HALF-YEARLY REPORT ON THE LATIN AMERICAN ECONOMY

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*Introduction*

Following several years of low growth, the pace of economic activity gathered strong momentum in the first half of 2004. For the region's main countries taken as a whole, year-on-year GDP growth stood comfortably above 5% in the first two quarters of the year. Growth was above 3.5% in all of them at the end of June, highlighting the fact that the expansionary phase is generalised in Latin America. Further, after some uncertainty at the start of Q2, the region's financial markets were able to ride the start of the cycle of rising rates in the United States without excessive difficulty, and thus helped strengthen the favourable short-term prospects for the Latin-American countries. The incipient impetus of domestic demand, which firmed during the first six months of 2004 after a period of slackness, should continue to buoy activity in the second half of the year, offsetting the gradual closing of the output gaps and the smaller expected contribution of external demand. Fiscal policies, following a period of strong restrictiveness, were able to adopt a somewhat more expansionary stance and contribute, too, to boosting activity. In any event, the improved public finances position suggests that the degree of fiscal discipline has not weakened, though caution remains necessary here.

Against this favourable international background, one of the factors of risk for economic developments in the region is that inflation pressures may take root and force the monetary policy stance to be tightened further than was already the case in some countries in the first half of the year. Such a scenario might slow the recovery, but would be unlikely to interrupt it. Also, a downward adjustment in commodity prices might adversely affect the external accounts and detract more quickly than desirable from the current solid contribution of exports to growth. Taking a broader view, public finances continue to be fragile and external debt remains high, while capital flows and, in particular, direct investment have not regained the vigour observed a few years back. Accordingly, the current favourable circumstances should be harnessed – and there are signs this is happening in most countries – to lessen economic and financial vulnerability, increase support for reform and restore the attractiveness of the region for investors.

*Economic and financial developments in the area*

EXTERNAL ENVIRONMENT

Against the backdrop of the global economic expansion (see Chart 1), the predominant factor on international financial markets during the first half of the year was the expectations of the start of interest rate rises in the United States. At the outset of Q2, the emergence of potential inflationary pressures, generated by the strong rise in crude oil prices and underscored by the favourable data on US activity and employment, prompted an upward revision of expectations about future rises in interest rates. It also led to a notable increase of around 100 bp in long-term rates in the developed countries, which increased the slope of the yield curve even more. Although the indicators of global risk-aversion did not undergo significant changes, investors reacted by unwinding positions in emerging economies' debt markets. These adjustments triggered a bout of financial turbulence on these markets which was sharper and longer-lasting than that in January, which had brought to an end a long and intense process of squeezes on sovereign spreads. These rebounded notably, losing in a few short weeks all they had gained in the second half of the previous year (see Chart 1). The movement was across the board, albeit sharper in the countries with greater fiscal vulnerabilities, though the turbulence proved transitory. Rises in interest rates in the United States actually began at the end of June, but they did not adversely affect the financial markets. Indeed, the fact that these rises were widely anticipated and, above all, that they coincided with renewed expectations that monetary tightening would be gradual and moderate has led, in recent

**GLOBAL MACROECONOMIC AND FINANCIAL INDICATORS** CHART 1
**Year-on-year changes, percentage, basis points and index**


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

a. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore and Taiwan.
b. B1 bond: US industrial corporations.
c. Implicit volatility in CBOE options multiplied by 10.

months, to a reduction in long-term interest rates and to a squeeze on emerging countries' sovereign spreads, taking the latter to levels close to those at the beginning of the year.

Stock markets in the developed countries, despite firmer expectations of recovery, performed erratically, with no notable gains having arisen during the year to mid-September. The indices of the emerging Asian countries trended similarly, while the performance in Eastern Europe and Latin America was more favourable. A negative factor bearing on the first half of the year, along with the prospect of interest-rate rises, was the upward trend of crude oil prices, which intensified during the summer. This was in contrast to the behaviour of other commodities, where the generalised price rises observed since early 2003 were curtailed. Thus, metal prices stabilised, with moderate declines in the price of copper, and agricultural commodities prices contracted.

**LATIN AMERICAN GDP**
Year-on-year change

CHART 2


SOURCE: National Statistics Offices.

a. Excluding Argentina, Venezuela and Uruguay.

ECONOMIC ACTIVITY

The growth rate of Latin American GDP stood at 5.5% in 2004 Q2 compared with the same period a year earlier, practically unchanged on Q1. That confirms that the expansionary cycle in the region is taking root at a vigorous rate (see Chart 2). The stabilising of the growth rate in Q2 is due to the tendency towards the normalisation of growth rates in those countries whose activity had risen very strongly in previous quarters, following economic crises (Venezuela, Argentina and Uruguay), since growth rates in the remaining countries have held steady or increased notably. Excluding the three foregoing countries, then, growth would have reached 4.9% year-on-year in Q2, compared with 3.4% in Q1 and with 1.4% in 2003 Q4. As a result, there has been less dispersion in growth rates, which exceeded 3.5% in all cases at the end of the first half of the year. Of particular note is the buoyancy of the recovery in Brazil, with growth rising from a rate of practically zero at end-2003 to 5.7% in 2004 Q2. That entailed a contribution of over 2 pp to the region's annual growth and, above all, dispelled doubts over the difficulties of resuming robust growth rates.

## LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

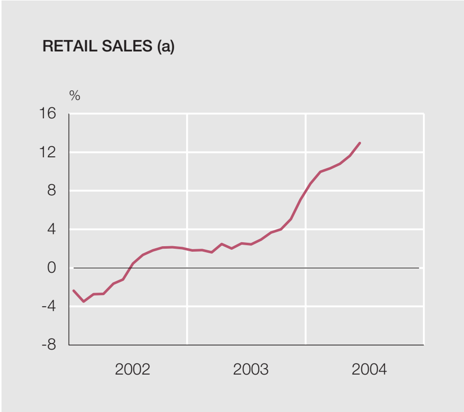
| | 2001 | 2002 | 2003 | 2002 | | 2003 | | | | 2004 | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 |
| GDP (year-on-year change) | | | | | | | | | | | |
| Latin America (a) | 0.3 | -0.3 | 1.8 | 0.6 | 1.4 | 1.9 | 0.8 | 1.3 | 3.0 | 5.5 | 5.5 |
| Argentina | -4.4 | -10.8 | 8.7 | -9.8 | -3.4 | 5.4 | 7.7 | 10.2 | 11.7 | 11.2 | 7.0 |
| Brazil | 1.4 | 1.9 | -0.2 | 3.0 | 3.9 | 1.9 | -1.1 | -1.5 | -0.1 | 2.7 | 5.7 |
| Mexico | -0.3 | 0.7 | 1.3 | 1.8 | 1.8 | 2.5 | 0.1 | 0.6 | 2.0 | 3.7 | 3.9 |
| Chile | 3.1 | 2.1 | 3.3 | 2.4 | 3.2 | 3.7 | 2.8 | 3.0 | 3.3 | 4.8 | 5.1 |
| Colombia | 1.4 | 1.8 | 3.7 | 2.0 | 2.6 | 3.8 | 2.6 | 4.4 | 5.0 | 4.2 | 4.4 |
| Venezuela | 2.7 | -8.2 | -7.6 | -5.9 | -15.8 | -25.0 | -5.2 | -6.7 | 7.0 | 34.8 | 13.6 |
| Peru | -0.1 | 5.1 | 3.8 | 5.2 | 4.5 | 5.7 | 3.6 | 3.0 | 2.9 | 4.9 | 3.6 |
| Uruguay | -3.1 | -10.8 | 2.5 | -13.4 | -14.0 | -8.1 | -4.7 | 7.5 | 15.8 | 14.3 | 12.7 |
| CPI (year-on-year change) | | | | | | | | | | | |
| Latin America (a) | 5.8 | 9.2 | 11.1 | 10.0 | 12.1 | 14.0 | 12.2 | 10.0 | 8.0 | 6.1 | 5.7 |
| Argentina | -1.1 | 25.9 | 14.8 | 36.0 | 40.3 | 35.7 | 14.5 | 5.2 | 3.7 | 2.4 | 4.1 |
| Brazil | 6.8 | 8.5 | 14.8 | 7.6 | 10.6 | 15.6 | 16.9 | 15.2 | 11.4 | 6.8 | 5.5 |
| Mexico | 6.4 | 5.0 | 4.6 | 5.2 | 5.3 | 5.4 | 4.7 | 4.1 | 4.0 | 4.3 | 4.3 |
| Chile | 3.1 | 2.9 | 2.8 | 2.4 | 2.9 | 3.8 | 3.7 | 2.7 | 1.1 | 0.0 | 0.5 |
| Colombia | 8.0 | 6.4 | 7.1 | 6.0 | 6.8 | 7.4 | 7.6 | 7.1 | 6.4 | 6.2 | 5.6 |
| Venezuela | 12.5 | 22.4 | 31.4 | 24.8 | 30.6 | 35.4 | 34.1 | 29.6 | 26.2 | 24.0 | 22.4 |
| Peru | 2.0 | 0.2 | 2.3 | 0.3 | 1.4 | 2.8 | 2.4 | 1.9 | 1.9 | 3.0 | 3.4 |
| Uruguay | 4.4 | 14.0 | 20.0 | 18.9 | 25.0 | 27.9 | 26.3 | 15.0 | 10.7 | 9.3 | 9.2 |
| PUBLIC SECTOR DEFICIT (% GDP) | | | | | | | | | | | |
| Latin America (a) | -3.2 | -5.1 | -2.0 | -4.7 | -5.1 | -4.8 | -3.2 | -2.0 | -2.0 | -1.7 (b) | -1.9 (b) |
| Argentina | -3.0 | -1.5 | 0.4 | -2.2 | -1.3 | -0.7 | 0.0 | 0.5 | 0.4 | 1.1 | 2.4 |
| Brazil | -5.2 | -10.5 | -3.7 | -8.9 | -10.3 | -10.2 | -6.5 | -3.7 | -3.7 | -3.4 | -4.2 |
| Mexico | -0.7 | -1.2 | -0.7 | -0.6 | -1.1 | -0.6 | -0.5 | -0.6 | -0.7 | -0.4 | -0.7 |
| Chile | -0.3 | -0.8 | -1.4 | -1.2 | -0.8 | -0.3 | -0.5 | -1.1 | -1.4 | -1.1 | 0.3 |
| Colombia | -4.3 | -3.6 | -2.6 | -5.4 | -3.6 | -3.6 | -2.8 | -2.9 | -2.6 | … | … |
| Venezuela | -4.5 | -1.1 | 0.2 | -3.6 | -1.1 | -1.2 | -0.5 | 1.9 | 0.2 | … | … |
| Peru | -2.4 | -2.2 | -1.8 | -2.6 | -2.1 | -1.9 | -1.8 | -1.7 | -1.8 | -1.5 | -1.0 |
| Uruguay | -4.5 | -5.1 | -5.2 | -5.2 | -5.1 | -5.1 | -6.8 | -5.8 | -5.2 | -5.4 | -2.9 |
| PUBLIC SECTOR DEBT (% GDP) | | | | | | | | | | | |
| Latin America (a) | 40.8 | 51.7 | 56.2 | 57.2 | 54.9 | 56.9 | 52.4 | 55.6 | 56.2 | 55.6 | 55.4 (b) |
| Argentina | 53.8 | 140.0 | 130.0 | 142.6 | 144.9 | 142.0 | 121.6 | 131.1 | 130.0 | 133.1 | … |
| Brazil | 52.6 | 56.5 | 58.7 | 62.5 | 55.5 | 55.0 | 55.6 | 58.1 | 58.7 | 57.0 | 56.0 |
| Mexico | 22.4 | 24.4 | 23.5 | 24.0 | 22.9 | 23.5 | 22.8 | 24.8 | 23.5 | 23.5 | 23.8 |
| Chile | 11.8 | 12.3 | 13.6 | 12.3 | 11.9 | 12.3 | 14.1 | 14.7 | 13.6 | 14.6 | 13.2 |
| Colombia | 44.3 | 50.5 | 48.9 | 48.1 | 47.6 | 51.3 | 49.2 | 49.8 | 48.9 | 48.8 | … |
| Venezuela | 46.4 | 48.4 | 61.0 | 44.1 | 48.4 | 41.9 | 45.6 | 52.0 | 61.0 | 47.0 | … |
| Peru | 46.1 | 47.0 | 47.0 | 47.1 | 46.6 | 48.3 | 41.8 | 46.9 | 47.0 | 45.9 | 40.0 |
| Uruguay | 54.0 | 97.4 | 123.8 | 117.0 | 116.4 | 117.7 | 120.0 | 124.8 | 123.8 | 130.7 | … |
| CURRENT ACCOUNT BALANCE (% GDP) | | | | | | | | | | | |
| Latin America (a) | -2.9 | -0.1 | 1.1 | -1.3 | -0.2 | 0.2 | 0.8 | 1.0 | 1.1 | 1.3 | 1.1 (b) |
| Argentina | -1.7 | 9.8 | 5.7 | 8.1 | 10.1 | 10.0 | 7.4 | 6.8 | 5.7 | 4.5 | … |
| Brazil | -4.6 | -1.7 | 1.0 | -3.6 | -1.9 | -1.1 | 0.3 | 0.9 | 1.0 | 1.0 | 1.5 |
| Mexico | -2.9 | -2.2 | -1.4 | -2.5 | -2.2 | -2.0 | -1.7 | -1.7 | -1.4 | -1.3 | -1.2 |
| Chile | -1.8 | -0.9 | -0.8 | -1.1 | -1.3 | -1.3 | -1.5 | -0.7 | -0.8 | -0.1 | 1.5 |
| Colombia | -1.5 | -1.9 | -1.8 | -1.6 | -1.9 | -2.3 | -1.9 | -1.9 | -1.8 | -1.9 | … |
| Venezuela | 1.7 | 9.5 | 14.5 | 4.2 | 8.2 | 9.6 | 13.5 | 13.3 | 14.5 | 17.3 | … |
| Peru | -2.2 | -2.0 | -1.8 | -1.8 | -2.0 | -2.2 | -2.0 | -2.0 | -1.8 | -1.0 | -1.0 |
| Uruguay | -2.6 | 2.1 | 0.5 | 0.2 | 2.8 | 1.8 | 2.4 | 1.8 | 0.5 | 0.8 | … |
| EXTERNAL DEBT (% GDP) | | | | | | | | | | | |
| Latin America (a) | 39.2 | 57.3 | 46.7 | 55.7 | 57.3 | 55.9 | 47.3 | 48.0 | 46.7 | 55.4 (b) | … |
| Argentina | 52.2 | 136.9 | 106.7 | 143.9 | 141.6 | 133.7 | 102.1 | 108.9 | 106.7 | 108.9 | --- |
| Brazil | 41.6 | 51.9 | 41.2 | 51.4 | 57.3 | 54.0 | 45.3 | 43.5 | 41.2 | 39.7 | --- |
| Mexico | 23.1 | 21.6 | 22.1 | 23.1 | 21.7 | 23.9 | 21.6 | 22.8 | 22.1 | 21.1 | 21.3 |
| Chile | 56.2 | 62.2 | 61.6 | 62.2 | 62.7 | 60.9 | 56.5 | 58.2 | 61.6 | 55.0 | 47.5 |
| Colombia | 44.4 | 39.7 | 43.2 | 45.6 | 45.1 | 48.9 | 45.8 | 44.4 | 43.2 | 40.4 | … |
| Venezuela | 36.0 | 50.6 | 57.6 | 60.0 | 59.9 | 56.2 | 55.3 | 56.5 | 57.6 | … | … |
| Peru | 50.7 | 49.3 | 48.3 | 51.0 | 49.0 | 50.4 | 43.7 | 48.6 | 48.3 | 47.3 | 41.8 |
| Uruguay | 47.9 | 90.2 | 112.5 | 106.4 | 107.8 | 103.3 | 104.9 | 107.6 | 112.5 | 115.2 | … |

SOURCES: IMF, Banco de España and National Statistics Offices.

a. Aggregate of 8 represented countries.

SUPPLY AND DEMAND
Year-on-year changes

CHART 3


SOURCE: National Statistics Offices.

a. Quarterly moving averages.

The most frequent indicators reveal that the growth rate in the area remains vigorous moving into the second half of the year (see Chart 3). The strength of industrial production growth, which ended Q2 standing at a year-on-year rate of 7.3%, compared with 3.3% at end-2003, is taking hold in Q3 (in July, growth stood at over 8%). And other indicators, such as retail sales, continue to accelerate (certain exceptions such as Mexico and Chile aside), posting a year-on-year growth rate of over 10% for the region as a whole in July.

The most notable aspect of the regional expansion was the firming of internal demand, after a lengthy phase of slackness prompted by the economic adjustment arising from past financial turbulence. While the financial situation progressively moved onto a normal footing during 2003, the effects of this turbulence were particularly persistent on internal demand since it reduced disposable income and agents' appetite to invest, and heavily restricted public spending. The recent rise in private consumption, reflected too in the increase in consumer confidence (although this variable has tended to behave somewhat erratically), was sustained by the improvement in the labour market which, however, was not generalised. Real wages in the area as a whole once again posted positive growth rates after continuous declines since early 2002 (see Chart 4). They picked up most in those countries where they had been most depressed, in Argentina and Brazil for instance, while in other countries, such as Mexico, they are rising very moderately. In parallel, the growth of employment held stable at around 3% year-on-year in Q2, though there are countries such as Chile where, despite buoyant activity, job creation fell below 1%. Investment (see Chart 5) also picked up markedly, rising for the region as a whole to a growth rate of 10% in Q1 compared with the same period a year earlier. The resumption of robust increases in investment in Brazil following the decline in recent years was noteworthy, as was the scale of investment growth in Argentina and Venezuela, albeit from very depressed levels. However, few countries have resumed the investment/GDP ratios that were being posted at the end of the nineties, which would be desirable if medium-term growth prospects are to take root. In any event, the recent buoyancy of internal demand, in all its components, has meant that, for the first time in recent years, it is taking up the baton from external demand as the driving force of the expansion, accounting for all of the year-on-year growth in Q2 (5.5 pp), compared with its end-2003 contribution of only 2 pp.

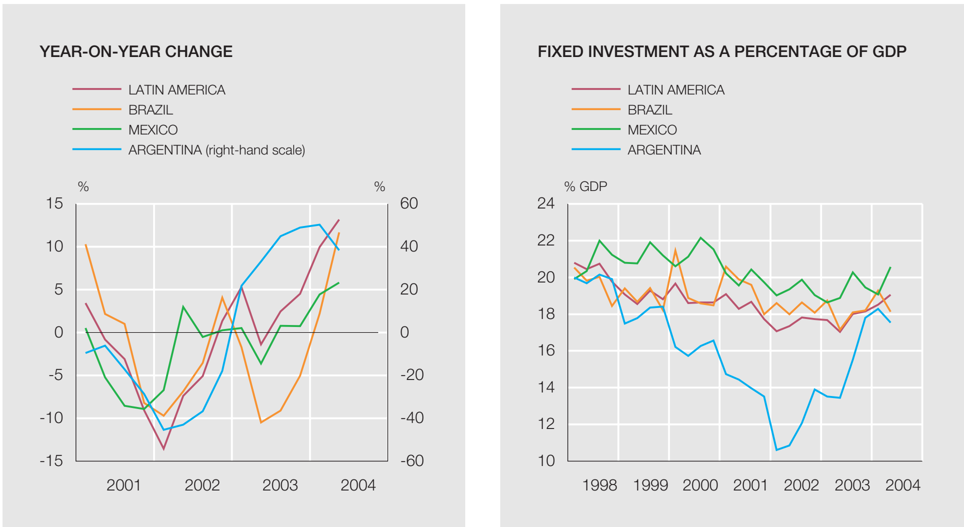
## LABOUR MARKET
### Year-on-year changes

CHART 4


SOURCE: National Statistics Offices.

