Moody's, Standard and Poor's and Fitch IBCA.

eign issues on international markets, which have fallen in relation to the previous year. This reduction, which is in contrast to other emerging regions, has come about despite the highly favourable external financing conditions. This may be attributed to lower effective financing requirements owing to the improvement in fiscal positions and to the preference shown by the authorities to local-market issuance. Nonetheless, fewer sovereign issues proved compatible with net inflows on the debt markets. On one hand, foreign investors' demand for Latin American bonds was partly met through purchases on national debt markets and, on the other, corporate issues grew strongly, especially in Mexico and Brazil in the first half of 2005. There was a 60% increase in corporate issues compared with 2004, which more than offset the slight reduction in sovereign issues. As a result, the total volume of issues amounted to $43 billion, 20% up on the previous year. The pick-up in portfolio flows was countered by the increasingly sharp decline in net flows of foreign loans and credits, the behaviour of which has maintained its negative sign of the past decade.

In Latin America, debt that is linked to the exchange rate, either because it has been issued in a foreign currency or because it is indexed to some currency, has traditionally played an important role in the financing of the public sector. It has also been a significant source of public finance vulnerability, by generating imbalances between assets and income denominated in local currency and liabilities and payments in foreign currency. At end-2002, in most of the main countries, this type of debt accounted for more than 50% of total government debt, and in some cases, like Peru and Uruguay, for around 90%. There are several factors that explain this tendency to borrow in foreign currency, including the absence of exchange rate hedging instruments in domestic markets, the distortions in incentives generated by the fixed exchange rate regimes, monetary policy credibility problems and the financial and exchange rate instability of the emerging countries.

Since 2003, however, the region has been enjoying exceptional financial conditions, which have enabled the weight of debt linked directly or indirectly to the exchange rate to be reduced, in some cases drastically. Chart 1 illustrates this tendency in the aggregate for the seven most important countries in Latin America (excluding Argentina). As seen in Chart 1, the ratio of gross government debt in foreign currency fell from 49% at end-2002 to 30% at end-2005, a reduction of almost 20 pp. Among the various countries, Brazil is notable, since its exchange-rate linked government debt fell from 52.8% of total debt at end-2002 to 14.1% in 2005, a fall of 73%, while in the other economies this reduction was between somewhat less than 3% in Peru and Venezuela and 31.7% (or 20.7pp) in Chile. The exception was Mexico, where the share of this type of debt rose slightly.

These developments may be linked to changes in the structure of debt, but also to the sharp appreciation in most Latin American currencies during this period (see Chart 11 of the main text). Latin American fiscal authorities are increasingly aware of the importance of sustained reductions in the vulnerability of public finances, and limiting the exposure of government debt to exchange-rate fluctuations is one of the most effective ways of reducing this vulnerability. The active debt management carried out by most of the countries would suggest that this may have been an important factor in the reduction of exchange-rate linked government debt[1].

The importance of the exchange-rate effect and of the composition effect (associated with changes in the structure of debt) can be calculated for each of the countries for the period considered. The former is determined by fixing the structure of the debt at the beginning of the reference period (December 2002) and calculating the percentage of debt that would be linked to the exchange rate at the end of the period (December 2005), taking into consideration only the exchange rates prevailing at that moment; i.e. ignoring the actual changes in the composition of the debt. The difference between the weight of the debt linked to the dollar calculated thus and the actual weight determines the composition effect. Both effects are shown separately in Chart 2 for each of the countries analysed, and also for the aggregate of all the countries.

The largest contribution to the reduction in exchange-rate linked debt arose from a change in the composition of debt instruments. The composition effect, for the countries as a whole, explains 15 pp of the fall, or around 80% of the total. The proportion is similar in the cases of Brazil and Chile, amounting to 20 pp and 16 pp of the reduction achieved. In Peru, with the same percentage, the size of the reduction is much smaller, since the fall in the exposure to the dollar was much smaller. This smaller link has involved an effective reduction in these countries in issues denominated in foreign currency or linked to the exchange rate and, even, in some cases, the swapping of external for domestic debt. Brazil, whose exchange-

1. See Box 1 of the "Half-yearly report on the Latin American economy", *Economic Bulletin*, April 2005, Banco de España.

CHART 1: EXCHANGE RATE-LINKED DEBT RELATIVE TO TOTAL PUBLIC DEBT

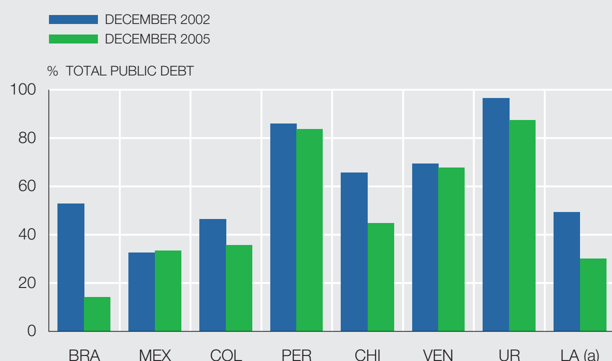
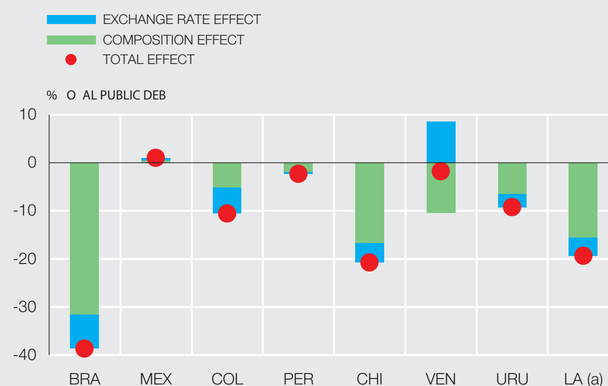


CHART 2: BREAKDOWN OF CHANGE IN PUBLIC DEBT



SOURCES: National statistics, IMF and in-house calculation.

a. Weighted mean of the seven countries.

rate indexed debt fell from a high of 56% of all debt in September 2002 to zero, is a case in point. In Colombia, the contributions of both the exchange-rate and the composition effect were balanced. Venezuela was a special case, given that its exchange rate depreciated substantially over the period considered, so that its impact tended to increase the weight of dollar-linked debt, instead of reducing it.

