Introduction

In terms of the aggregate of the main countries, growth in Latin America in 2004 was 5.9%, the highest rate since 1980 (see Chart 1). The buoyancy of growth was widespread and only a small portion may be attributed to the rebound in the activity of economies previously in crisis. The outlook for the current year is favourable and underpinned by the strength of domestic demand, which became the driving force of activity in 2004. Domestic demand was further upheld by the pick-up in employment and investment, which provides a sound basis for the recovery. Significantly and uniquely (as can be seen in Chart 1), the firming of the recovery was accompanied by a sizable trade and current-account surplus, which was higher even than that of the previous year. The soundness of exports, based on the marked improvement in the terms of trade over the past three years, accounts for this situation and mitigates the risk of growth being curtailed in the short term by the unsustainable build-up in external imbalances, as occurred in other previous episodes. Despite the start of the upward cycle in interest rates in the United States, the region's foreign borrowing costs are, as can also be seen in Chart 1, at their lowest level since the series began, owing to the conjunction of sovereign spreads at minimum levels since 1998 and very low long-term interest rates in the United States, which is perhaps due to the extensively anticipated and gradual pace of the tightening of US monetary policy. In Argentina, the completion of the restructuring of defaulted debt, which resulted in a substantial haircut for bondholders, opens a new stage for this country and its relationship to the international financial community. Monetary policies have been prudent, acting restrictively in an environment of moderate rises in inflation rates. In the fiscal domain the reductions in deficits and increases in primary surpluses were notable, assisted by a strong increase in tax revenue. Less positive was the progress in structural reforms, certain exceptions such as Brazil aside.

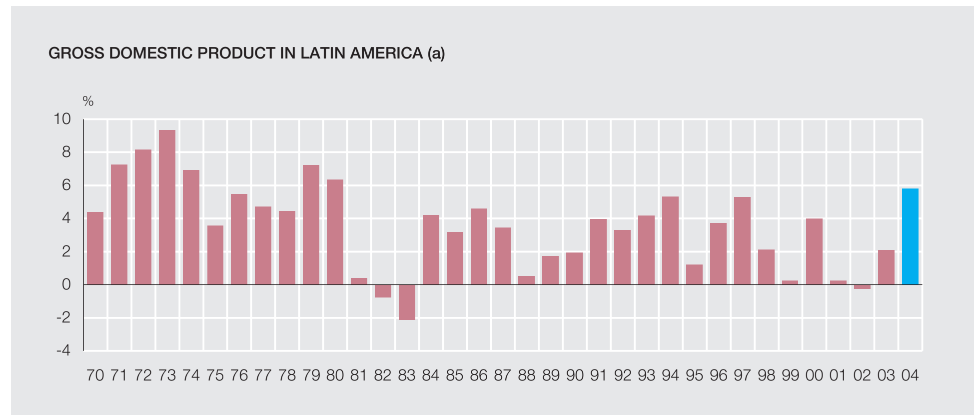
The current economic situation would suggest a favourable medium-term horizon, reinforced by the perception that financial vulnerability has eased notably in the recent period. Nonetheless, caution and perseverance in reducing the factors of vulnerability still in place should be maintained. For one thing, although all the vulnerability indicators have improved recently, this progress is largely due to the sharp improvement in financing conditions. Given that the ratios of external and, above all, public debt to GDP are still considerably higher than before the crisis and that the economies generally remain relatively closed and highly sensitive to changes in financial variables, an unfavourable and pronounced change in financial conditions may bring to the surface the underlying vulnerability still in place in many of these economies. For another, Latin America is, as indicated, benefiting from exceptional global circumstances, such as high commodity prices and low long-term interest rates. Were these circumstances to be reversed, that would entail risks for the region.

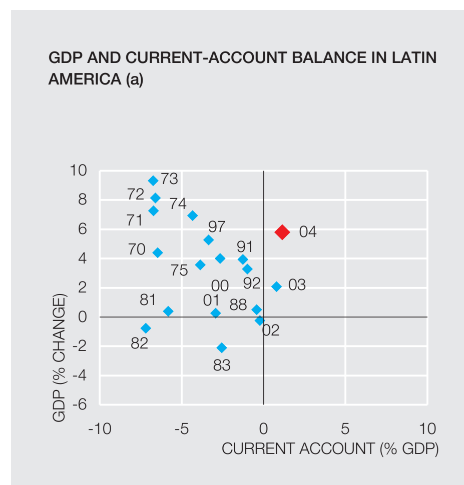
With regard to commodity prices, which are sustaining the region's current-account surplus, a reduction in global demand, particularly by China, might mean a sudden adjustment in the terms of trade and a rapid deterioration in the external accounts. However, the comfortable external sector position provides a degree of cushioning against this risk. As to the continuity in the United States of abnormally low long-term interest rates (given the cyclical phase of the US economy), their conjunction with a high and persistent US current-account deficit opens the way for a substantial and speedy upward correction of US bond yields. Such an adjustment might not only feed through to the region's financing costs, but might also generate an increase in global risk aversion, with a subsequent fall-off in financial flows to Latin America and a widening of sovereign spreads.

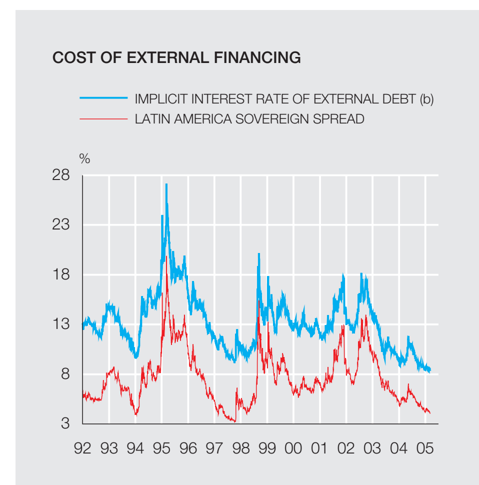
LATIN AMERICAN ECONOMIC PERFORMANCE: MEDIUM-TERM OUTLOOK

CHART 1

Year-on-year change and percentage







SOURCES: IMF, JP Morgan and national statistics.

a. Comprises eight countries (Argentina, Brazil, Mexico, Chile, Colombia, Venezuela, Peru and Uruguay).
b. Sovereign spread as represented by Latin America EMBI+ plus US long-term interest rate.