## FIXED INVESTMENT
### Year-on-year changes and percentage of GDP

CHART 5

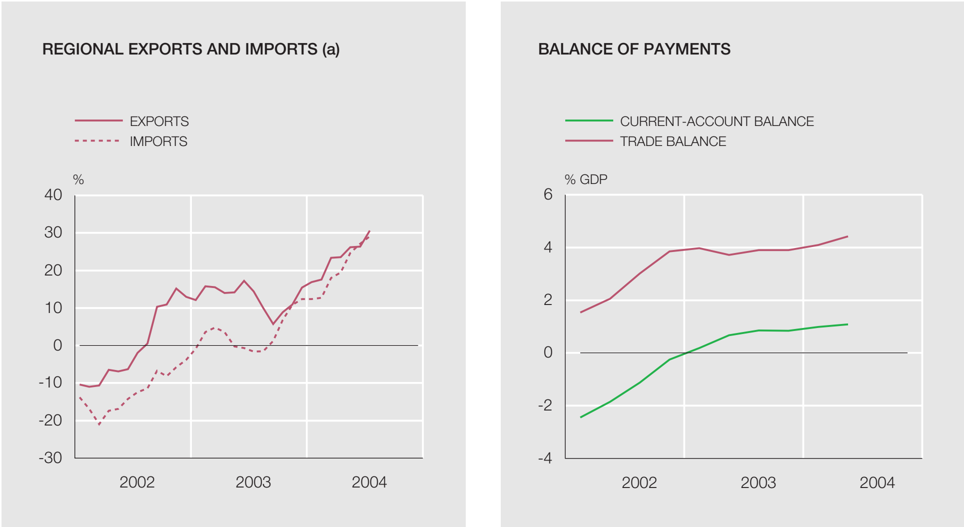



SOURCE: National Statistics Offices.

The zero contribution of external demand to growth in Q2, following the significant positive contribution it was still posting at end-2003 (0.8 pp), is due to the pick-up in imports and does not mean that the vigour of exports is diminishing. Indeed, the persistent strength of exports is a particularly salient feature of recent economic developments in the region. Exports climbed to a year-on-year growth rate of 27% at the end of the first half of the year, despite the fact that at the same juncture a year earlier they were already posting growth of over 15% (see Chart 6). This strength was across the board, though it was most notable in Venezuela, Chile and Brazil, whose respective rates exceeded 80%, 50% and 40%. That said, in Venezuela the base effect played a leading role. Mention should also be made of the acceleration in the pace of Mexican exports, after this country's lagging recovery in relation to the pick-up in the United States. In Argentina and Colombia, where

EXTERNAL ACCOUNTS
Year-on-year changes and percentage of GDP

CHART 6




SOURCE: National Statistics Offices.

a. Quarterly moving average.

the growth rate of exports was most moderate, the related corresponding rates stood at around 10%. No doubt contributing to these figures was the increase in global demand (particularly that stemming from China) and, in association with this, the sound behaviour of commodities prices. Yet it should be stressed that the expansion of exports does not compare favourably with other emerging regions, which are also benefiting from the global increase in trade, as analysed in Box 1, calling into doubt whether such an expansion is due to a structural improvement in the competitiveness of Latin American economies. Further, the recent fall in the price of certain non-energy products that are very important for some countries, such as copper (Chile) and soybeans (Brazil, Argentina), may adversely affect exports in the coming quarters. In step with the strength of internal demand, imports quickened strongly in the first half of the year to a growth rate similar to that of exports, around 25% at the end of June. In countries such as Argentina (90%) and, to a lesser extent, Brazil and Venezuela (around 40%), the increases were even more significant.

The favourable performance of the external sector helped prolong the improvement in the trade surplus in many countries, which comfortably exceeded 4% of GDP in the area as a whole in Q2 (see Chart 6). However, the recent trend of imports and, as mentioned, of commodity prices has suggested that in the coming quarters the substantial trade surplus might progressively narrow. In any event, behaviour diverged across the different countries. Brazil continued to post growing surpluses which placed the trade balance at over 5% of GDP in Q2 and Chile witnessed a strong rebound to 7%, while the deficit narrowed in Colombia and Mexico. Nonetheless, the surplus in Argentina narrowed by 0.4 pp of GDP over the last year to 11% in 2004 Q2. Along with the favourable performance of emigrants' remittances, external dynamism underpinned the prolonged improvement in the current-account balance in most countries, which is a particularly favourable aspect of the current upturn. In all countries except Argentina and Uruguay, current-account balances improved in the first half the year. In particular, Chile and Peru are close to reaching a balanced external position. In the region as a whole, meanwhile, the surplus stabilised at around 1% of GDP.

A notable feature of the recent performance of the Latin American economy has been the prolonged strength of exports. Since 2002 Q2, when the current phase of export buoyancy in the region began, sales abroad measured in current dollars have increased by 14.2% in annual terms. This growth has, moreover, been accelerating over time, rising to its highest rate for the region as a whole in 2004 Q2. Nonetheless, these positive figures do not compare favourably with recent export growth in other emerging markets. Indeed, according to IMF figures, the annual average increase between 2002 and 2004 in the value of exports will amount to 18.8% in Asia and 21.2% in eastern Europe, and even Africa, with growth of 15.3%, will outpace Latin America. Consequently, Latin America would be one of the areas least to have benefited from the momentum of global demand, a fact equally apparent in its share in overall world trade, which fell from 5.8% in 2001 to 5.4%, while the share of the other emerging countries was rising, markedly so in the case of Asia. Compared with other expansionary cycles in the region, the current situation is akin to the pick-up following the 1999 crisis, in which Latin American exports grew, for the region as a whole, by 15.7% in annual average terms (between 1999 Q4 and 2001 Q2).

These comparisons would suggest that Latin America's recent export impetus is not exceptional in relative terms, either when compared with that of other emerging regions or in relation to its own past experience. They would also indicate that the region's gains in competitiveness have not been substantial. In fact, it has been pointed out that what are leading the increase in exports are the beneficial effects of price rises, particularly commodities prices, rather than an increase in export volumes. To examine this matter, the accompanying table shows the observed cumulative increase during the latest growth phase in the value of exports (2002 Q2 to 2004 Q2, the latest figure available) in the seven main Latin American countries (in local currency or in current dollars, according to the source), breaking it down into change in price and amounts. As far as data availability permits, figures are also presented for different export headings, distinguishing between commodities and manufactures, so as to examine on which sectors (across which there will foreseeably be substantial differences in value added) increases in prices and amounts have been concentrated.

The countries are ranked according to the recorded increase in export volume. Brazil is the country where value (48.3%) and volume (25.5%) have most increased, and the only one in which increases in amounts have been higher than increases in prices, due above all to the vigour of exported amounts of manufactures (50%), whose price has moreover fallen. In Peru, the strong rise in value (44.5%) is mainly due to the increase in the price of mined (metals) exports and oil, but there has also been a notable rise in the volume (34.6%) of non-traditional exports, essentially manufactures. Chile, Mexico and Argentina have seen significant but moderate increases in volume. Mexico has witnessed an increase in volume in all items, but one lower in all instances to the increases in prices. Worthy of mention here is the increase (33.8%) in the price of Chilean exports, based on the strong rise in metal commodities, especially copper, one of the mainstays of Chilean exports. Finally, Colombia and Venezuela, where the related figures are less accurate, also recorded strong increases in the value of exports, although rises were small in terms of volume, and even negative in the case of oil.

**LATIN AMERICAN EXPORTS**
**Change 2004 Q2/2002 Q2**

| | VALUE | VOLUME | PRICE |
|---|---|---|---|
| BRAZIL (a) | | | |
| Total | 48.3 | 25.5 | 22.8 |
| Primary sector | 66.5 | 22.8 | 43.8 |
| Semimanufactured | 51.4 | 21.9 | 29.5 |
| Manufactures | 42.4 | 50.8 | -8.4 |
| PERU (A) | | | |
| Total | 44.5 | 19.6 | 24.9 |
| Agriculture | 11.2 | 1.7 | 9.5 |
| Mining | 47.3 | 4.2 | 43.1 |
| Crude oil | 62.8 | 13.5 | 49.3 |
| Non-traditional products | 52.4 | 34.6 | 17.8 |
| CHILE (a) | | | |
| Total | 43.7 | 9.9 | 33.8 |
| Mining | 66.7 | 6.8 | 59.9 |
| Agriculture | 23.0 | 19.3 | 3.7 |
| Manufactures | 31.4 | 12.7 | 18.7 |
| Rest of exports | 16.5 | 1.6 | 14.9 |

| | VALUE | VOLUME | PRICE |
|---|---|---|---|
| MEXICO (b) | | | |
| Total | 26.6 | 6.9 | 19.7 |
| Oil | 28.4 | 9.4 | 19.0 |
| Mining | 48.3 | 10.7 | 37.6 |
| Manufactures | 22.1 | 5.7 | 16.4 |
| ARGENTINA (a) | | | |
| Total | 22.7 | 5.7 | 17.0 |
| Primary sector | 11.7 | -12.5 | 24.2 |
| Manufactures | 5.2 | 5.3 | -0.1 |
| Manuf. of agricultural origin | 47.9 | 23.3 | 24.6 |
| Energy | 23.7 | -5.9 | 29.6 |
| COLOMBIA (b) | | | |
| Total | 30.4 | 2.3 | 28.1 |
| Coffee (a) | 12.3 | 8.8 | 3.5 |
| Oil (a) | 8.0 | -15.8 | 23.8 |
| VENEZUELA (a) | | | |
| Oil | 24.6 | -8.7 | 33.3 |

a. Value in US dollars.
b. Vaule in local currency.

**THE RECENT EXPORT BUOYANCY** (cont'd) BOX 1

The factors behind these divergent performances would be the structure of exports (Argentina, Brazil, Peru and Chile would be better placed, in principle, to harness the great momentum of the demand for agricultural and mineral commodities) and the improvement in relative costs, induced by currency depreciation and the strong adjustment of real wages in certain countries, such as Brazil, Argentina and, to a lesser extent, Peru. Lastly, while difficult to quantify, the extension of inter- and intra-regional agreements might have given an added and more permanent boost to trade. Despite these sizable increases in export volumes, comparison with developments in other emerging regions reveals that the behaviour of the Latin American economy is not remarkable: export volumes in Latin America would have grown by 8.2% in annual average terms in the period under study, far below Asia (16%), the emerging Asian countries (12%) and eastern Europe (10.5%).