The strategy of reducing the exposure of debt to the exchange rate requires a financial analysis that may limit the attractiveness of this option. Thus, debt managers may be obliged to choose between minimising the expected cost of debt service, both in financial terms and in terms of credibility, and minimising the risk associated with drastic changes in the debt burden. In the short term, in view of the fact that the external interest rates that must be paid are at historical lows and of the strong appreciation of most currencies, it would be cheaper to increase the relative weight of debt in dollars. However, in the long-term this option would increase the exposure of the public sector to the exchange rate and, therefore, the risk of external shocks to the budget, which could ultimately lead to the payment of higher sovereign risk premiums.

The implementation of an active debt management policy may also be limited by a number of restrictions on the demand side. The domestic and external debt markets are segmented on account of the existence of barriers to entry, tax distortions, etc., which make it difficult to place local-currency securities with international investors and, as a consequence of the lack of depth of the local markets, hinder the construction of a yield curve with a broad range of maturities. Moreover, these problems are exacerbated by the fact that domestic issues tend to raise domestic interest rates and to crowd out private sector financing, which may have adverse effects on activity. Hence, the recent tendency to reduce market segmentation (which should facilitate more effective management of public debt and greater development of local markets) is positive.

In any event, the active management of debt policy in order to reduce vulnerability and financial volatility is supplemented by the entrenchment of fiscal discipline. Both factors may have costs of one type or another in the short term, but they complement each other in strengthening public finances in the medium and long-term. Persevering with this type of policy, therefore, helps improve the foundations for sustained economic growth in the area.

Also notable has been the ongoing recovery in foreign direct investment flows. These stood at over $50 billion in 2005 as a whole, a figure not far off that for inflows in the second half of the 90s, despite the theoretical competition for these flows from the Chinese economy, which is analysed in Box 3. The recovery was centred on Mexico and on other countries such as Peru, since in Brazil and, above all, Argentina, foreign investment is still at a relatively low level.

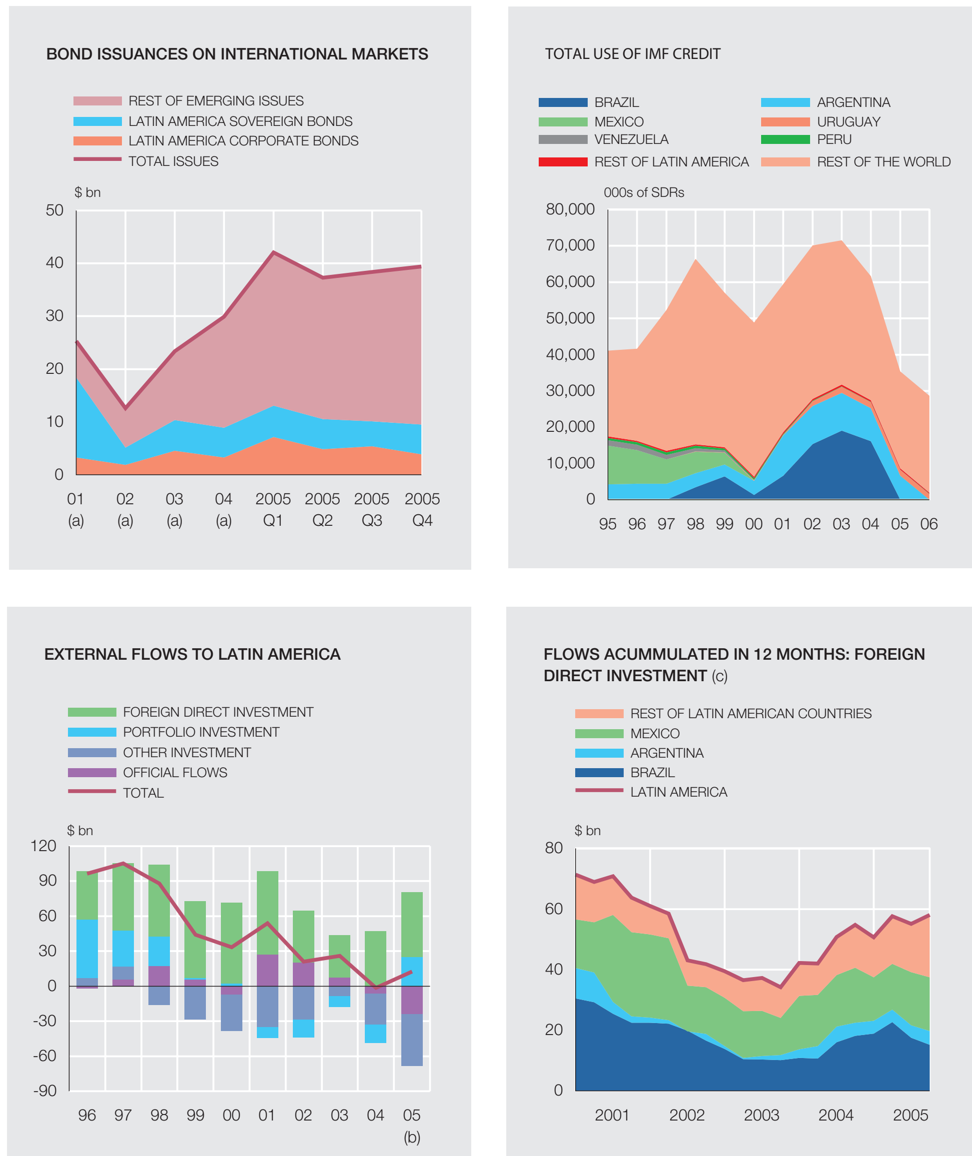
EXCHANGE RATE, PRICES AND MONETARY POLICIES

Strong upward pressures continued to be perceptible on the foreign exchange markets, though in recent quarters there were notable bouts of exchange rate volatility, associated in some cases with issues of political instability (see Chart 11). As a result, the aggregate exchange rate for the area appreciated by only 2.1% against the dollar in the second half of 2005. The appreciation of the Brazilian real was particularly significant, rising by 5% between September and February, after having appreciated by 10% in the first eight months of 2005. Exceptions to this trend were the traditionally very stable Peruvian sol, which underwent a depreciation at the end of the year, and the Argentine peso, which moved on a depreciating course from September until exceeding the level of three pesos per dollar, against the background of the economic policy changes in the country and the interruption of the programme with the IMF. Indeed, the cancellation of loans with this institution by Argentina and Brazil, which entailed a strong cut in their reserves, interrupted - probably temporarily - the build-up of reserves in the region as a whole, which fell by 1.6% in the second half of the year. As can be seen in Chart 11, were it not for this impact total reserves would have continued increasing, and they did so notably in Mexico and Colombia, principally.