Economic and financial developments in the area

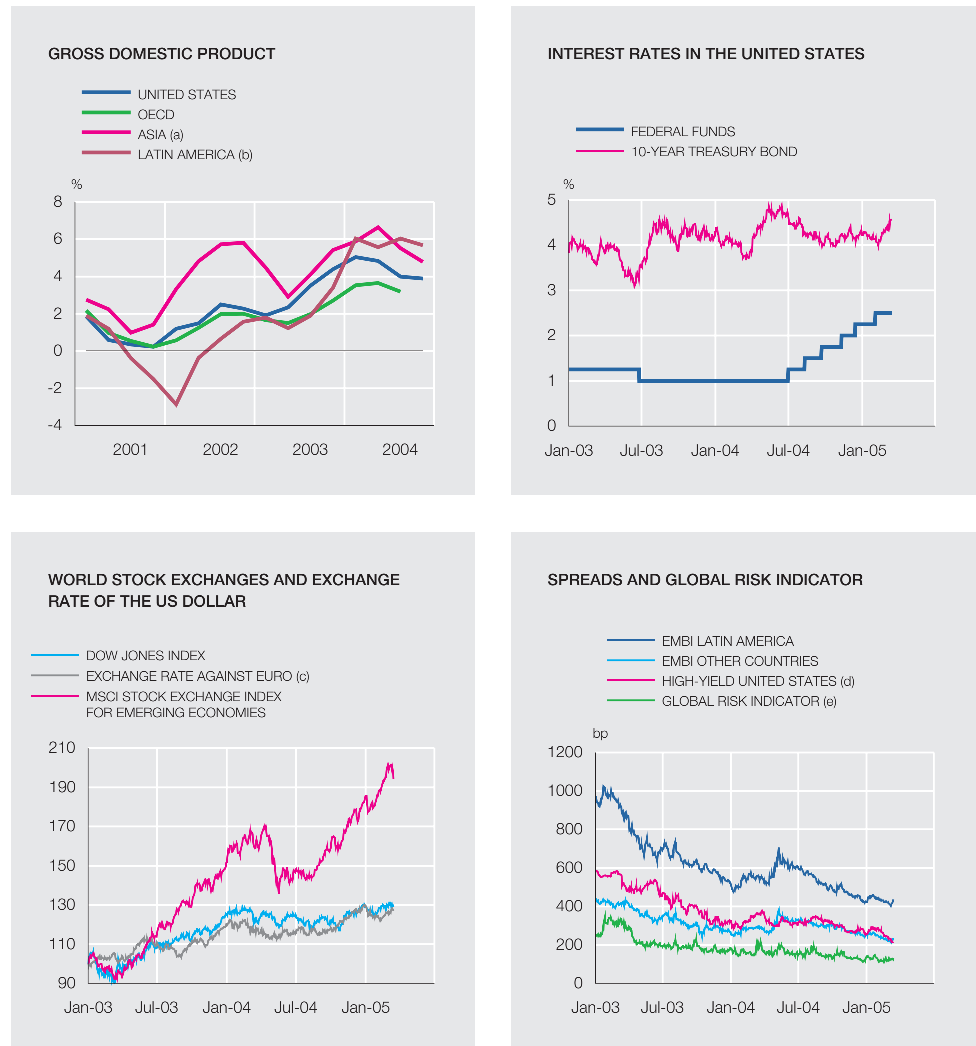
EXTERNAL ENVIRONMENT

In the second half of 2004 the global economy maintained robust momentum, albeit at a somewhat more moderate pace than in the first half of the year (see Chart 2). Also, certain previous trends were reinforced (the tightening of US monetary policy and the rise in crude oil prices), with potentially adverse consequences for financing conditions in Latin America, though such consequences have not materialised.

The Federal Reserve continued to withdraw its monetary stimulus gradually but sustainedly, raising interest rates by 150 bp from June 2004 to February this year and placing the federal funds target rate at 2.75%. Oil prices reached an all-time high in late October 2004 and, following a correction, peaked again in March 2005. Further, the depreciation of the dollar against the euro intensified (by 10% in 2004 Q4), although it has stabilised at around $1.30 per euro in 2005 Q1. International stock markets, which had behaved fairly erratically since the start of 2004, took off in the final months, posting appreciable rises (of around 10% in the industrialised countries). However, the year 2005 began with an across-the-board stock market correction in January, which has turned round completely since against a background of expectations of growth and favourable business profits. These financial developments and, in particular, the depreciation of the dollar (accentuated by greater concern about the US current

GLOBAL MACROECONOMIC AND FINANCIAL INDICATORS
Year-on-year changes, percentage, basis points and indices

CHART 2



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

a. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore and Taiwan.
b. 2004 Q4: estimation.
c. A fall denotes an appreciation of the dollar.
d. US B1 rated corporate bond.
e. Implied volatility of options traded in CBOE, multiplied by 10.

deficit) were not reflected in US long-term interest rates, since the exchange rate adjustment was relatively orderly and did not prompt disinvestment in dollar-denominated assets. Indeed, government bond yields trended downwards in the second half of the year to below 4% at the start of 2005, underpinned by low inflation prospects, the gradual and predictable pace of monetary tightening in the United States and, to a certain extent, the build-up of US government paper in the hands of Asian central banks. These low interest rates heighten the likelihood of a sudden and marked rise in yields, as evidenced since late February, when they rose by more than 0.5 pp to over 4.5% in a question of days.

The low levels of long-term interest rates, along with the firming of activity and the improvement in the financial position of companies in the developed countries (reflected in a narrowing of corporate bond spreads), made once again for a global environment of low risk aversion and a search for profitability in the emerging markets. Latin America benefited particularly from this in view of its relatively high level of foreign debt. Eastern European and Latin American