In sum, these results would, first, support the hypothesis that the recent export buoyancy in Latin America is essentially due to the improved terms of trade of its exports (among which commodities are predominant in many cases), to the expansion of global demand and to the cumulative real depreciations in most of the region's countries in recent years. Further, they would confirm that the gains in competitiveness, in a structural sense, have not been significant, and this has been reflected in a loss of market share vis-à-vis other emerging economies.

FINANCIAL MARKETS AND EXTERNAL FINANCING

The performance of financial markets during the first half of the year contrasted to some extent with that of activity, although a notable improvement has been taking root in recent months. There were two bouts of instability, which affected, above all, the sovereign debt markets. But in a less generalised and more temporary way, they bore on certain currency markets (see Chart 7). The first of the two episodes, in mid-January, saw Latin-American spreads (Mexico and Chile excepted) resume levels above those recorded at end-2003, momentarily bringing to a halt the narrowing of spreads that had taken place for over a year. The second episode was in mid-April and was longer and more intense. The countries most affected were Brazil and Colombia, whose spreads increased by over 60%. For the region as a whole the deterioration was close to 25%, and the regional spread stood at 700 bp in May, almost 230 bp above the low recorded in mid-January. From late May spreads moved on a declining path again, meaning that by the end of September most countries had seen reductions compared with the start of 2004 (Chile stood at a historical low). Lastly, Argentina's sovereign spread stood at a very high level, oscillating ostensibly in step with the ongoing process of public debt restructuring. Overall, sovereign debt developments in Latin America this year have been fairly similar to those in other emerging regions, as can be inferred from the rise in the correlation of sovereign spreads plotted in Chart 7.

The contrast between the growing buoyancy of economic activity – which is, moreover, being accompanied by diminishing external and fiscal vulnerability – and the more erratic course of sovereign debt during the first half of the year may be seen as rather striking. The most likely explanation for this behaviour is that, as discussed in the introduction, investors have in recent quarters been more concerned by the prospect of a tightening of monetary conditions in the developed countries than by the economic fundamentals of each country. The rises in spreads can not be associated with corresponding increases in risk aversion, which has held relatively stable during the six-month period. Of note, indeed, is the recent discontinuation of the close correlation usually seen between the different indicators of global risk aversion and the sovereign spreads of the Latin-American countries (see Chart 7). Accordingly, the recent outbreaks of instability are due mainly to investors' adaptation to a setting of lower expected liquidity. Given that the positions in emerging debt were being financed with short-term debt in strong currencies, the attractiveness of these assets diminished in the face of the prospect of interest-rate rises in the developed countries.

**SOVEREIGN SPREADS AND CORRELATIONS**
**Basis points and level**

CHART 7

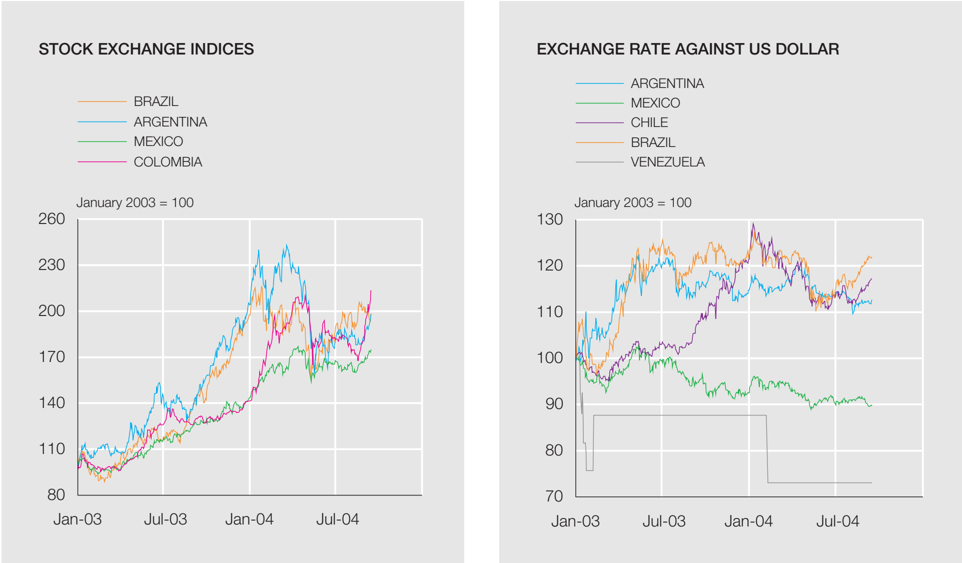

SOURCE: JP Morgan.

a. Average of three-month cross-correlations of Latin American countries included in the EMBI.
b. Three-month correlation between Latin America EMBI and other EMBI components.
c. Three-month correlation between Latin America EMBI and US high-yield bond, and implied volatility of CBOE options.

During the first two quarters of the year, the improvement in the economic and financial situation did not lead either to across-the-board changes in sovereign ratings by the rating agencies. Only Chile and Peru, in January and June, respectively, saw their sovereign rating upgraded, while that of the Dominican Republic, affected by financial and energy problems, was downgraded in February. Nonetheless, the ratings of Uruguay and, more recently, Venezuela and Brazil were upgraded in Q3.

The performance of stock markets (see Chart 8) differed from country to country, although on the whole it was somewhat more positive than in the developed nations and in the emerging Asian countries. Stock market gains in the first half of the year were notable in Colombia (29%) and comfortably exceeded 10% in Mexico, Peru and Venezuela. In Chile, meanwhile, the stock market was virtually flat during the first half of the year and, in Brazil, following declines of close to 20%, the first six months closed with losses of 5%. In Argentina, there was a fall of close to

**STOCK EXCHANGE INDICES AND EXCHANGE RATES** CHART 8
**Indices**




SOURCE: Datastream.

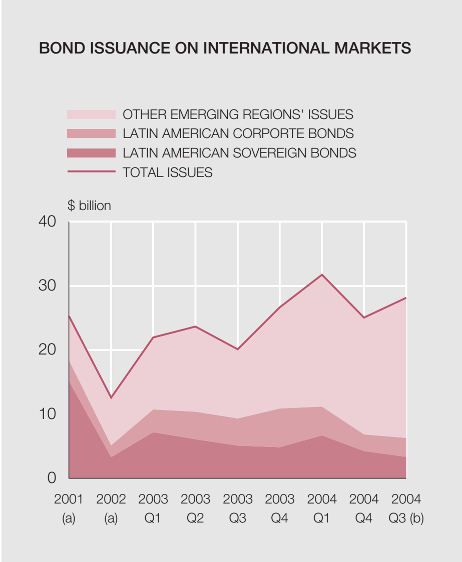
12% in the face of debt restructuring problems. By contrast, developments in Q3 are proving favourable, with increases across the board, especially in countries such as Chile and Brazil. As a result, at the end of September gains since the start of the year had been posted in all countries. And in some cases, such as Colombia, these were over 45%.

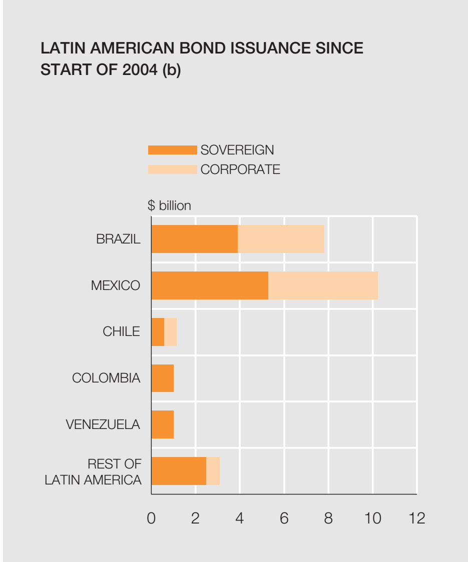
Exchange rates against the dollar fluctuated notably during the first six months of the year, prompted by the depreciations seen practically across the board during the bout of financial turbulence in April. At the end of the first half of 2004, the biggest depreciations were those of the Brazilian and the Chilean peso, which had lost around 10% of their value since the start of the year. Venezuela, the only important country in the region – along with Ecuador – to retain a fixed exchange rate regime, devalued the bolivar by 20% in February. In Mexico, the exchange rate displayed a moderate downtrend from Q2, as a result of which at mid-September the peso had lost 3% of its value against the dollar since the start of 2004. On the other hand, Colombia recorded a moderate appreciation as at the end of the first half of the year, which firmed at the beginning of the second half. In this latter period, the Brazilian real has practically reversed the whole of its first-half depreciation. Real exchange rates, by contrast, did not depreciate significantly, except in Venezuela (5.8% between January and August), and there were even some notable appreciations, such as Colombia (9%), and Brazil and Peru (both by more than 5%). Against this background of lower upward pressure on the nominal exchange rate, the upward trend in international reserves that dated back to the beginning of 2002 was generally cut short.

Caution on the part of external investors, reflected in developments in sovereign spreads, also governed the rate of issuance on the primary debt market (see Chart 9). In Q1, issuance totalled more than USD $11.2 billion, similar to the level in the same period of 2003, but was only $6.8 billion in Q2, less than a year earlier, owing to the unfavourable financing conditions. In fact, there were hardly any issues at all in May, though in June the market picked up again, and the projections for Q3 would confirm this improvement. In any event, the first half as a whole compares unfavourably with the first half of 2003; as other emerging countries reduced their issuance by a smaller proportion during Q2, the trend decline in the weight of Latin America in

**EXTERNAL CAPITAL FLOWS**
**Billions of US dollars**

CHART 9




SOURCE: JP Morgan.

a. Quarterly average.
b. Updated to September 15th.