The progressive easing of prices embarked upon in mid-2005 continued in the area as a whole (see Chart 12), and the year ended with a rate slightly below 6%. Underlying inflation, whose ongoing reduction (which is very gradual but constant across the area as a whole) dates back to the second half of 2003, ended the year at a rate of 5.2%, around 1 pp down on end-2004.

EXTERNAL CAPITAL FLOWS
Billions of US dollars

CHART 10



SOURCES: National statistics, JP Morgan and IMF.

a. Quarterly average.
b. 2005: projection.
c. 2005 Q4: estimate for Argentina, Latin America and the rest of Latin America.

The exception to this behaviour was Chile, where underlying inflation continued to rise strongly. Unlike that year, in 2005 all countries with direct inflation targets met their pre-set goals, which firmly underpinned the ongoing build-up in the area's monetary credibility. Nevertheless, recent inflation developments were divergent from one country to another. In Brazil, Mexico and Colombia, inflation moved onto a declining path that was particularly notable in the latter two economies, where the inflation figures posted were unusually low (below 3% and 5%, respectively). Conversely, in Peru and Chile the rates rose from very low levels, driven by the robustness of the expansion, to close to 3% and 4%, respectively, at the start of 2006. In Venezuela, the inflation rate continued on a gradually declining course, although it still stood comfortably above double figures at the end of the year. Finally, the acceleration in prices in Argentina was sustained and the inflation rate ended the year at over 12%, without clear signs of any easing apparent at the start of this year, which is a cause for growing concern.

The rapid expansion of China in the world economy has important global repercussions, one of which is the attraction by this country of an enormous quantity of foreign direct investment (FDI). In fact, China has become the world's leading recipient of FDI, with inflows of more than $60 billion in 2005, which accounted for around 25% of the net flows to emerging countries. Foreign investors have been attracted, on one hand, by the strong Chinese economic growth, its enormous population and its growing domestic demand and, on the other, by its comparative advantage as an export platform, thanks to its low labour costs. In addition, China's accession to the World Trade Organisation (WTO) in 2001 has strengthened investor interest in this country.

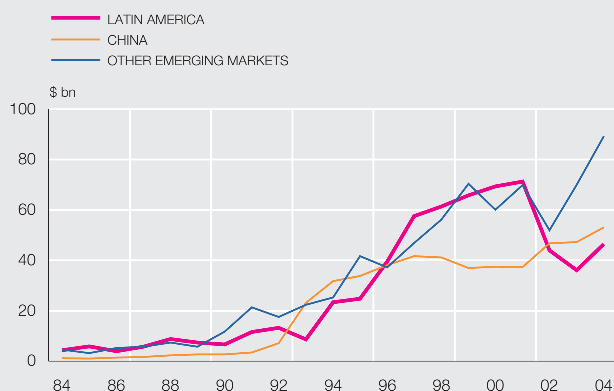
In the same way that many countries see China as a clear competitor in export markets, there is growing concern, especially in the emerging countries, that the FDI they receive may be diverted towards China. This is the case in Latin America, where FDI has been the main source of external financing in recent years and has played a decisive role in modernising its economic structure. In fact, FDI in Latin America began to fall in 2000, while that in China continued to grow rapidly (see left-hand chart).

There are various factors – some of which conflicting – that may, at least potentially, influence how FDI in China affects what the Latin American economies receive. The *first* relates to the global supply of FDI and segmentation in this market. One question that has to be considered is whether the flows of this nature to China affect world supply. If global supply is given, an increase in FDI in China will entail a reduction in that in other regions; but if it is not, and foreign investors obtain high profits from their presence in China, it is likely that total FDI will increase, leading to an increase in FDI in other parts of the world too. Another question is whether regional and proximity considerations are important in the allocation of this type of investment, in which case the global market will be geographically segmented and there may be little substitutability between the FDI in two different countries or regions. This seems to be the case of part of the FDI received by China, specifically that received from other Asian countries with close cultural and ethnic links, such as Hong Kong, Korea, Japan, Taiwan and Singapore, whose investment accounted for 59% of the total received by China in 2004 (see right-hand chart). It is simply not plausible to think that the Latin American countries could be a substitute for China for this type of investment, so that this supports the hypothesis of significant segmentation in this market. FDI in Latin America, in contrast, mostly originates from the OECD countries, which accounted for 76% of the total investment received by these countries in 2002, as against 35% in the case of China. A *second* aspect that should be considered is the sectoral distribution of FDI. If the flows to China are targeted on the export sector, there should be a larger substitution effect with third countries that receive this type of investment to compete in the same export markets. If, on the other hand, FDI is used to supply domestic Chinese demand, the impact on third countries is less obvious. The *third* element at play is the knock-on effect of FDI in China. Thus, the increase in international, commercial and financial relations with China may boost Chinese direct investment in the rest of the world, especially if its very high savings ratio is taken into account. Moreover, the FDI in China may increase the imports of this country, leading to an increase in direct investment in countries supplying these factors of production, including investment by China, which would thus be securing strategic access to these resources. The case of raw materials in Latin America may be illustrative of this type of argument.

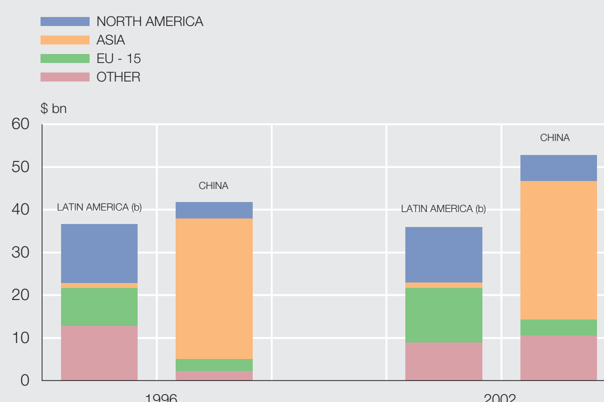
Given this diversity and the potential opposition of factors, a recent empirical paper[1] has analysed how FDI in China may affect that re-

1. Alicia García-Herrero and Daniel Santabárbara (2005), *Does China Have an Impact on Foreign Direct Investment to Latin America?*, Banco de España Working Paper No. 0517.