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

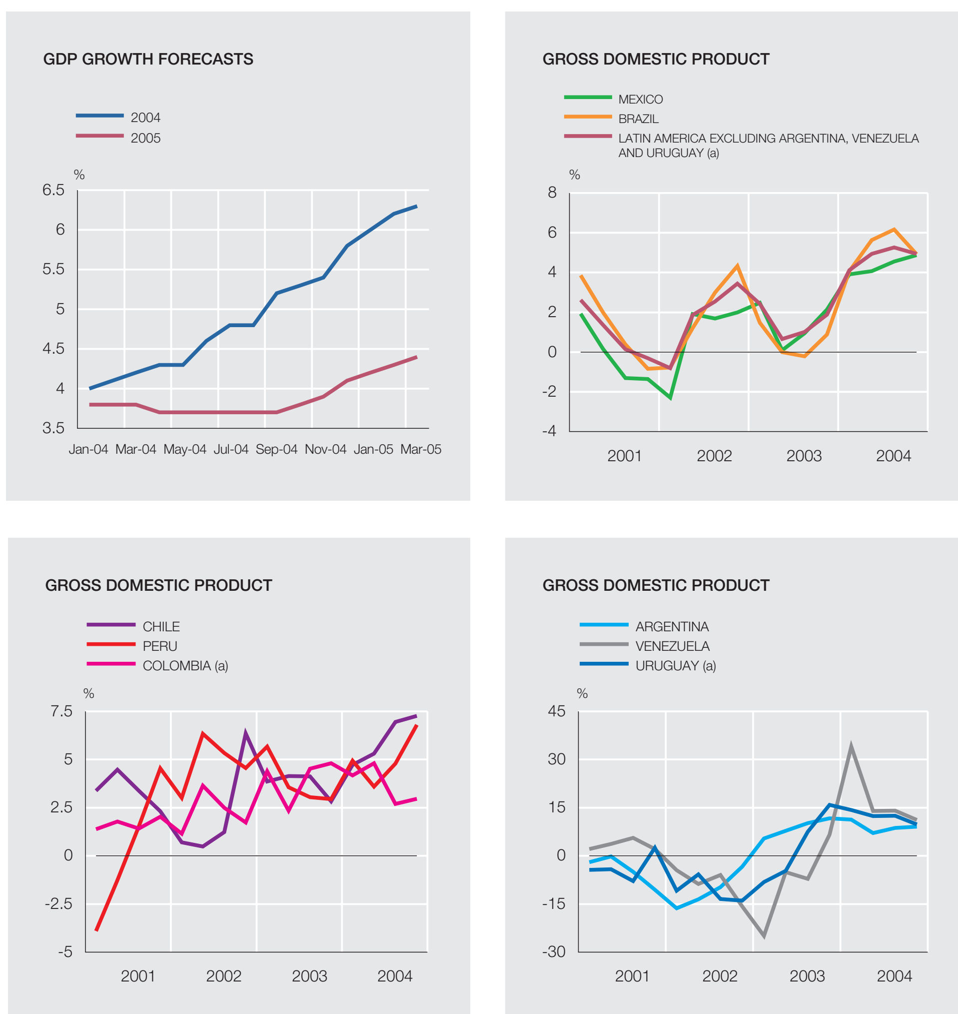
	2002	2003	2004	2003				2004			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP (year-on-year change)											
Latin America (a)	-0.2	2.1	5.9	1.8	1.3	1.9	3.4	6.0	5.6	6.0	5.8
Argentina	-10.9	8.8	9.0	5.4	7.7	10.2	11.7	11.3	7.1	8.7	9.1
Brazil	1.9	0.5	5.2	1.5	0.0	-0.2	0.9	4.1	5.6	6.1	4.9
Mexico	0.8	1.4	4.4	2.5	0.1	1.0	2.1	3.9	4.1	4.6	4.9
Chile	2.2	3.7	6.1	3.9	4.1	4.1	2.8	4.7	5.3	7.0	7.3
Colombia	2.3	4.0	4.1	4.5	2.4	4.6	5.3	4.0	5.0	3.1	4.4
Venezuela	-8.2	-7.7	17.3	-24.9	-5.0	-7.1	6.6	34.0	14.0	14.1	11.2
Peru	4.9	3.8	5.0	5.7	3.6	3.0	2.9	4.9	3.6	4.8	6.8
Uruguay	-11.1	2.5	12.3	-8.1	-4.7	7.5	15.8	14.3	12.4	12.5	10.2
CPI (year-on-year change)											
Latin America (a)	9.3	10.9	5.9	14.2	11.9	9.6	7.7	5.6	5.2	6.2	6.4
Argentina	25.9	14.9	4.4	35.8	14.6	5.2	3.7	2.4	4.1	5.4	5.7
Brazil	8.4	14.8	6.6	15.6	16.9	15.2	11.4	6.8	5.5	6.9	7.2
Mexico	5.0	4.6	4.7	5.4	4.7	4.1	4.0	4.3	4.3	4.8	5.3
Chile	2.5	2.8	1.1	3.8	3.7	2.7	1.1	0.0	0.5	1.5	2.3
Colombia	6.3	7.1	5.9	7.4	7.6	7.1	6.4	6.2	5.7	6.0	5.7
Venezuela	22.2	31.4	21.9	35.5	34.2	29.6	26.3	24.0	22.4	21.5	19.5
Peru	0.2	2.3	3.7	2.8	2.4	1.9	1.9	3.0	3.4	4.4	3.8
Uruguay	14.0	19.4	9.2	27.9	26.3	15.0	10.7	9.3	9.2	10.0	8.2
PUBLIC-SECTOR BALANCE (% GDP)											
Latin America (a)	-5.1	-2.0	-0,9 (b)	-4.7	-3.1	-1.9	-2.0	-1.7 (b)	-1.7 (b)	-1.0 (b)	-0.9 (b)
Argentina	-1.3	0.4	2.6	-0.7	0.0	0.5	0.4	1.1	2.0	2.7	2.6
Brazil	-10.3	-3.6	-2.5	-10.1	-6.4	-3.7	-3.6	-3.3	-4.0	-2.8	-2.5
Mexico	-1.1	-0.7	-0.3	-0.5	-0.5	-0.6	-0.7	-0.4	-0.7	-0.2	-0.3
Chile	-0.8	-1.4	2.2	-0.3	-0.5	-1.1	-1.4	-1.1	0.3	1.1	2.2
Colombia	-3.6	-2.6	…	-3.6	-2.7	-2.9	-2.6	-2.4	-0.8	…	…
Venezuela	-1.0	0.2	…	-1.1	-0.5	1.8	0.2	…	…	…	…
Peru	-2.1	-1.8	-1.3	-1.9	-1.8	-1.7	-1.8	-1.5	-1.0	-1.1	-1.3
Uruguay	-4.9	-4.6	-2.5	-4.4	-5.9	-5.1	-4.6	-3.9	-2.0	-2.4	-2.5
PUBLIC-SECTOR DEBT (% GDP)											
Latin America (a)	54.4	54.4	50,8 (b)	56.3	51.8	54.7	54.4	53.6	50.1	50.8	50.8 (b)
Argentina	140.0	141.0	…	157.5	121.6	131.0	129.9	133.0	111.0	120.3	…
Brazil	55.5	57.2	51.8	54.6	54.9	56.9	57.2	55.6	54.2	52.0	51.8
Mexico	24.0	24.7	24.1	23.0	22.8	24.8	23.5	23.5	23.8	24.2	24.4
Chile	15.7	13.3	11.6	16.5	14.7	15.0	13.5	13.4	12.0	12.1	10.0
Colombia	50.1	50.9	…	49.5	49.3	49.8	48.1	48.7	47.5	47.7	…
Venezuela	45.1	56.9	53.7	39.1	42.5	48.5	56.9	43.1	45.1	50.0	53.7
Peru	46.9	47.7	46.4	48.3	41.8	46.9	47.0	45.8	40.2	43.0	42.7
Uruguay	92.7	108.3	…	102.6	104.7	108.9	108.3	94.6	96.0	100.3	…
CURRENT-ACCOUNT BALANCE (% GDP)											
Latin America (a)	-0.2	0.8	1,1 (b)	0.1	0.6	0.8	0.8	0.9	1.0	1.1	1.1 (b)
Argentina	9.1	5.4	2.1	9.1	7.0	6.6	5.4	4.3	2.8	2.4	2.1
Brazil	-2.0	0.8	2.0	-1.1	0.3	0.7	0.8	1.0	1.5	1.7	2.0
Mexico	-2.3	-1.5	-1.4	-2.0	-1.7	-1.6	-1.4	-1.3	-1.1	-1.1	-1.4
Chile	-0.9	-1.5	1.5	-1.3	-1.8	-1.4	-1.5	-0.5	0.9	1.2	1.5
Colombia	-2.0	-1.7	…	-2.3	-2.0	-1.6	-1.5	-1.4	-1.6	-1.6	…
Venezuela	7.7	13.4	14.5	8.8	12.5	12.4	13.4	16.1	14.8	14.1	14.5
Peru	-2.0	-1.7	-0.1	-2.2	-2.0	-2.0	-1.8	-1.1	-1.1	-0.5	-0.1
Uruguay	3.4	0.5	…	1.5	1.4	0.7	-0.3	0.1	0.1	-0.4	…
EXTERNAL DEBT (% GDP)											
Latin America (a)	59.1	46.7	41,3 (b)	57.8	48.4	48.8	46.7	45.3	42.3	42.4	41.3 (b)
Argentina	159.8	130.2	118.7	156.0	117.4	124.1	119.9	121.6	101.6	110.2	118.1
Brazil	57.3	40.1	31.3	53.6	44.7	42.7	40.1	38.7	38.1	35.3	31.3
Mexico	21.3	22.1	21.7	23.2	21.6	22.8	22.1	21.2	21.5	22.1	21.7
Chile	62.0	54.8	41.7	62.5	56.5	59.6	54.8	47.9	46.1	48.6	41.7
Colombia	47.6	44.9	…	50.7	49.1	47.0	44.9	42.6	41.2	39.9	…
Venezuela	48.4	48.3	40.4	46.5	48.3	46.5	48.3	39.5	42.0	40.0	40.4
Peru	49.0	48.3	43.2	50.4	43.7	48.6	48.3	47.2	42.1	44.2	43.2
Uruguay	85.9	98.0	…	89.9	91.3	93.7	98.0	84.2	80.9	84.6	…

SOURCES: IMF, Banco de España and national statistics.

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

LATIN AMERICAN GDP
Year-on-year change

CHART 3



SOURCES: National statistics and Consensus Forecasts.

a. 2004 Q4: estimation.