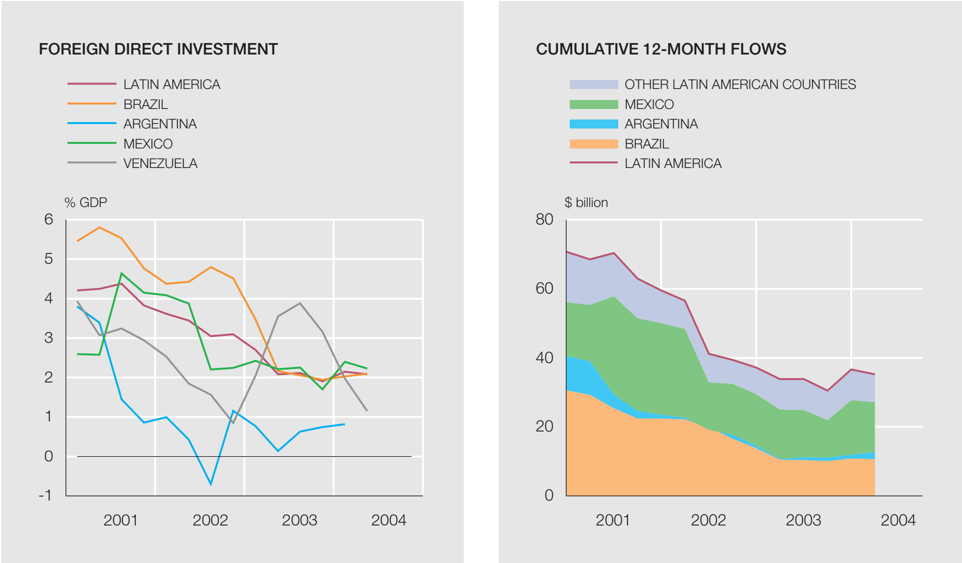
the issuance of emerging countries continued in the first half (from almost half the total in the second half of 2003 to barely one-quarter in the last half). This fall in share may be merely temporary, associated with the adjustment of recent years, which has also involved a switch towards local markets for the coverage of financing requirements.

As regards the cross-country distribution of issuance, Mexico accounted for 42% of Latin American issuance to mid-September, Brazil 32% and Chile, Venezuela and Colombia more than 4% each. Comparing sovereign with corporate issuance shows that the latter fell to a greater extent in Q2; in the first half of 2004, corporate bond issuance was $7 billion, as against $11 billion of sovereign bonds. In any case, compared to the previous year, the reduction in corporate issuance was slightly less than that of sovereign bonds (11.5%, against 16.7%, respectively). Other sources of financing, such as share subscription and syndicated loans, were at very low levels, even though in other emerging regions they recovered during the first half. Thus, Latin America continued to lose weight among the emerging economies in these forms of financing: it accounts for only 3% of share issuance and barely 10% of syndicated loans, when in 1999 these figures were 9% and 30%, respectively.

Another source of financing whose trend is particularly interesting is foreign direct investment (see Chart 10), which fell sharply from 4% of the region's GDP in 2002 to barely 2% in 2004 Q2 (around $35 billion over the past year). A large part of this sharp fall is explained by the exclusion of Argentina as a preferential destination for investments, but the truth is that there has been no forceful recovery in direct investment. The flows remain stable in Brazil, at around $10 billion over the last 12 months, and the upturn in Mexico ($14.3 billion) relates to the one-off acquisition of the rest of a bank's capital by a Spanish investor at the beginning of the year. The role of Spanish investors in Latin America, which is described in detail in Box 2, has been fundamental in the last decade and has also been affected in recent years by the deteriorating economic developments in the region.

FOREIGN INVESTMENT FLOWS
Percentage of GDP and millions of US dollars

CHART 10




SOURCES: Central Banks and IMF.

PRICES AND MACROECONOMIC POLICIES

In Q1, inflation in the area as a whole marginally broke through the 5% floor, subsequently rebounding vigorously to more than 6% in July (see Chart 11). The gradual firming of domestic demand and the increase in the prices of inputs and energy were responsible for this down-up movement which was common to the whole region. Especially notable, for its intensity, was the rise in inflation in Brazil between May and August (from 5.2% to 7.2%), and in Argentina, from 3.7% at end-2003 to 5.3% in August 2004, which ended the downtrend that began in mid-2002. In Mexico, the inflation rate increased gradually, by almost 1 pp, from 4% at the beginning of the year. The exception to this behaviour was Venezuela, which was still involved in a process of economic normalisation, its rate of inflation falling from 27.1% at end-2003 to 21.8% in July.

At the same time, inflation expectations also rose forcefully in most countries. This, together with the outlook for a further strengthening of domestic demand led to a change in the monetary policy stance in the area, towards more restrictive positions (see Chart 11). Mexico was the first country in the area to tighten monetary policy, in view of the deterioration in prices and the consequent danger to its inflation target, with a rise in the three-month CETES rate of more than 2 pp to over 7.5%. In Brazil, small reductions continued in the SELIC rate in April (to make a 50 bp reduction in the first half) but, following the evaporation in recent months of expectations of further reductions, in mid-September there was a rise of 25 bp to a rate of 16.25%. Similar developments were seen in Peru and Chile, which in Q3 also joined the group of countries that have raised interest rates. In Argentina, rates also rose sharply in Q2, to more than 5% on the interbank market, although in this case the data are affected by the timing of tax payments and changes in monetary instruments, in the process of transition to direct inflation targeting. Only in Venezuela, where rates were reduced significantly from very high levels, and Colombia, where the process of reduction was limited to a 25 bp cut in Q1, have interest rate rises been avoided for the time being. Box 3 analyses the role played by reserve requirements for bank deposits in Latin America. Apart from their theoretical role of providing support to monetary policy implementation, they may also be required for prudential reasons, in which case they may be positively viewed, or for fiscal reasons, in which case they should be seen in negative terms.

During the nineties, overall foreign direct investment (FDI) flows to Latin America expanded vigorously. According to ECLAC data, net FDI inflows into Latin America grew from a level of $7.8 billion in 1990 to $85.8 billion in 1999, before declining once again to $36.5 billion in 2003 (see the upper left-hand panel of the chart). The surge in FDI, which was most marked in the second half of the nineties, was driven by the widespread privatisation of state-owned companies, against a background of structural reform and macroeconomic stabilisation. In the wake of this privatisation process, Spanish investment in Latin America began to take off, and the period marked the consolidation of our companies' internationalisation. Thus, in 1996, foreign direct investment by Spanish companies exceeded for the first time investment by foreign companies in Spain. Latin America became the preferred investment destination and absorbed 48% of Spanish FDI in the period 1996-2000 (see upper right-hand panel of the chart). This investment exposure is far greater than trade exposure, since Spanish exports to the region only account for 5% of the total. Moreover, Spain became a key supplier of capital for the region, standing only behind the United States in terms of cumulative FDI in Latin America over the past decade: during this period, Spanish companies were the source of 14.6% of global FDI in Latin America (this peaked in 2000 at 33.2%). It is also notable that flows took off when Latin America was moving into a period of financial crises and low growth. This situation, along with the major privatisation programmes coming to a halt and uncertainty over continuing reform, would account for the reduction in FDI in the region from 2000. Between 2001 and 2003, FDI in Latin America accounted for only 23.7% of total Spanish FDI, and this fall has proven greater than the reduction in global FDI flows towards Latin America.

Spain's cumulative net direct investment over the past decade (1993-2003) in Latin America stands at $87.7 billion, which represents approximately 11.8% of Spanish GDP in 2003, according to Banco de España data. In contrast to global FDI targeted on Latin America, the distribution of which responds basically to the weight of each country's GDP in the region, Spanish FDI has shown something of a preference for the Southern Cone countries (Argentina and Chile, which are overweighted in respect of their weight in the region's GDP, as displayed by their position, below the 45 degree line, in the lower left-hand panel of the chart) and has been of less relative significance in Mexico. The reason for the low relative weight in Mexico is that NAFTA has been conducive to major investments by the United

## FOREIGN DIRECT INVESTMENT IN LATIN AMERICA


SOURCES: ECLAC, IIF and Ministerio de Economía.

a. Percentage of investment in each country in relation to investment in whole of Latin America.

States and, to a lesser extent, Canada, particularly in the exporting processing ("maquiladora") industries. Nevertheless, Mexico is the country where Spanish companies' market share in the Latin American financial sector is highest, since they manage over 40% of the country's deposits. Brazil and Argentina are the two countries where the biggest investments have been made, with percentages standing at over 30% of total Spanish FDI in Latin America. Pivotal in this respect in Argentina was the purchase of the state oil company (YPF) in 1999, which was the biggest investment by a Spanish company in a single operation over the entire period, accounting for around 55% of Spanish investment in Argentina. By contrast, investments in the financial system scarcely account for 10% of total Spanish FDI in Argentina.

If we take the sectoral breakdown of Spanish FDI in Latin America as a whole, the most notable feature is that FDI is focused essentially on the services sector and, therefore, targeted on the domestic market. This is in contrast to other countries' investment, which is more geared to the industrial sectors, in many cases for export. The main exception to this general rule would be the investment in the oil and gas extraction industry in Argentina. As mentioned earlier, Spanish companies decided to use the window of opportunity that opened in the past decade further to the privatisation of state telecommunications, electricity and other utilities and to the liberalisation of financial systems. As can be seen in the last panel, FDI is highly concentrated in four main sectors: telecommunications, oil and gas (both extraction and refining and distribution), the financial sector, and public utilities concessionaires (electricity and water). As a result, Spanish companies currently have high market shares in these industries, shares that stand at 40% in some countries in the telecommunications, banking and pension fund management sectors.

As regards fiscal policy, the public deficit for the area as a whole stabilised, to stand at 1.8% in Q2, while the primary surplus increased by 0.4 pp, in terms of GDP, with respect to end-2003, to 3.4% in Q2 (see Chart 12). Driven by the dynamism of activity and of the external sector, revenues resumed a growth rate, in year-on-year terms and for the region as a whole, of close to 20% after following a downward path from end-2002. The strength of oil prices also had a very beneficial effect on the revenues of countries like Mexico and, in particular, Venezuela. Argentina stood out from all the other countries with year-on-year growth in revenues of more than 50% in Q2, which took the fiscal balance to more than 2% of GDP and the primary balance to close to 4% of GDP. It should be stressed that in this case, and also in others, a sizeable part of the increase in revenues was attributable to taxes that raise large revenues, but which are at the same time highly distortive, such as withholdings on exports and taxes on financial transactions.