FDI: HOST COUNTRIES (a)



FDI: HOME COUNTRIES



SOURCES: IMF, UNCTAD and CEIC.

a. Net flows
b. Latin America: Argentina, Brazil, Mexico, Chile, Venezuela and Colombia.

ceived by each Latin American country. This study focuses on the flows originating in the OECD, whether to China or to Latin America, since only for these is it possible, in principle, to speak of an integrated market, with a greater possibility of substitution between recipient countries. Notable among the findings is that FDI in China does seem to have had a negative effect on that to Latin America as a whole during the years in which the negotiations for China's accession to the WTO were intensifying (1995-2001), but not since the start of the Chinese reform process (1984-2001). This negative effect is concentrated in Mexico and Colombia, but is not seen in the rest of the main Latin American economies analysed: Argentina, Brazil, Chile and Venezuela. This may partly reflect the differing characteristics of Latin American countries, especially as regards their productive structures and the sectoral type of FDI received. Thus, while direct investment in Mexico and Central America was concentrated in the export sectors, in South America it has been used in non-tradable sectors, like the financial sector, utilities and infrastructure, as well as in natural resource extraction.

Looking ahead, there are many reasons to think that China will continue to attract a large volume of FDI. First, in its agreements with the WTO, China undertook to continue its process of privatisation and opening up to foreign capital. Also, it is likely that China's comparative advantage, related to the low cost of labour, will be maintained for a time, given its surplus agricultural labour. Moreover, even if wages were to rise, the purchasing power of China's enormous population would too, so that China would become a more attractive destination for FDI aimed at supplying the domestic market.

This outlook may give rise to some concern on the part of Latin American countries, in particular those with a very similar productive structure to China, like Mexico and Central America. However, China will also generate a large number of opportunities in the medium term. Some of these opportunities are not particularly relevant to Latin American countries, especially those arising from productive integration, as they can be much more readily exploited by China's neighbours and other developed countries, as is in fact already occurring. However, Latin America has the opportunity to benefit from China's significant and growing demand for raw materials. This will not only boost Latin America's commodity exports to China, but should also increase the FDI in this sector, as long as there are no obstacles to foreign investment. Moreover, China may become one of the main investors in Latin America, as it is rapidly increasing its role as a world investor and wishes to diversify its net external assets and ensure access to its scarcest factor of production: raw materials. As a result, Latin American countries should strive to increase their attractiveness to investors so as to be able to harness the benefits arising from China's greater weight in the international economy.

With the odd exception, monetary policies mirrored recent developments in prices. As Chart 13 shows, in the countries with declining inflation paths, interest rates were in a downward cycle, although the room for further cuts could be seen to be more extensive in Brazil than in Mexico or Colombia. The official rate in Brazil declined by more than 3 pp between September and March, while in Mexico the so-called bank funding rate that has become the monetary policy signaller in recent quarters fell by 2 pp. Despite these declines, in Brazil the yield curve continues to have a negative slope, while in Mexico it has flattened in recent months. Chile is the economy most ahead among the countries with interest rates in the upward part of their cycle. With the odd interruption, the moderate tightening of monetary policy in train since late 2004 continued there. At the other extreme, Peru began to tighten its monetary policy only in January this year, while in Argentina the rises in rates since 2005 Q1 were rather too muted to exert any impact on real rates: the three-month interbank rate stands at around 10%, which is still below actual inflation.

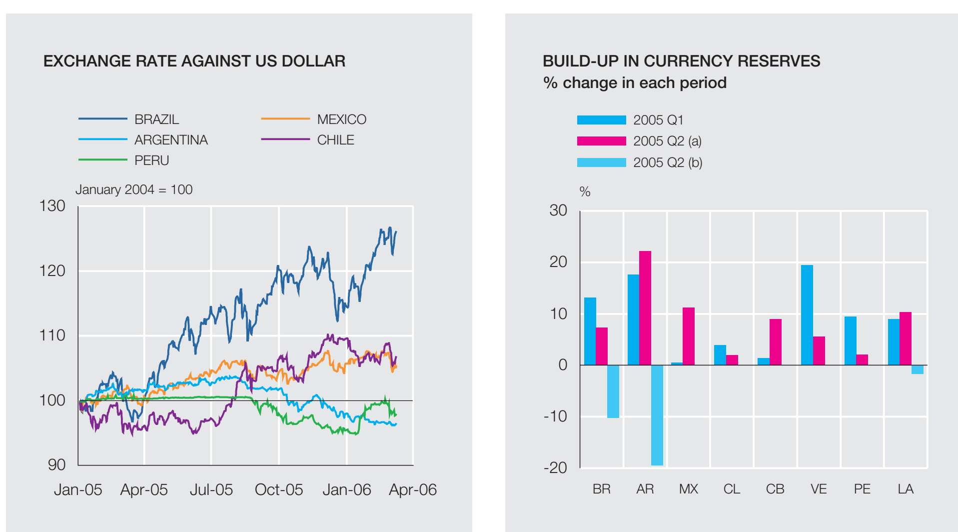
TRADE INTEGRATION AND STRUCTURAL REFORMS

Progress in trade integration and Latin America differed from one trade area to another; in some cases there was significant headway, but in others considerable backtracking. On the positive side, mention may be made of Chile's free trade agreement with China and also with India (albeit a partial one in the latter case), while negotiations were initiated with Japan. Colombia and Peru also concluded negotiations for a free trade treaty with United States, albeit separately and outside the scope of the Andean Community to which they belong. Further, CAFTA – the Central American Free Trade Agreement with the United States – encountered difficulties coming into force on 1 January, as scheduled, owing to the resistance by certain Central American parliaments, whereby it only entered into force with El Salvador. Finally, in MERCOSUR, Brazil and Argentina agreed on a set of restrictive rules for trade under certain

EXCHANGE RATES AND RESERVES

Indices and rate of change

CHART 11



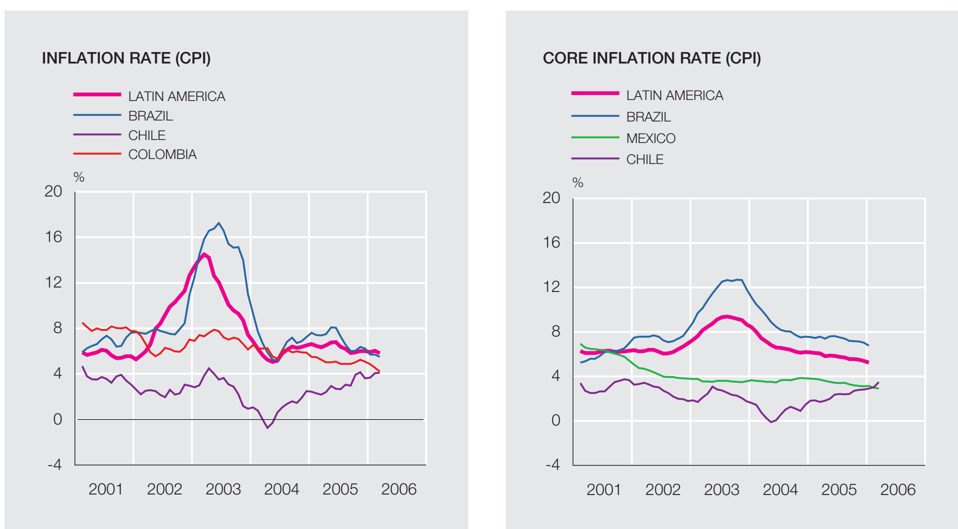
SOURCES: National statistics.

a. Excluding the payment to the IMF.
b. Including the payment to the IMF.