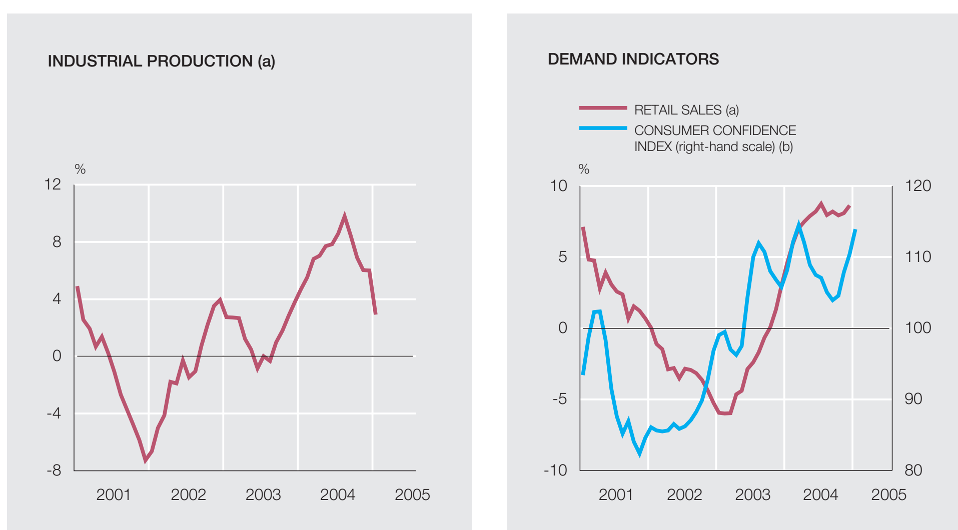
stock markets were those that most rose worldwide, and sovereign debt spreads narrowed substantially in the emerging countries, reaching an historical low of below 330 bp. Despite investors' favourable sentiment, which held up until mid-March 2005, vulnerability to a potential increase in long-term interest rates is a significant factor of risk for Latin America ahead of the coming quarters.

ECONOMIC ACTIVITY

During the second half of the year the pace of activity in Latin America remained very high, similar to that in the first six months, as shown by the year-on-year GDP growth rates of 6% in Q3 and 5.8% in Q4 (see Chart 2 and Table 1). In quarter-on-quarter terms, growth rates eased during the year but remained robust (1.3% in Q4). This performance exceeded previous expectations, as reflected in the successive upward revisions of the growth forecasts for 2004 as from Q2, and it also bore – though less intensely – on the outlook for the current year (see Chart 3). All the main countries in the region ended the year growing at a rate of over 4%. Significantly, the countries that underwent the sharpest crisis in recent years (Venezuela, Argentina and Uruguay) continued to grow at annual rates close to or above 10%, despite the fact that their respective recoveries started more than two years ago. Indeed, in Argentina there was a notable rise in growth in the second half of the year. In any event, even without the

SUPPLY AND DEMAND
Year-on-year changes

CHART 4



SOURCE: National statistics.

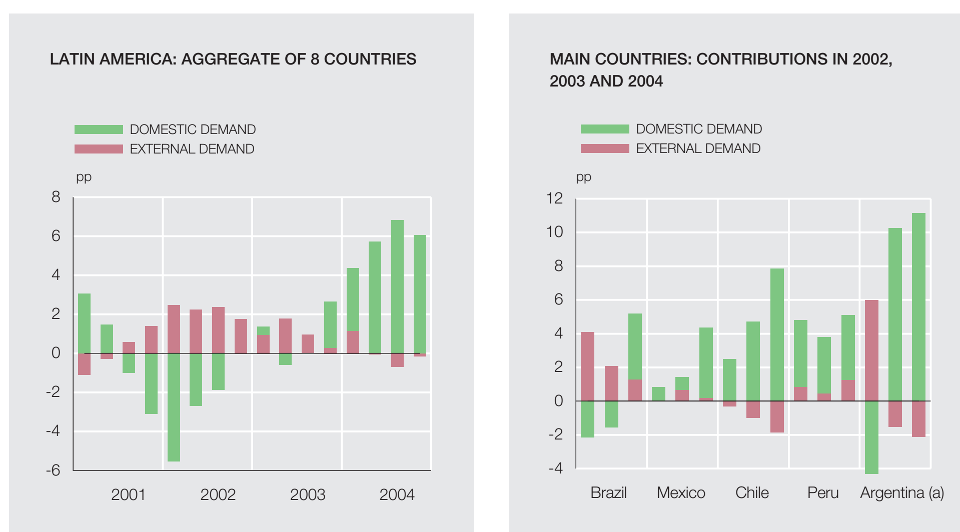
a. Quarterly moving averages.
b. Index. Quarterly moving average.

additional momentum provided by these economies, growth in the region would have been close to 5% in the last quarter, a very similar figure to that attained in the two biggest countries, Mexico and Brazil. The start of 2005 is being marked by a slight moderation in activity, judging by the recent trend of higher frequency indicators. Industrial output slowed towards the end of the year (from 10% early in the second half of 2004 to 3% in January 2005) and retail sales stabilised (see Chart 4). On the other hand, consumer confidence continues to strengthen in most countries, presaging continuing buoyancy in domestic demand.

The strong acceleration in domestic demand was, indeed, one of the salient characteristics of the second half of 2004. This was also the case in those countries, like Mexico, which started from a lagging position. The contribution of domestic demand (see Chart 5) to growth stabilised at around 6 pp at the end of the year, and in certain countries, such as Brazil, it turned positive again after having weighed down output growth for several years. The composition of domestic demand also became more balanced and healthy: consumption remained sound, but investment quickened notably; for the area as a whole a year-on-year rate of 16% was posted in Q3, compared with the negative rates recorded at mid-2003. In all main economies, except Colombia, investment growth stood at over 10%, although a slowdown was perceptible in most of them in 2004 Q4.

Behind the firming of domestic demand is the pick-up in wage income, reflected in the strengthening of labour market indicators (see Chart 6). Growth in employment stood at over 3.5% in 2004 for the region as a whole. There was notable headway – far above the average – in Argentina and Peru, firmness in Brazil and a recovery in employment in Mexico, owing to the dynamism of the ‘maquila’ companies, and in Chile. The improved labour market situation enabled unemployment to fall by 0.7 pp in Latin America as a whole to 10% of the labour force. The rate of joblessness fell significantly in Brazil, while in the second half of the year it moved onto a declining path in Mexico. Real wages increased by more than 2% in the region as a whole, although they did not offset the cumulative decline of the two previous years, of close to 5%. Moreover, developments were heterogeneous across the different countries: marked rises were recorded in Brazil, Argentina and Vene-

CONTRIBUTION TO GDP GROWTH CHART 5
Percentage points



SOURCE: National statistics.

a. The figure for the contribution of domestic demand in 2002 is –16.7 pp.

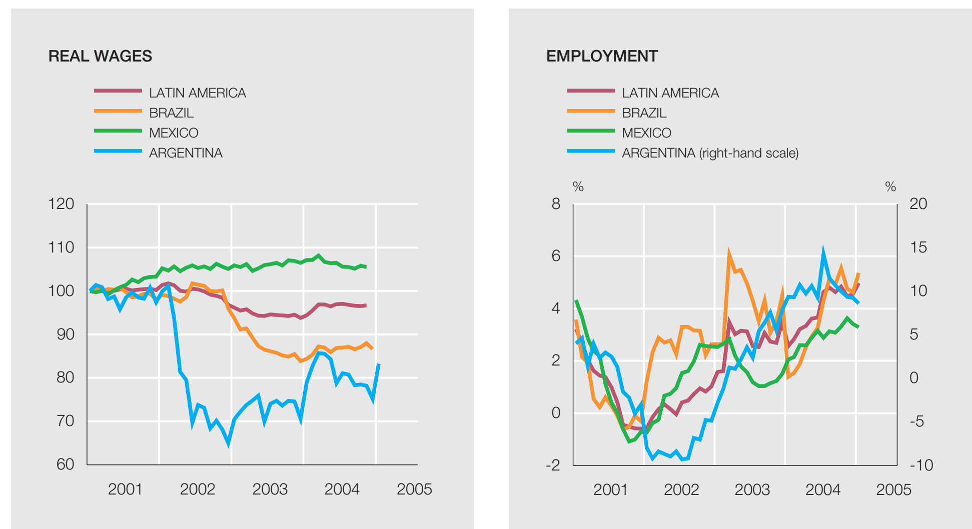
zuela, where there had been a marked downward wage adjustment in past years, while in Mexico wages even slipped.