On the expenditure side, after emerging from the period of fiscal restrictiveness associated with the economic problems of previous years, which culminated in mid-2003, there was a notable increase, in the region as a whole, in total spending (5.8% year-on-year, in real terms, in Q2) and, in particular, in primary spending (8.5%). The budgetary leeway deriving from lower interest payments, against a background of greater financial stability, would explain this divergence between the growth of total and primary expenditure. Brazil, Argentina and Venezuela recorded increases in primary expenditure of around 10% in real terms. In the latter two countries this expansion of government expenditures may raise doubts about the sustainability of fiscal discipline. Yet in Brazil this expansion of primary expenditure (equal to around 0.5 pp of GDP) reflects a reversal of the intense fiscal adjustment implemented up to the start of 2003, and total expenditure in terms of GDP was stable. In short, the maintenance of total spending in the region as a whole at around 25% of GDP would suggest that, despite the generally more expansionary stance of fiscal policies, budgetary discipline is being maintained in most countries.

The increase in spending is being used to revive public investment and to reinforce social spending, which may help to strengthen the recovery and to mitigate some of the region's structural problems. That said, the implementation of such spending must be prudent to avoid

## THE USE OF RESERVE REQUIREMENTS IN LATIN AMERICA

BOX 3

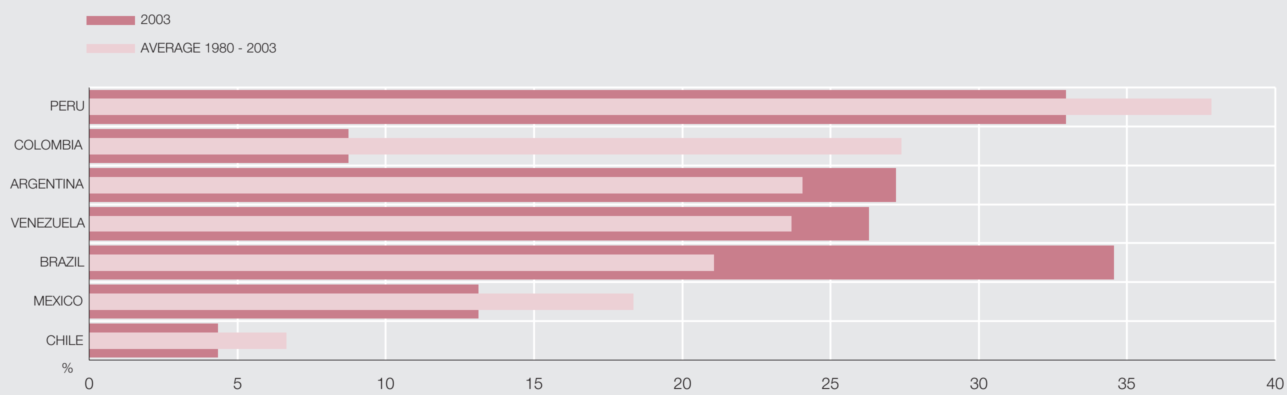
Reserve requirements, defined as the proportion of their deposits that banks must hold as reserves at the central bank, satisfy three basic functions in practice in Latin America: the first is prudential, the second relates to monetary policy management and the third is fiscal. The first two functions fall under orthodox uses of reserve requirements, while the third involves a financing of the budget deficit that should be avoided.

The prudential use of reserve requirements seeks to ensure that banks have a cash buffer to meet their liquidity requirements, particularly in the face of unexpected situations. Reserve requirements can also be increased in emerging countries to reduce potential imbalances associated with periods of strong capital inflows, though these increases can be reversed if inflows suddenly grind to a halt or if there are massive withdrawals of deposits. Discrimination in the level of reserve requirements between deposits in local and foreign currency may be considered as another use related to the prudential function, and is frequently applied in Latin America. Setting a higher requirement in foreign currency helps discourage the supply of foreign currency deposits, helping check the degree of bank dollarisation and thus reducing financial vulnerability.

The use of reserve requirements as a monetary policy implementation element allows for the regulation of liquidity in the banking system and, through their impact on money market interest rates, they act as a transmission channel for monetary impulses. In most developed countries, reserve requirements are not used actively (in the sense of being frequently altered to regulate liquidity in the economy); rather, a fixed level is set within a framework in which other liquidity-regulating instruments are used (e.g. open market operations). Nevertheless, in emerging economies in general, and in Latin America in particular, changes in reserve requirements play a more relevant role in monetary policy implementation owing to the fact that the alternative instruments have limitations derived from the scant depth of their financial markets. However, the active use of this instrument is not risk-free. Excessive activism may prove inefficient, insofar as it may prompt abrupt changes in bank portfolios for the purposes of compliance. Moreover, the monetary multiplier is less susceptible to control than other mechanisms and loses effectiveness over time since banks, anticipating changes in the reserve requirement, will tend to hold excessive reserves to ensure compliance, whereby the changes in the reserve requirement have to be bigger in order to affect bank liquidity.

The fiscal use of reserve requirements derives from below-market or zero remuneration of financial institutions' reserves held at the central bank. Other requirements or ratios, such as the liquidity ratio, which generally has to be met with government securities, also constitute a privileged financing mechanism for the public sector. One of the main problems this use of reserve requirements entails is that it is an implicit tax on financial intermediation, whose cost will be borne either by banks or by their clients depending on the degree of substitutability of bank loans and deposits in the financial system. In either event, it generates distortions in resource allocation and is conducive to financial disintermediation. Moreover, monetary implementation is hindered not only because the requirement pursues other objectives, but also because in these cases large loans from the central bank to the public sector are usual and these, in order to maintain monetary control, must be offset through some other type of instrument. In sum, the use of reserve requirements for tax-raising purposes subordinates monetary policy to the government's financial requirements, which imposes a constraint on monetary autonomy and detracts from the monetary authorities' credibility. Despite these drawbacks, the use of reserve requirements as a tax-raising instrument prevailed in emerging economies until the early nineties, when price stabilisation became a primary policy goal and diminished monetary subordination to fiscal policy began to be perceptible. Nevertheless, reserve requirements remain a source of privileged public financing in some economies.

ACTUAL RESERVES/BANK DEPOSITS RATIO




SOURCE: Banco de España from IMF data.

a. Value in US dollars.
b. Value in local currency.

Despite the recent progress in terms of fiscal orthodoxy and monetary policy implementation, the actual reserve requirement ratio in Latin America remains high, both in absolute terms (see chart) and in relation to more developed countries (it stands at 2% in the euro area). Also of note is the fact that after falling substantially in the nineties compared with the eighties (from 29.8% to 17.6% on average), reserve requirements have once again risen considerably in the period 2000-2003 in several countries, owing to the financial turbulence over these years. On figures for 2003, the average ratio in Brazil, Peru, Colombia and Venezuela was still above 25%, it was over and slightly below 10% in Mexico and Colombia, respectively, and only in Chile was it under 5%. In many countries in the region it would perhaps be desirable for reserve requirements to move to more moderate levels, as their end-purpose becomes geared to monetary policy implementation and prudential regulation, and their tax-raising uses are abandoned.

any erosion of fiscal discipline. In this respect, there was notable progress on a number of initiatives led by Brazil in relation to infrastructure spending, such as the approval of a law that reinforces the role of private enterprise in the realisation of public works and the study, with the IMF, of a possible special treatment for public investment in the deficit targets agreed with this institution in future.

The greater fiscal leeway is welcome after a long period of adjustment, but it should be managed with caution and used to reduce the levels of public debt and to improve its time profile and composition, since the fiscal vulnerabilities are still very great in most countries in the region.

TRADE INTEGRATION

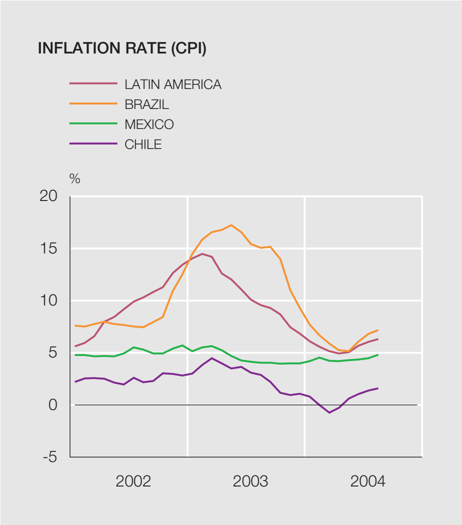
During the first half of the year, progress in the area of trade integration was sporadic, with some setbacks. Notable among these was Argentina's reneging on certain commitments in the area of trade liberalisation. However, there was also some progress within MERCOSUR, such as the establishment, in mid-August, of a tribunal to resolve trade disputes between members, the start of negotiations for a free trade treaty with the Andean Community and Mexico's application to become an associate member. As regards the expected free trade agreement with the European Union, progress was made, but certain loose ends still remain, such as access to the European agricultural market and government purchases by MERCOSUR members. The United States continued to enter into agreements with Central American countries, the latest being with the Dominican Republic, and in Chile the treaty signed with Korea entered into force. Under the Doha Round, there was a notable proposal by the European Union and the United States to reduce their agricultural subsidies by up to 20%. This was made at the Geneva discussions in August which also enabled the future agenda for the negotiations to be unblocked. This progress could have a positive impact on the negotiations for the Free Trade Area of the Americas (which made hardly any progress in the period considered), the problem of US agricultural subsidies being one of the most important sticking points.