INFLATION, FULFILMENT OF INFLATION TARGETS AND CORE INFLATION

Year-on-year rate of change

CHART 12



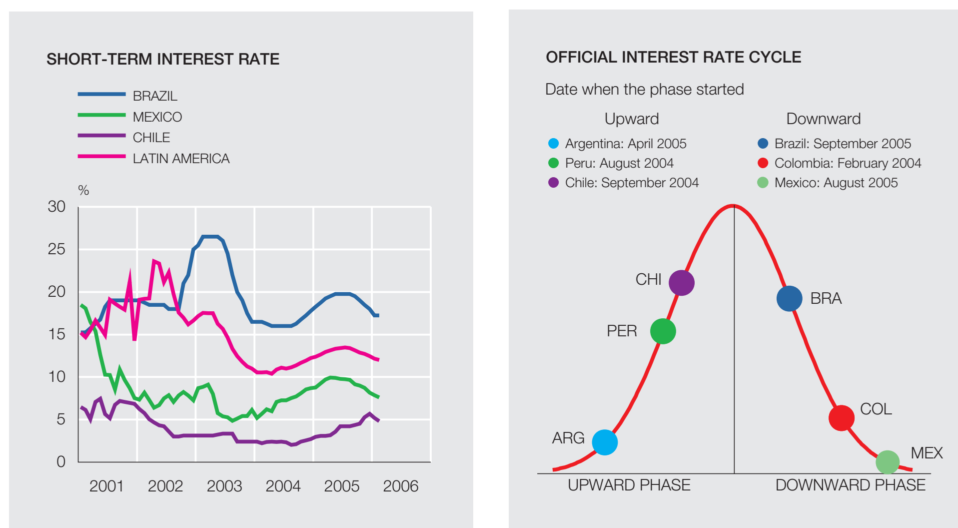
Country	2004	2005			2006
	Fulfilment	Target	Fulfilment	December	Target
Brazil	Yes	4.5±2.5 (a)	Yes	5.7%	4.5 ± 2
Mexico	No	3 ± 1	Yes	3.3%	3 ± 1
Chile	No (b)	3 ± 1	Yes	3.7%	3 ± 1
Colombia	Yes	4 ± 0,5	Yes	4.8%	4 ± 1
Peru	Yes	2.5 ± 1	Yes	1.5%	2.5 ± 1

SOURCES: National Statistics Offices

a. In September 2004 the central target was adjusted to 5.1%, and the range was maintained.
b. Below the lower limit.

SHORT TERM INTEREST RATES IN LATIN AMERICA

CHART 13



SOURCES: National Statistics Offices.

circumstances, so as to protect industries particularly affected by competition from imports. This so-called competitive adaptation mechanism, which was agreed upon without taking into consideration the other MERCOSUR members, marks a step backwards in the process of trade integration between these countries.

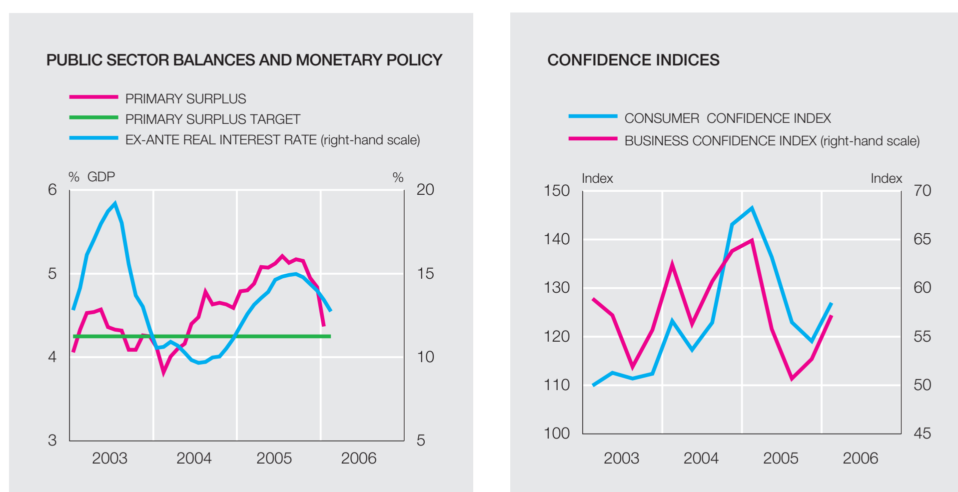
Turning to reforms, these stagnated in recent quarters. Few reforms were approved and few projects started up, as there were scarcely any advances in the financial field in Mexico and only minor ones in Brazil. The government's forceful reform drive in Brazil over the past three years was abruptly curtailed by political problems. Further, both countries, like practically the whole of the rest of the area, remain immersed in an electoral period. Ideally, new governments should work on re-forging consensus around the need to reactivate reform so as to improve growth possibilities in the medium term. That would also help shape a critical active mass of governments committed to reform that could counter the backtracking seen in some countries.