External demand, which had driven activity in previous years, began to contribute negatively to GDP growth in the second half of the year (see Chart 5), though for the year as a whole the contribution was still slightly positive across the region and in all countries, except in Argentina and Chile. Domestic demand progressively boosted imports, although these appeared to ease towards the end of the year (see Chart 7). In dollar terms, imports grew by 30% for the area as a whole compared with 2003 (the related figure in Argentina and Venezuela was above 60%). Even more notable was the continuing vigour of exports; sales abroad also increased by close to 30% over the year as a whole and, despite more moderate growth in recent months, there are no clear signs of them weakening. In those countries where trade in commodities is predominant, such as Chile, Peru and Venezuela, exports posted growth rates of around 50% for the year. Essentially behind these results lay the sound behaviour of commodities prices. Although the overall commodities index stabilised and the prices of agricultural commodities moved on a declining path (which restricted the growth of exports in certain countries such as Argentina and Colombia), metals and energy prices continued to climb.

The favourable trend of commodities prices since 2002 and the more recent appreciation of the Latin American currencies against the dollar (see the section on financial markets) have prompted a strong improvement in the terms of trade in the region of over 17% in cumulative terms. This situation has allowed trade surpluses to firm in most countries (with the exceptions of Mexico and Colombia), and even to move on a rising path in certain cases, such as Chile, Peru and Brazil. The area as a whole will run a positive balance this year of over 4% of GDP, which is even higher than in 2003. Chart 7 shows that the improvement in the terms of trade accounts for most of the surplus whereby, had they held at their level as at the beginning of 2002 (depicted in the chart as the adjusted trade balance), the trade balance would have declined in Latin America, all other things being equal, by more than 3 pp of GDP to 1.1%. It is thus the improvement in the terms of trade that is behind the unparalleled situation of a growing trade surplus at a time of strong economic growth.

LABOUR MARKET
Indices and year-on-year changes

CHART 6



SOURCE: National statistics.

In parallel with trade surplus developments, the region's current-account surplus continued on a rising course, recording a balance of 1.2% for the year as a whole, 0.4 pp up on 2003. As with the trade balance, if the positive impact of the terms of trade is factored out, the region would have posted a current-account deficit of 2% of GDP in 2004. In countries such as Peru, Mexico or Ecuador, the current-account balance was assisted by the increasingly higher levels of remittances to Latin America. In 2004, for the region as a whole, remittances amounted to 45.8 billion, 20% up on the previous year and amply exceeding 2% of GDP.

FINANCIAL MARKETS AND EXTERNAL FINANCING

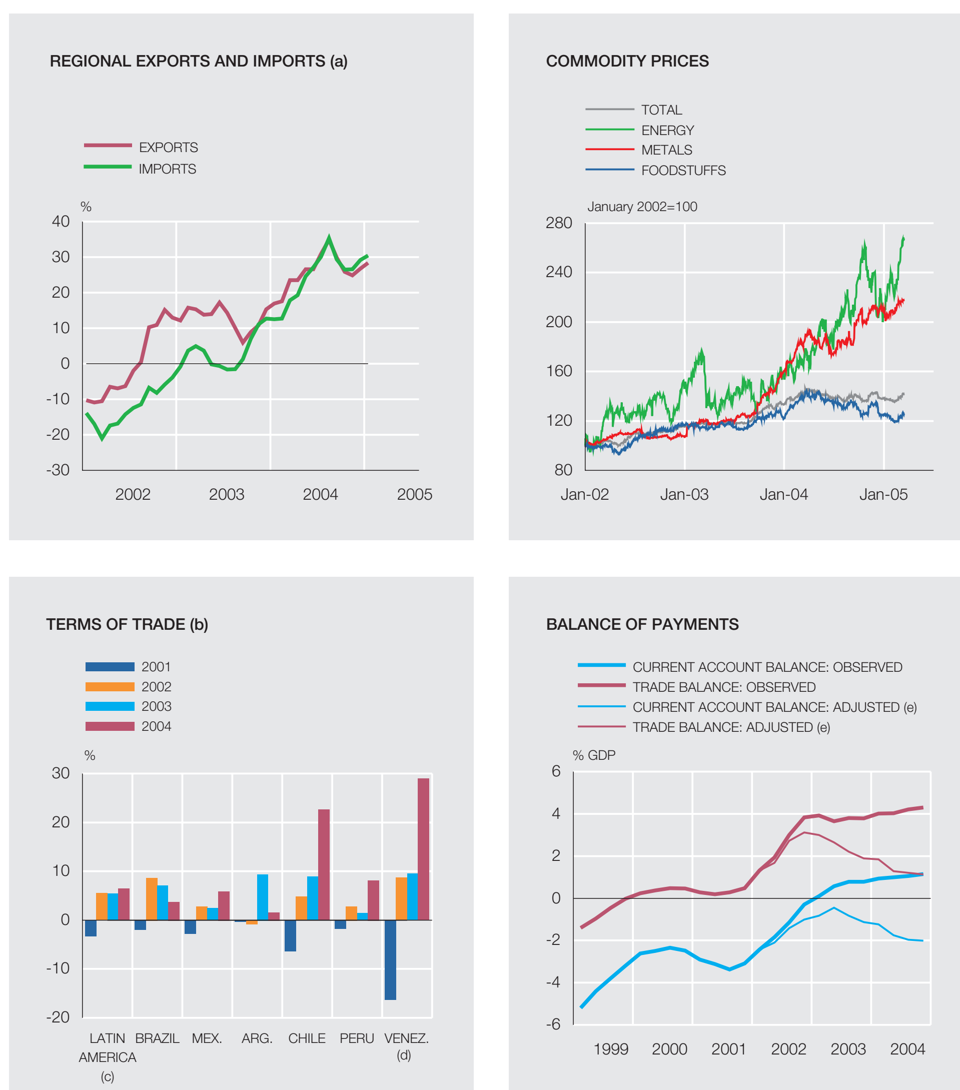
During the second half of the year financial markets performed very favourably, against a benign economic and financial background both within and outside the area.

Sovereign spreads were particularly favoured by this situation and held on a clearly falling trend from late May (see Chart 8). Lows for the year were recorded in December for most countries, as were indeed all-time lows (since the series have run) for some economies (Mexico, Colombia, Chile and Peru). The deterioration in inflation expectations, the tightening of monetary policies in most countries, or political factors in Venezuela or Ecuador exerted only a temporary effect and did not break the downward trend of spreads. The regional EMBI fell by practically 40% from its May high to around 425 bp at the end of the year. As can be seen in Chart 8, the narrowing of the sovereign spreads of Brazil, Peru and Uruguay were particularly notable, but the decline exceeded 20% in all the countries. Even in Argentina, the reduction in the spread of the BODEN bonds issued after the default exceeded 40%. In 2005 Q1, sovereign spreads fluctuated, reaching new lows in late February but rebounding moderately in March.