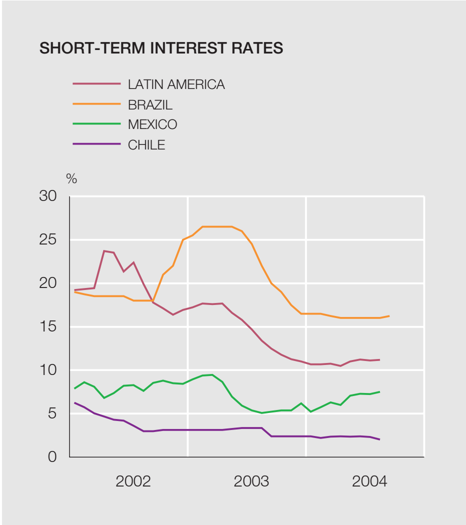
***Developments in the main countries***

Brazil's economy posted a strong acceleration in activity in the first half, which has strengthened the prospects for a robust expansion. GDP grew by 2.7%, year-on-year, in Q1 and by 5.7% in Q2, after stagnating in 2003 Q4. Moreover, the composition of the growth was notably more balanced, and finally extended to domestic demand through private consumption and investment. The recovery in domestic demand was sustained by the impact of monetary policy loosening, which started in the second half of 2003, and by the signs of improvement in the labour market; the rate of unemployment fell from April by almost 2 pp, to 11.2% in July, and real wages began to recover. This performance is based on very positive developments in the external accounts (the current surplus stood at 1.5% of GDP at the end of Q2), while fiscal

**INFLATION AND INTEREST RATES**
**Year-on-year change and percentage**

CHART 11




SOURCE: Central Banks.

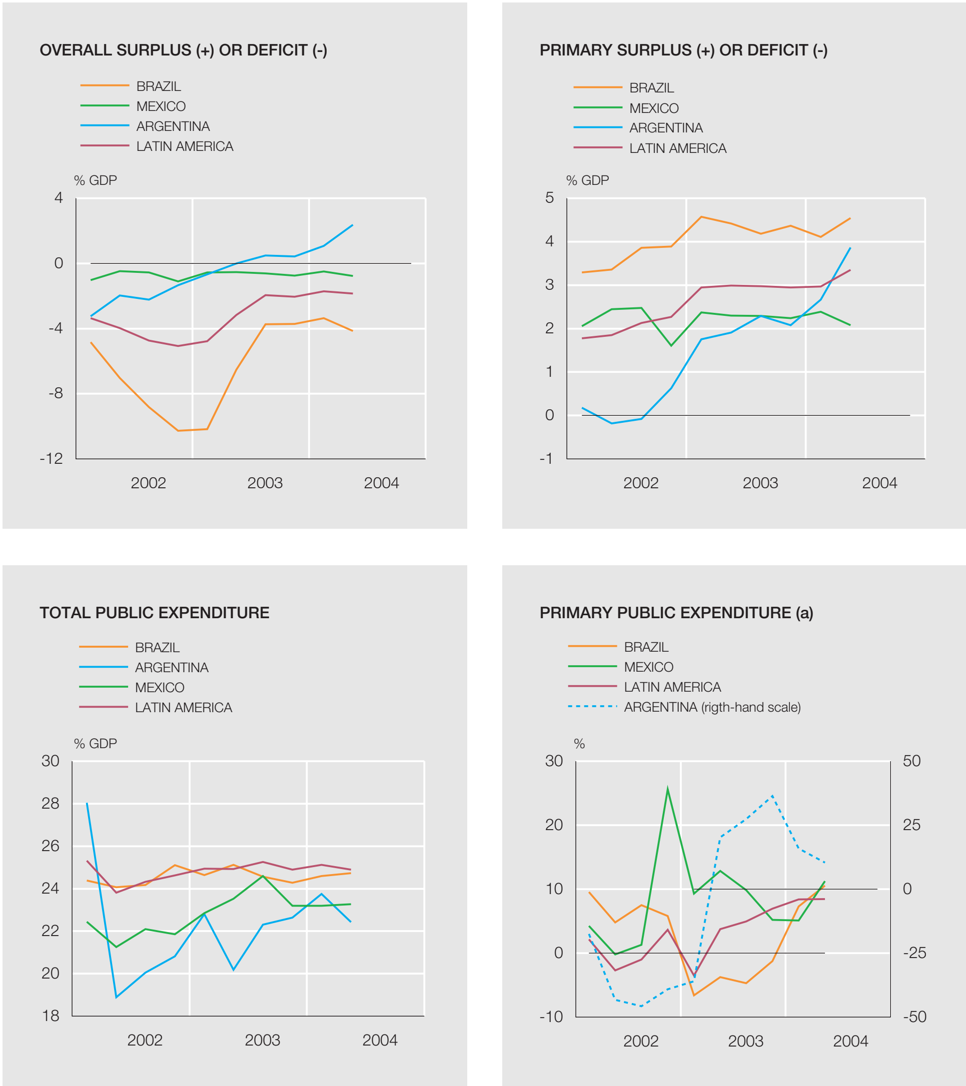
imbalances continued to be corrected, especially as regards the magnitude and composition of debt (see Chart 13). The prospects for economic growth, low real interest rates, the sustained primary surplus and the slight appreciation in the real exchange rate provide a favourable scenario for a reduction in fiscal vulnerability, as shown by the fall in the public debt ratio by 3.4 percentage points since the beginning of the year, to 55.3% of GDP in July, and by the notable reduction in exchange rate-indexed debt. The persistence of a high degree of vulnerability, along with some political uncertainty, meant that the bout of volatility at the beginning of Q2 had a particularly strong impact in Brazil, but the deterioration in sovereign spreads and in the exchange rate (which moved back above three reals to the dollar) has been completely reversed in recent months and, in September, the sovereign credit rating was upgraded.

The acceleration in activity was accompanied by unfavourable inflation developments; the annual rate of inflation exceeded 7% in August, although the behaviour of the underlying rate was more moderate. The acceleration in inflation was caused by specific factors, such as adjustments to the rates charged for public services and the impact of the rises in commodity prices, and especially in oil prices. But, even so, expectations point to inflation rates close to the upper limit of the target band (5.5% +/– 2.5%) at year-end. This situation, in a context of increasingly buoyant domestic demand, led the monetary authorities to take a more cautious approach and, from April, they stopped reducing interest rates. Finally, progress on structural reforms was limited, especially in comparison with the first year of the current administration. That said, there was notable progress on the bankruptcy law, judicial reform, reform of the electricity sector and the sanctioning by the Supreme Court (albeit with some amendments) of the pensions reform approved in Parliament in 2003.

The upturn in economic activity in Mexico, already apparent in the second half of 2003, firmed in the first half of 2004. GDP grew by 3.9% in Q2, exceeding the year-on-year rate of Q1 (3.7%). Domestic demand strengthened notably, especially the investment component, while external demand sustained its positive contribution to growth. Meanwhile, having made a negative contribution to growth in recent years, industry recovered momentum and joined the recovery in US manufacturing after a longer lag than on other occasions. The high oil price had a positive impact on the public and external accounts. During the first half of the year, the cur-

MAIN INDICATORS OF PUBLIC SECTOR PERFORMANCE
Year-on-year changes and percentage of GDP

CHART 12




SOURCE: National Statistics Offices.

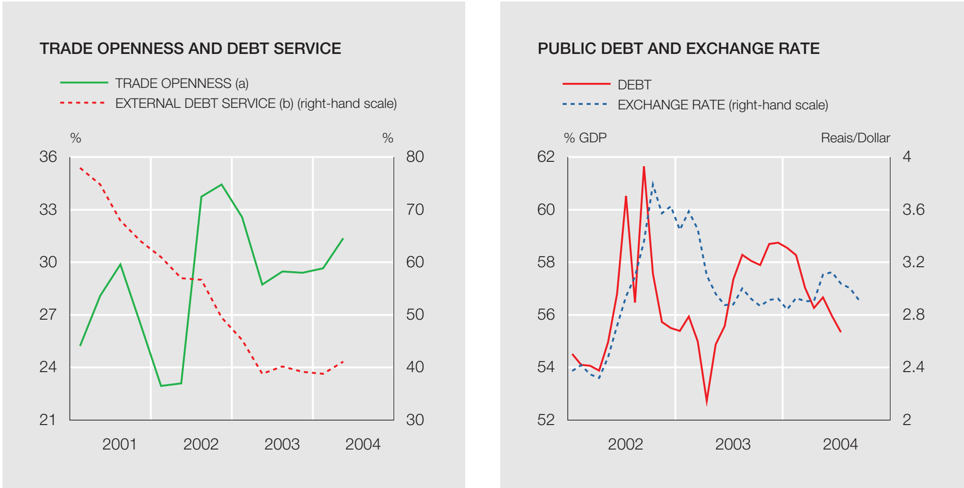
a. Deflated by CPI. Annual moving average.

rent account deficit narrowed by 35.1% with respect to the same half of 2003, owing to the larger surplus on the transfers account and to the smaller trade balance deficit. As for the public accounts, the primary surplus, driven by the price of oil, increased by 8.8% in real terms in the first seven months of the year compared with the same period of 2003, which enabled the budget balance to improve significantly. Fiscal containment was also reflected in the notable fall in government consumption (–5% in Q2). If the revenues remain above those projected for the rest of the year, then a mechanism in the 2004 budget for the prepayment of debt and increased transfers to the states for public investment will apply. On the financial markets the strong performance of equities was notable, with gains of 19% in the first half of 2004, prices flattening off thereafter. Meanwhile the Mexican peso reached an all-time low in May of 11.68 pesos to the dollar, subsequently fluctuating around the 11.50 level.

Inflationary pressures worsened in Mexico in the first half of the year (see Chart 14). The inflation rate rose to 4.8% in August, while underlying inflation stood at 3.7%, the highest level since the second half of 2003, leading the central bank to raise the “corto” on various occa-

## BRAZIL

CHART 13

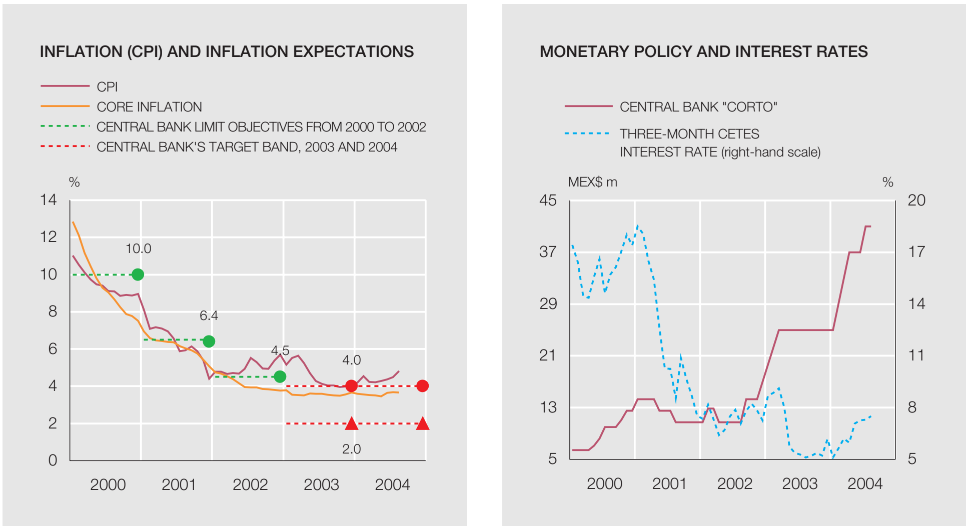



SOURCE: Banco do Brasil.

a. Exports plus imports as a percentage of GDP.
b. As a percentage of exports.