Developments in the main countries

In *Brazil,* the rate of expansion of economic activity slowed notably in the second half of 2005. GDP grew at a year-on-year rate of 1% in Q3 and of 1.4% in Q4, closing the year with growth of 2.3%, less than half the rate in 2004 (4.9%). The main causes behind the slowdown in activity were the restrictiveness in economic policies, in both their monetary and fiscal strands, and the impact of the political crises on consumer and, especially, business confidence. Both factors began to be corrected towards the end of last year (see Chart 14), but they notably affected investment figures, which increased by scarcely 1.6% during 2005. Activity was mainly underpinned by private consumption, which posted growth of 3.1% thanks to income gains brought about particularly by the decline in inflation and the relative strength of employment (which diminished in the second half of the year), prompting a reduction in the unemployment rate from 9.6% to 8.3 % during the year. The contribution of external demand was positive (0.3 pp), but less than in previous years. Indeed, exports slowed more than imports in real terms, although their growth rate remained somewhat higher. In 2005, too, there was a significant current-account surplus (1.8% of GDP), thanks to the strength of the trade balance, which posted a record surplus in nominal terms, albeit similar to that of the previous year as a proportion of GDP (around 5.7%). As regards public finances, the primary surplus ended the year at 4.8% of GDP, above the government target (4.25%) and several tenths of a point above the

BRAZIL

CHART 14



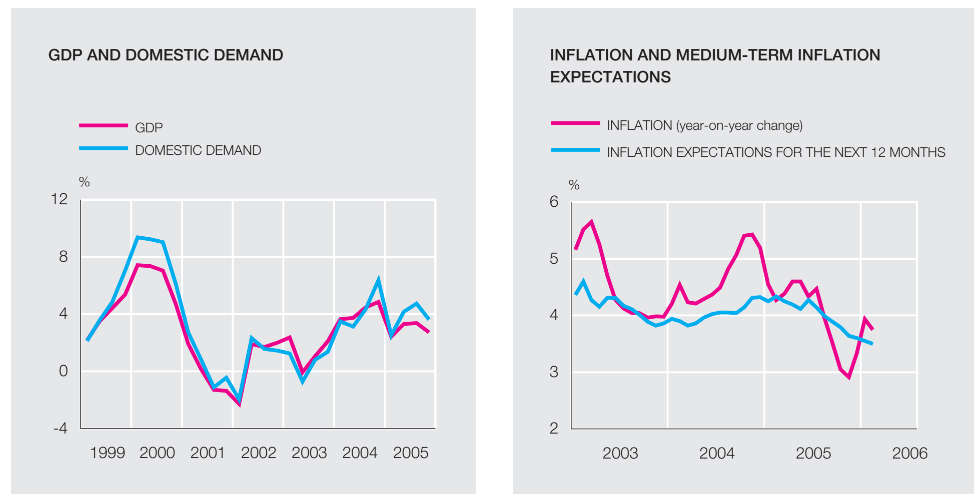
SOURCE: Banco Central do Brasil.

figure in previous years, thanks to the expansion of tax revenue and the containment of public spending. However, the notable increase in interest payments, linked to the monetary restrictiveness of the previous quarters, meant the budget deficit stood at 3.3% of GDP. Moreover, as a result of the foregoing, public debt held stable in comparison with 2004 (51.6% of GDP), despite the better management of debt.

The 12-month rate of inflation slowed in the second half of the year and stood at the end of 2005 at 5.7%, close to the adjusted central target and 2 pp down on end-2004. This deceleration was prompted by the exchange-rate appreciation, the favourable trend of agricultural prices and the cumulative monetary tightening between May 2004 and September 2005. The latter month saw the start of a cycle of monetary easing which has seen interest rate cuts of 3.25 pp, to 16.5%. The real appreciated notably against the dollar during 2005 (14%, and by an even higher amount in real effective terms), ending the year at a similar level to mid-2001, a trend which continued in 2006 Q1. The sovereign yield, after posting scarcely any changes in the first half of 2005, narrowed by almost 100 bp in the second half of the year and by a similar amount in the opening months of 2006, standing at a historical low of almost 200 bp. This behaviour was also seen in the stock markets, with slight losses in the first half of the year and strong gains in the second, which were confirmed in the early months of 2006. Influential in the excellent recent performance of financial variables was the warm reception given by the markets to the numerous debt management operations undertaken last year, including the aforementioned cancellation of the loan with the IMF, which entailed a 23% reduction in reserves. Significantly, the political difficulties last summer were followed by a period of greater calm, in the run-up to the campaign for the presidential elections to be held in October.

In *Mexico*, the economic performance was mixed in the second half of 2005. Activity quickened in Q3 to a year-on-year growth rate of 3.4%, but turned somewhat sluggish once again in Q4, standing at 2.7%, though this figure was strongly influenced by the very adverse behaviour of the agricultural sector. As a result, growth during 2005 was 3%, 1.2 pp below that recorded in 2004. Accounting for this slower growth was a growing negative contribution of the external sector (1.1 pp in Q4), given the greater slowdown in exports than imports, and the diminished buoyancy of domestic demand (Chart 15). This was attributable to the decline in inventories, since private consumption quickened to a growth rate of 5.4%, underpinned by

MEXICO CHART 15



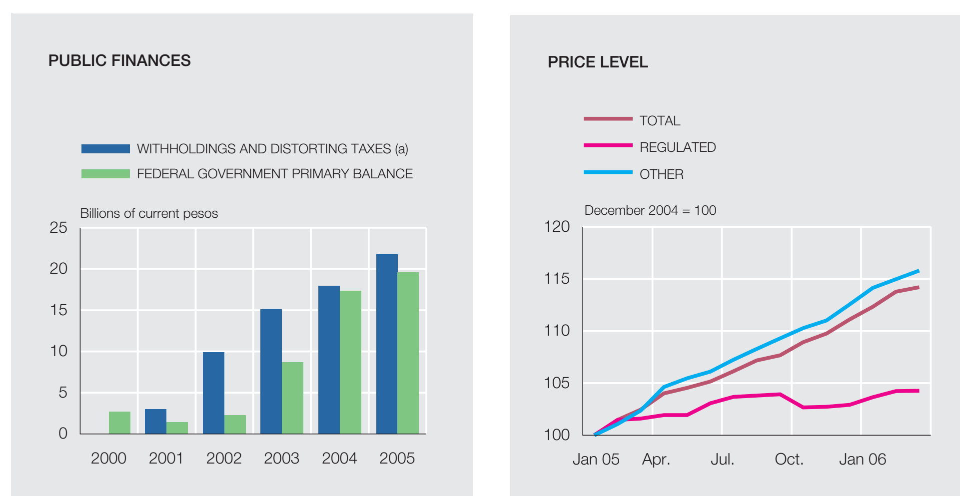
SOURCES: Banco de México.

the sound behaviour of employment and the strong growth of bank lending to the private sector; the growth rate of investment held at 7.6% and government consumption did not fall as it did in 2004. The trade deficit narrowed to 1% of GDP (compared with 1.3% in 2004), mainly as a result of the increase in oil exports, although in recent months there has also been a rise in the volume of non-oil exports. The current-account deficit during 2005 stood at 0.7% of GDP (1.1% in 2004), the lowest figure since 1995. This favourable development was the outcome of the reduction in the trade deficit and of the increase in the surplus on the balance of transfers (remittances grew by 20.6% and stood at 2.6% of GDP). Foreign direct investment in the country ($17.8 billion) was on a similar scale to 2004, when it was considered fairly favourable. The fiscal deficit was equivalent to 0.1% of GDP, lower than budgeted and than the 2004 figure of 0.3%. The reduction in the deficit came about due to lower interest payments, since the primary surplus (2.4% of GDP) was the same as in 2004. Along these lines, the ongoing reduction in external debt continued as did the promotion of debt issues at a fixed nominal rate with a maturity equal to or exceeding one year.