The stock markets ended 2004 with significant gains, concentrated in the second half of the year, and virtually all the region's stock market indices stood at historical highs as at end-February 2005. The Colombian stock market recorded the biggest rise, of over 85% in local currency, followed by the Peruvian and Mexican markets. The gains on the Brazilian market for the year as a whole (slightly over 15%) were held back by the negative performance early in 2004. The year 2005 began with a correction of the region's main stock markets in January, which was more than offset by the rises in the following months. The Argentine stock market was notably volatile following the definition and undertaking of the debt exchange, and the rise of over 13% in January and February was mostly reversed in March.

EXTERNAL BALANCES AND THEIR DETERMINANTS
Year-on-year changes and percentage of GDP

CHART 7



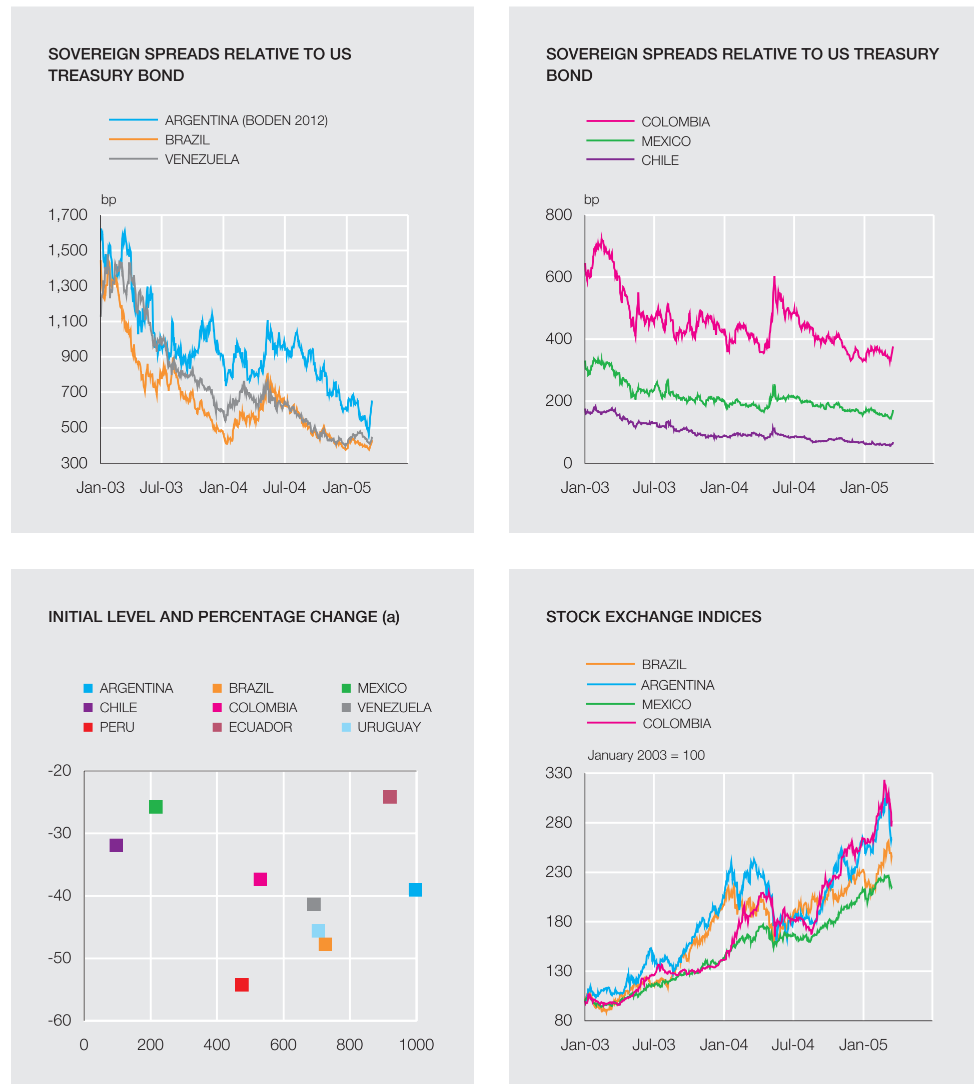
SOURCES: National statistics and own calculations.

a. Quarterly moving average.
b. Ratio of export to import prices.
c. Comprises seven countries.
d. The figure for 2001 is -16.2%.
e. Calculated with terms of trade at the beginning of 2002.

Most exchange rates in the region tended to appreciate against the dollar in the second half of the year (see Chart 9), some markedly so. The appreciation in the area as a whole against the dollar was 4.4% during 2004, while in nominal effective exchange rate terms it was limited to 1%, owing to the weakness of the dollar against the other main trading partners in the region. The divergence between the exchange rate trend against the dollar and against the other currencies proved favourable for Latin America as it enabled a lesser debt burden (since most of the foreign liabilities of government and private-sector agents are denominated in dollars) to be reconciled with limited losses in terms of competitiveness abroad. The Colombian peso posted the biggest appreciation in the region over 2004 as a whole (17% against the dollar), and also notable as from May was the appreciation of the Brazilian real and the resilience of the Mexican peso, thereby interrupting the depreciating course on which it had moved since the beginning of 2002.

SOVEREIGN SPREADS AND STOCK EXCHANGES
Basis points and indices

CHART 8



SOURCE: JP Morgan.

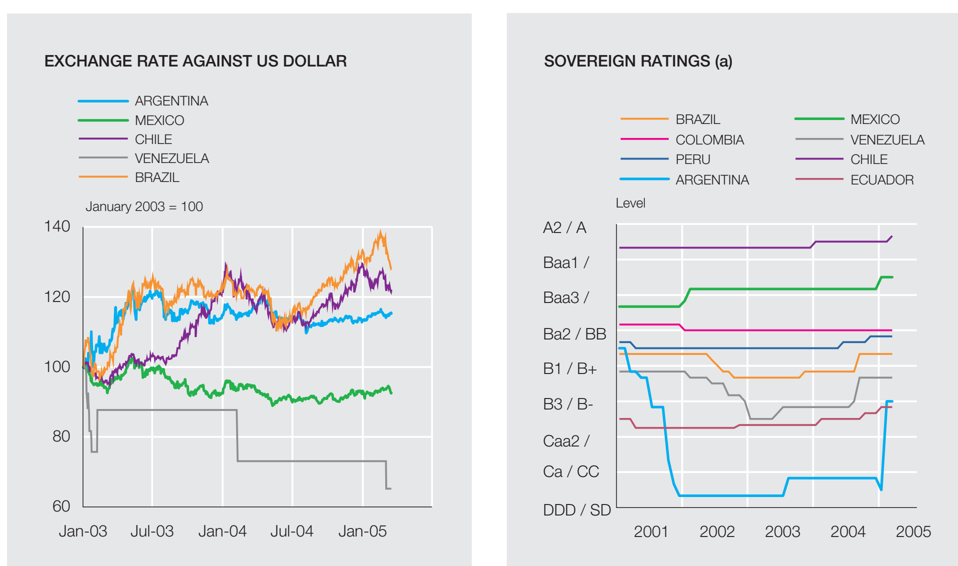
a. From last week of May to December.

The favourable economic and financial situation continued to translate into selective upgrades of sovereign ratings, a process which had begun timidly in late 2003, as can be seen in Chart 9. Brazil, Uruguay and Venezuela benefited from an upgrade in the second half of the year, as did subsequently Mexico, Ecuador, Chile and, once again, Uruguay in 2005 Q1. According to some of the rating agencies, Argentina might receive the same rating as that of Ecuador when the new bonds begin to trade in April, thereby abandoning the “Selective Default” category associated with the suspension of payments in force since late 2001. In contrast to this trend, the Dominican Republic’s credit rating was downgraded.