## MEXICO

CHART 14



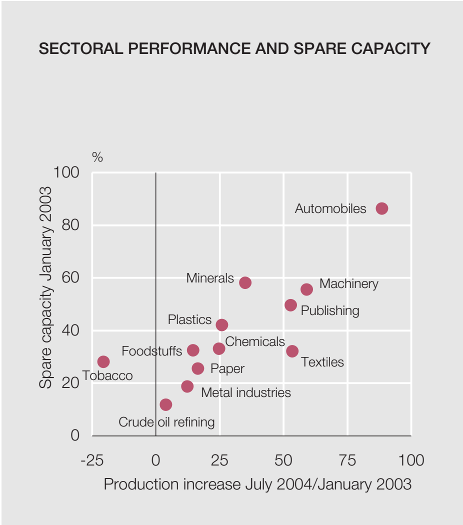

SOURCE: Banco de Mexico.

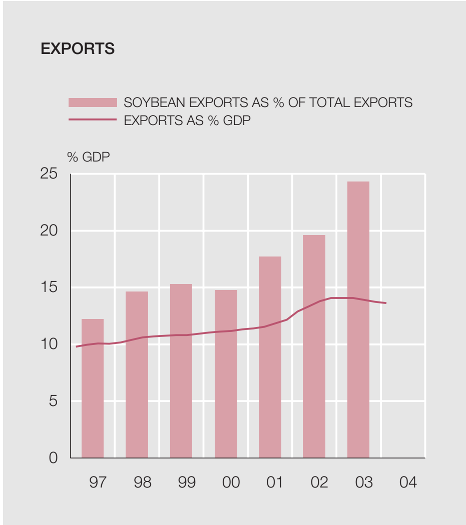
sions to reinforce the restrictive stance of monetary policy. Even though the reform process continues to encounter major difficulties, Parliament approved a reform of the Social Security pensions system in August, with the aim of bringing future pensions into line with current contributions.

In Argentina, a notable turning point was reached in the path of growth, which had been highly vigorous since the beginning of 2003: the Q2 figure for GDP growth, at 7% year-on-year, was well below the Q1 rate (11.2%). Private consumption and investment were the main components of growth, while the external sector deducted 3 pp from the Q2 growth rate. The specific impact of the energy crisis in April explains only part of the slowdown, since the progressive correction of the base effect and the gradual absorption of slack also bore on the rate of activity. In this respect, sectoral developments in manufacturing show the importance of the extensive spare capacity in the recovery of the last two years (see Chart 15). This partial de-

## ARGENTINA

CHART 15




Source: National Statistics Office.

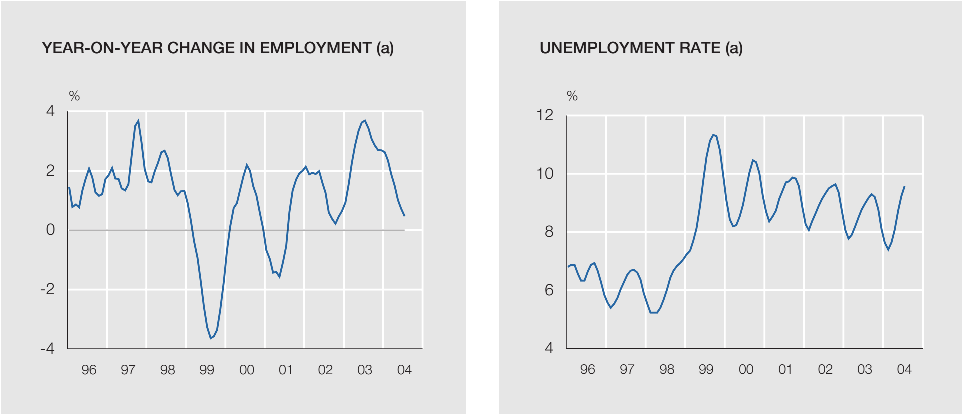
celeration was reflected in a moderation in the growth of employment. The inflation rate, albeit still at moderate levels, has risen recently (to 5.3% in August), largely as a result of the adjustment of certain regulated prices. The fiscal results were very favourable: in the first half the federal primary balance exceeded the target agreed with the IMF for the whole of 2004 by more than 10%, thanks to the extraordinary strength of revenues, which increased by 42%. The provinces' fiscal results were also highly positive. However, public expenditure, driven by increases in civil servants' wages and in pensions, together with other spending programmes, also grew at a high rate.

The external sector showed signs of a progressive exhaustion, as a result of the strong expansion in imports and the relative stagnation of exports (especially in terms of GDP; see Chart 15), so that the trade balance in 2004 Q2 was 30% worse than in the same period of 2003. The recent falls in the price of soybeans, one of the mainstays of Argentine exports, will accelerate the deterioration in the trade balance in forthcoming quarters. Despite the official launch of a new debt restructuring proposal, the prospects for a successful conclusion to this process are still uncertain. Nor was it possible to revise the IMF programme (the structural objectives of which were not met in any case), which led to fresh doubts regarding the state of Argentina-IMF relations. The uncertainty in these spheres affected the financial markets: sovereign spreads held at their previous high levels, the exchange rate fell significantly at the beginning of Q3 and, by August, the stock market had fallen by 10% since the beginning of the year, although it has recently rebounded.

Chile's economy posted year-on-year GDP growth of 5.1% in Q2, above the Q1 rate of 4.85% and the highest rate recorded since 2000 Q2. Domestic demand, driven by investment, outweighed the negative contribution from external demand. Notwithstanding this, exports reached all-time highs due to the high price of copper (which has experienced a downward correction in recent months) and this generated a strong increase in the trade surplus during the first half taking the current-account balance to 1.5% of GDP. The fiscal surplus also rose to 1.3% of GDP in the first half. Despite the acceleration in growth, job creation lost steam, which may be symptomatic of structural obstacles to the creation of jobs (see Chart 16). The inflation rate rose out of negative territory (reaching 1.6% in August), driven by fuel prices, although underlying inflation increased less sharply. Given the favourable trend and prospects

CHILE

CHART 16




SOURCE: National Statistics Office.

a. Quarterly moving average.

for activity and the stabilisation of the inflation outlook, the monetary authorities decided in September to start moderately reducing the existing monetary stimulus, raising its key interest rate by 25 bp (to 2%).

Activity in Colombia regained momentum and continued to grow at a rate of more than 4% in the first two quarters of the year (4.4% year-on-year in Q2). The main engines of growth were private consumption, investment and, in sectoral terms, construction and industry. In addition, there was a clear improvement in the labour market. Inflation, despite rising from May, remained at levels compatible with the central bank's target for the year (5.9% in August), enabling its key rate to be held at 6.75% from February. The current-account deficit widened in Q1, as a consequence of the increase in interest payments and despite the notable growth of workers' remittances. The reduction in debt and sound revenue growth indicate that the deficit target for 2004 (2.5% of GDP) will be met and mean that the fragile fiscal situation can be improved somewhat, although primary expenditure also continued to increase at a high rate.

In Peru, GDP grew by 3.6% in Q2, down slightly from Q1. The vigorous rate of activity was based on domestic demand, although exports sustained a high rate of growth, especially those of metals. Against this background, the country enjoyed a comfortable external position and, for the first time since 1998, public finances were in surplus during a half-year period. The corollary of the economic dynamism was the sharp rise in inflation (to 4.6% year-on-year in August), which exceeded the central bank's annual target (2.5%±1%), prompting a rise in official rates in August. Peru's sound economic performance enabled the precautionary stand-by arrangement with the IMF to be renewed for another two years and its sovereign rating to be raised in June.

Venezuela posted extraordinary rates of year-on-year growth in the first two quarters of the year (34.8% and 13.6%, respectively), due to the weak starting point, the oil bonanza and the recovery in non-oil sectors. These sectors are benefiting from agents' greater holdings of liquidity in the national currency as a result of exchange controls, the substantial increase in real wages (21.3% in the first half) and the improved labour market situation. High oil prices ensured a comfortable external position, and this, along with the active management of domestic and foreign debt, considerably eased maturities in 2004 and 2005. In addition, a cushion of funds was created that enabled the government to raise public spending (by more than 5 pp of GDP) in the months prior to the August recall referendum, in which the motion to recall the president was defeated. The markets reacted positively to the result, which reduced short-term political uncertainty; sovereign spreads fell to their lowest levels since June 1998 and the country's sovereign rating was raised.

Economic recovery continued in Uruguay, with growth in Q2 of 12.7% year-on-year (a slight fall from the Q1 rate of 14.3%), driven by domestic demand and, in particular, private consumption and investment. Inflation held at high rates (10.2% in August), which led the central bank to restrict money supply growth. Meanwhile, activity slowed slightly in Ecuador and inflation reached a low at the end of the half-year. The difficulties in securing approval of the reforms of pensions and the electricity sector – which is required if the IMF programme, suspended since April 2004, is to be reactivated – were partially overcome. In Bolivia, the situation stabilised, following the crisis at the end of 2003, when the uncertainty had ended regarding the policy on gas resource management. Finally, in the Dominican Republic the financial situation and the problems in the energy and banking sectors remain complicated. However, the April agreement with the Paris Club creditors, the financial support from the IMF and the austerity measures adopted by the new administration in August may help to improve matters.

16.9.2004