Inflation stood at 3.3% at the close of 2005, its lowest level since 1968 and almost 2 pp less than in 2004. The decline in inflation was the result of the favourable behaviour of agricultural products and of administered prices, together with the decline in underlying inflation, which stood at slightly below 3%, which proved pivotal to the reduction in inflation expectations (see Chart 15). Inflation rebounded in the opening months of 2006 to 3.8%, within the central bank target interval, although it is expected to be corrected during the year. On the basis of this favourable behaviour of inflation, the central bank began to ease monetary policy from August 2005 after having kept it on a tight rein for the previous 18 months. Specifically, the bank funding rate – which has become the effective monarchy policy instrument, unseating the traditional "corto" rate, which did not alter throughout the rate-reduction process – has narrowed by 225 bp to 7.5%. As a result of this cut in interest rates, the yield curve has flattened in relation to its inverted position in 2005 Q3. The exchange rate of the peso against the dollar has been appreciating since late 2004. In parallel with the other countries in the region, the sovereign yield continued to narrow, reaching historical lows in late February 2006. After having held practically stable in the first half of 2005, stock markets rose by over 30% in the second half of the year, an upward movement which continued into 2006 Q1. As regards reform, some headway was made in the financial field (the new securities law) and in respect of fiscal responsibility.

ARGENTINA

CHART 16



SOURCES: Ministerio de Economía y Producción de la República de Argentina and Instituto Nacional de Estadística y Censos.

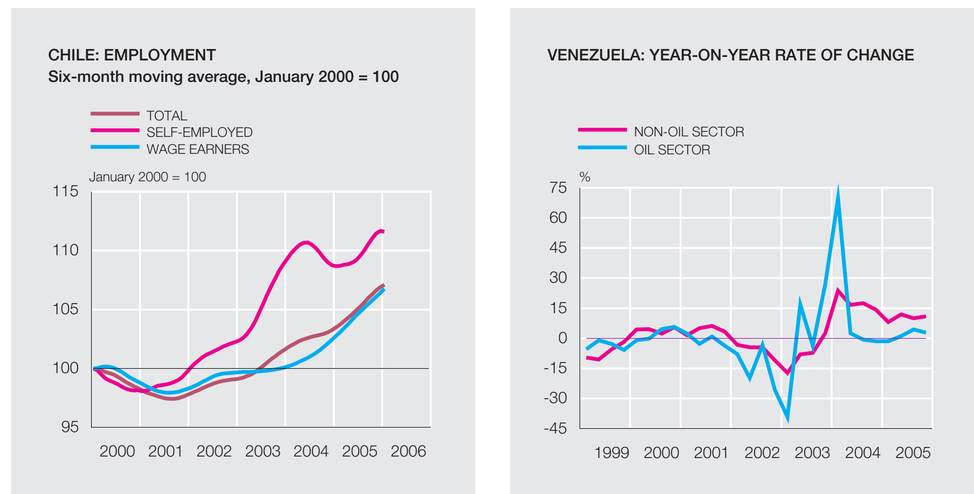
a. Distorting taxes: export duties and taxes on credit and debit balances in bank sight accounts.

In *Argentina*, in 2005, the economy grew by 9.2%, up slightly from the already high rates recorded in the previous two years. The year-on-year rates in the last two quarters were also slightly above 9%. By component, the higher growth stemmed from private consumption and, especially, investment. Unemployment was 2 pp lower than at end-2004. The negative contribution of external demand was significantly lower, since positive export developments partially offset the still sustained rate of increase in imports. The current account balance was positive, albeit lower than in previous years, owing to the excellent performance of the trade balance (which ran a somewhat smaller surplus, albeit still close to 6% of GDP). With regard to fiscal policy, the pattern of previous years continued: notable growth in revenues enabled primary expenditure to rise, and it did so more sharply in 2005 on account of the parliamentary elections. The public sector (excluding the provinces) ended the year with a primary surplus equivalent to 3.7% of GDP, down slightly from 2004. However, it should be noted that this ample surplus is still determined, as seen in Chart 16, by the size of the revenues from certain distorting taxes, in particular withholdings on exports, which reached 4% of GDP.

The acceleration in inflation is the main factor of concern. Inflation ended the year at 12.3% and the latest available data show no sign of a significant slowdown in the short run, although in February the rate edged down to 11.5%. The acceleration in inflation is attributed by the authorities to relative price adjustments, although other factors must also be playing a significant role, such as the rate of money creation imposed by the accumulation of reserves, the exhaustion of spare capacity in certain sectors and the impact of the depreciation of the peso on marketable products. The response of the central bank to the acceleration in inflation consisted of a mild and gradual tightening of monetary policy and partial sterilisation of money issuance through the sale of bills (LEBACs) and the cancellation of rediscounts granted to the banks during the crisis, in order to reconcile, at least temporarily, the control of inflation with the easing of the substantial pressures on the exchange rate, which has depreciated, however, by 6% against the dollar since September. This lack of reaction by the monetary authorities was made up for by administrative measures to restrain prices, through agreement with productive and distributive sectors and strong restraint of regulated prices, which, despite including energy products, increased by barely 3% in 2005. It is estimated that, without these measures, inflation would have been over 14% (see Chart

CHILE AND VENEZUELA

CHART 17



SOURCES: INE Chile and Banco Central de Venezuela.