The firming of the recovery, the buoyancy of the external position and benign financing conditions helped bring about a reduction in the degree of vulnerability, as reflected in the indicators in Chart 10, and an improvement in the financial outlook for these countries. In this respect, the series of improvements in sovereign ratings is a clear indicator of greater resilience in the face of future adverse shocks. Nonetheless, it should be stressed that, although sovereign spreads are at the level prior to the Russian crisis, vulnerability remains high and certain sig-

EXCHANGE RATES AND SOVEREIGN RATINGS
Indices and level

CHART 9



SOURCES: Datastream, Fitch, Moody's and Standard and Poor's.

a. Average of ratings by Moody's, Standard and Poor's and Fitch IBCA.
b. In January 2005, Standard and Poor's reduced the rating for Venezuela to "selective default" for technical reasons.
c. Including the possible change in rating for Argentina when the new bonds start to be traded, announced by Standard and Poor's but not yet fully confirmed.

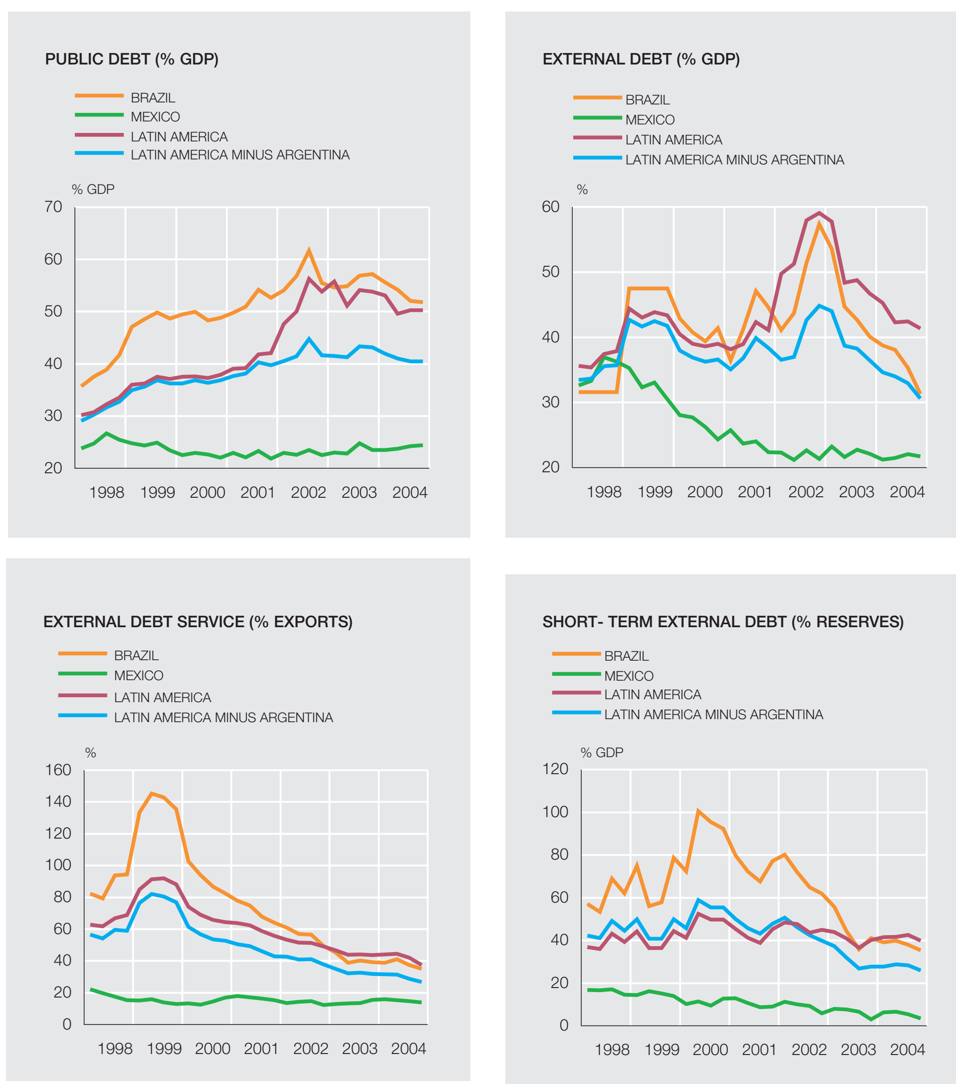
nificant indicators, such as the public and external debt/GDP ratios (see Chart 10), have worsened in relation to that period. Moreover, the particularly volatile nature of financial indicators in these countries entails a risk of sudden deterioration that may ultimately give rise to feedback in a short period of time. Perseverance is thus called for in the reduction of vulnerabilities via disciplined policies and in the more active management of debt instruments, harnessing the improvement in the investment environment. Box 1 describes the recent initiatives on the primary debt markets to reduce the degree of vulnerability associated with debt.

Total issues on primary markets (see Chart 11) in the second half of the year were similar in trend and amount to the first six months (17.5 billion, with Q3 proving more active than Q4). Corporate issues, however, posted a decline (more marked at the end of the year) which has been offset by the strong momentum of issues at the start of 2005. For the year as a whole, issues amounted to $36 billion, almost 10% down on 2003. The reduction was centred on corporate issues, which declined by 27%. That made for a loss of share of Latin America on the primary debt markets, such share accounting scarcely for one-third, compared with 44% in 2003 and over 70% in 2001.

As regards overall net capital flows to Latin America, the widening of the current-account surplus and the lesser pace of the build-up in reserves translated into a heavy reduction relative to 2003. Total flows amounted to $5.6 billion on aggregate for Latin America, less than one-quarter of those received the preceding year. Official flows turned negative, owing to the repayment of loans received from international financial institutions, while the negative contribution of portfolio flows and loans increased. Foreign direct investment (FDI) flows alone were positive, showing a notable recovery during the year and rising from $33 billion in 2003 to $50 billion in 2004, which brought their declining trend since 1999 to a halt. This latter figure is particularly favourable, especially given that the extraordinary performance of FDI in the latter part of the nineties was upheld by an intense privatisation process (which has yet to revive in

VULNERABILITY INDICATORS
Percentages

CHART 10



SOURCE: National statistics.

the current economic situation) and that Argentina remains practically on the sidelines as far as investment is concerned. Brazil and Mexico account for most of the increase in FDI, although there were certain one-off operations in these countries which biased their figures upwards.

PRICES AND MACROECONOMIC POLICIES

After rebounding notably in 2004 Q2, the aggregate inflation rate for the area continued increasing very slightly, closing 2004 at a year-on-year rate of 6.5% (see Chart 12). This result is very similar to that as at end-2003, although in annual average terms inflation has fallen from 10.9% in 2003 to 5.9% in 2004. All countries, except the Andean economies, saw an acceleration in inflation in the second half of the year, although in the opening months of 2005 there has been something of a slowdown in prices in most of them, most sharply so in Mexico. The exception is Argentina, where prices, after relatively stable behaviour in the second half of 2004, quickened markedly at the start of 2005. Only Venezuela ended the year with inflation running at over double figures.

These price developments meant a failure by Mexico to meet its explicit inflation targets and placed the Brazilian rate at the end of the year close to the upper limit of its target band, while

The difficulty of issuing local-currency-denominated debt on international markets, and even on the local market at a sufficiently long maturity period, has been extensively analysed in the literature as one of the key factors of financial vulnerability in emerging economies, in particular in Latin America[1]. This limitation lies at the root of the significant proportion of debt in dollars and the high sensitivity of public debt to financial conditions, in particular to the volatility of the exchange rate and of interest rates. As can be seen in the trend of interest payments on debt, in the left-hand panel of the chart, this problem tends to worsen in crisis or capital-drought situations, and when interest rates in the industrialised countries are higher. Symmetrically, the problem tends to ease in situations such as those in 2003 and 2004, when ample international liquidity coupled with the improved fundamentals of the emerging economies allowed debt to be issued under very favourable conditions.