16). The room for manoeuvre afforded by the favourable macroeconomic background led the government, after its strengthening in the legislative elections in October, to take measures to strengthen its financial autonomy. Thus, the IMF loan was repaid early (out of the large accumulated reserves, which were reduced by more than one-third), so that the country released itself from the conditionality associated with IMF programmes, while bonds with a value of USD 2.8 billion were sold to the Venezuelan government. The reaction of the markets to these measures was negative, but moderate: the stock exchange and sovereign spreads behaved less favourably than in the rest of the region. Finally, it should be noted that both the recent currency depreciation and the reduction in reserves arising from repayment to the IMF are conducive to continuation of the exchange-rate and monetary policies pursued to date.

Activity in *Chile* decelerated somewhat in the second half of 2005, from very high rates; year-on-year growth fell from 6.9% in the first half to 5.8% in Q3 and in Q4. In any event, growth in 2005 as a whole was 6.3%, similar to the rate in 2004. The slowdown was caused by slower export growth, which led to an increase in the negative contribution of external demand to around 6 pp, while domestic demand grew at year-on-year rates of over 10%. Paid employment grew strongly, in contrast to the fall in self-employment from mid-2005 (see Chart 17). Despite the strength of domestic demand, the high price of copper increased the trade surplus to 8.5% of GDP and enabled a surplus of 0.6% of GDP to be recorded on current account. These two factors, along with the spending restrictions augured by the structural surplus rule, also explain the fiscal surplus of 4.8% of GDP. Inflation increased during 2005 and ended the year at 3.7%. It rose higher in the first few months of 2006, to exceed the target range of 4%. Underlying inflation increased significantly, to reach 3.5% in February 2006, up from levels of close to zero. In these circumstances, the central bank continued to tighten monetary policy, until interest rates reached 4.75%. However, there was a pause at the end of 2005, owing to the concern prompted by the significant appreciation of the peso, both in nominal and in real terms in the second half of the year. Unlike most stock markets in the region, the Chilean market rose only moderately in 2005 (9%). The behaviour of sovereign spreads was not as favourable as in the rest of the region, but this was attributable to a technical reason relating to the change, at the end of October, in the composition of its EMBI. Finally, the coalition government's candidate won the presidential elections and the coalition achieved an absolute majority in both legislative chambers.

Growth in *Colombia* may have ended 2005 close to 5% (a ten-year high). In Q3, year-on-year growth was 5.7%, which meant that the strong buoyancy of activity in the previous quarter was sustained. Domestic demand grew vigorously, especially on account of the extraordinary behaviour of investment (up 32.5% year-on-year), although the improvement in the labour market also contributed to the buoyancy of consumption. The contribution of the external sector was strongly negative. There was a large current account deficit in Q3, as a consequence of higher profit and dividend payments, which meant the balance for the year as a whole returned to deficit. However, the increase in the capital account surplus in 2005 led to a heavy accumulation of reserves. The outlook for the fiscal result improved progressively over the year, as revenues increased by more than expected, owing to the boom in activity. On the spending side, lower interest payments were neutralised by higher current expenditure. Inflation ended 2005 at 4.9%, down 0.6 pp from end-2004 and within the central bank's target range, this behaviour being confirmed at the beginning of 2006. The fall in inflation was supported by the appreciation of the Colombian peso during the year, although the latter was moderate, especially in the second half of the year, on account of the central bank's foreign currency purchases. These purchases were partly sterilised by the sale of reserves to the government to manage the external debt. Against this background, the central bank decided to reduce its official interest rates in September by 50 bp to 6%. Stock markets rose by more than 100% during 2005, the largest gain in the region.

In *Peru*, the economy accelerated notably in 2005 Q4 (to 7.7% year-on-year), ending the year with growth of 6.7%, up almost 2 pp from the previous year. This higher growth was explained by the acceleration in domestic demand and is consistent with the increase in employment. A trade surplus was recorded in 2005 for the fourth year running (6.6%). This surplus was higher than in previous years, given the improvement in the terms of trade, which led to year-on-year export growth of 37%, in current dollar terms. These trade balance developments, along with the buoyancy of remittances, explain the current account surplus (1.3% of GDP), the first in 25 years, despite the deterioration in the factor income balance. The government deficit fell to 0.4% of GDP, 0.7 pp lower than in 2004 and below the fiscal target (1%), helped by the improvement in the primary surplus. Inflation ended the year at 1.5%, the lower end of the target range, but increased notably in the first two months of 2006. After holding its reference interest rate at 3% for 14 months, the central bank has raised it gradually by 1 pp since December 2005. The exchange rate, under strong pressure since 2003, depreciated against the dollar to 6% from September, although it has recently strengthened somewhat. The sovereign spread declined during 2005, to a historic low in October, since when it has been subject to some volatility.

In *Venezuela*, activity was highly buoyant in the second half of 2005, with year-on-year growth of 9.5% in Q3 and 10.2% in Q4. In 2005, therefore, the economy grew by 9.3%, although the contribution of the oil industry was very small, implying a change in composition with respect to previous years (see Chart 17). Despite slowing in the second half, domestic demand continued to grow at very high rates, driven especially by investment. The rate of unemployment was not in double figures at end-2005, for the first time since January 1999, although this was partly a consequence of unemployed persons moving outside the labour force owing to government social programmes. Although the contribution of the external sector to growth was strongly negative, high oil prices led exports to increase by 43%. The large trade surplus took the current account balance to a new historic high (22.4% of GDP) which, along with the maintenance of controls on outflows of foreign exchange, generated a heavy accumulation of reserves. Against this background, public spending increased drastically. Inflation continued to moderate, to stand at 14.4% at end 2005, down 4.8 pp from 2004. However, this reduction is the result of government-imposed price controls and the stability of the exchange rate, which

remained fixed following the February 2005 (of 10.7%), there being no plans to change it this year.

In *Uruguay*, the economy was highly buoyant, although its year-on-year growth rate moderated from 6.9% on average in the first half to 5.9% in the second half, making for a rate of 6.6% for the year as a whole. The inflation rate ended the year at 4.9%, at the upper end of the target range, although it rose to 6.7% at the beginning of 2006. In *Ecuador*, the economy continued to slow in the second half of 2005, mainly on account of the reduced buoyancy in the oil industry. Inflation rose from 1.5% in the first half of the year to around 5% in the first few months of 2006. Developments in the external sector were unfavourable, since the volume of exports fell, while imports increased slightly. This difficult economic environment and the uncertainty surrounding the October presidential elections would explain the scant reduction of sovereign spreads in comparison with other countries of the region. In *Bolivia*, following a prolonged period of upheavals, the opposition candidate achieved a resounding election victory. However, growing state intervention in certain spheres of activity may discourage foreign direct investment, which would have negative consequences for economic growth.

28.3.2006.