These circumstances have underscored the need for a more active approach in the management policies for debt and for new financing instruments, so as to provide for more stable debt composition. In recent years, such policies have firstly allowed the proportion of external debt - which is mostly in dollars and therefore sensitive to exchange rate fluctuations - to be reduced in favour of domestic debt, whose vulnerability to the exchange rate is a priori less (see the right-hand panel of the chart). There has moreover been considerable progress regarding the management of domestic debt. Significantly, the indexing of debt to the exchange rate has tended to lessen, in exchange for a moderate increase in inflation-indexed debt denominated in local currency both at floating and fixed interest rates, albeit at a shorter term in the latter case. Overall, then, the composition of current debt may be qualified as less vulnerable to exchange rate swings and also to interest rate volatility.

1. The term “original sin” for referring to this circumstance was coined by Hausman and Eichengreen (1999) in Exchange Rates and Financial Fragility, NBER Working Paper 7418, November 1999. Céspedes, Chang and Velasco (2003) in *Must Original Sin Cause Macroeconomic Damnation?,* Central Bank of Chile Working Papers No. 234, October 2003, and others have subsequently analysed this subject from different angles.

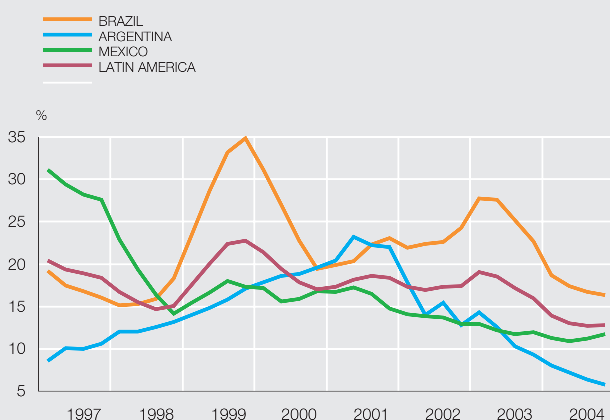
This concern for the quality of the structure of debt has seen the proliferation of new financing instruments on the part of sovereign issuers in the region and of multilateral institutions (the Inter-American Development Bank and the World Bank). The novel features displayed by the new issues are as follows:

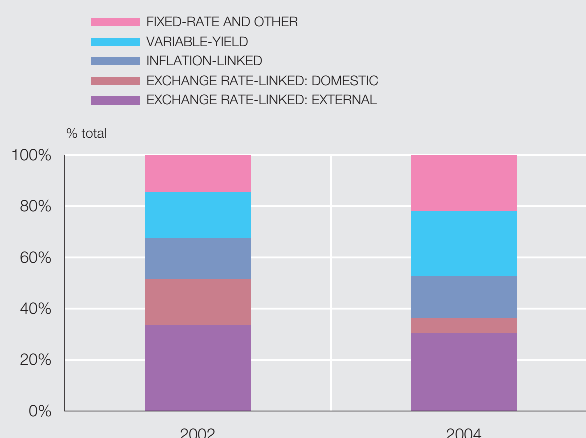
— Denomination in local currency and diversification of foreign-currency issues. The World Bank and the Inter-American Development Bank (IDB) issued bonds in 2004 in currencies other than the main reserve currencies, such as the Colombian peso, the Brazilian real and the Mexican peso. Colombia in 2004 and, previously, Uruguay in 2003 also issued bonds denominated in their respective local currencies on the international markets. These local-currency issues will contribute to reducing some of the main financial vulnerabilities characteristic to the region: for one thing, they will tend to lessen sovereign debt exposure to the exchange rate of the dollar and, for another, they will increase the depth of the local-currency markets, providing a broader range of assets in these currencies and accustoming investors to manage their foreign exchange risk. In this respect, some of the IDB issues in local currency were placed on international markets, as is habitually the case. But the IDB’s Mexican peso issues and the World Bank’s Colombian peso issues were placed for the first time entirely on local markets, providing local investors with the possibility of diversifying in assets with the best credit ratings. Further, in an attempt to diversify the currency composition of their debt, countries such as Brazil, Peru and Mexico resumed issues in euro in 2004, which will also allow for greater diversification of foreign exchange risk.

— Fixed-rate issues. Several international issues were made at a fixed interest rate, as well as in local currency. Cases in point were those of Colombia or those of the IDB in Brazilian reals and Mexican pesos. These offer the additional benefit of reducing vulnerability to interest rate volatility.

— Maturities. Most of the new instruments were issued with relatively long maturities, which will tend to lessen another financial

VULNERABILITY INDICATORS FOR LATIN AMERICA





SOURCE: National statistics.

vulnerability, namely refinancing risk if capital flows should grind to a halt. In this respect, issuers with a better rating, such as Mexico, managed to continue lengthening the maximum term of issue of their external debt to 15 years (in euro).

— CACs. Another key feature of international issues in 2004 was the preponderance of issues with CACs (collective action clauses), which allow a debt restructuring process to be initiated with a qualified majority, and which affect practically 90% of the volume issued by sovereign issuers over the past year.

— GDP-linked bonds. Finally, Argentina included a revision clause based on the course of GDP in the bonds it offered in the debt exchange (see Box 2). The aim of this type of indexing would be to align debt service with the issuer's ability to pay resulting from the economy's cyclical position and economic growth.

in Colombia, where inflation held on a declining path during the year, the target was met (see Table 2). In Chile, the inflation rates stood below target. The concern for the deterioration of the overall price index was softened by the better behaviour of underlying inflation (see Chart 12). The underlying rate fell by 2.2 pp during the year for the area as a whole and closed at 5.6% thanks to the notable reduction in Brazil, Colombia and Venezuela.

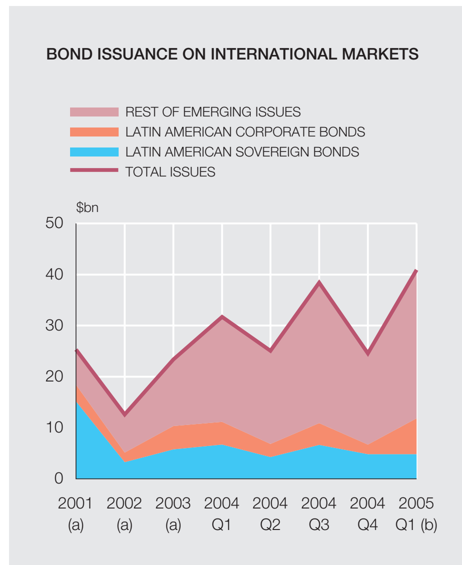
Faced with this situation, monetary policies were cautious and the tightening of monetary conditions was stepped up in all countries, except in Colombia, where the official rate was cut. The tightening of monetary policy was particularly intense in Brazil and in Mexico (see Chart 12). Nonetheless, the brighter economic outlook and the improved financial position prompted notable growth in credit in the region of over 8% at year-end. All the main countries, except Peru, were running positive growth rates at the close of the year. The increase was particularly notable in the consumer credit sector, with growth rates exceeding 30% in most countries. Of particular note was the behaviour of Argentina, which has maintained a positive rate of increase in credit in real terms since 2004 Q2, though its level is still far below that attained before the crisis (scarcely 43%, in real terms, compared with late 1999).

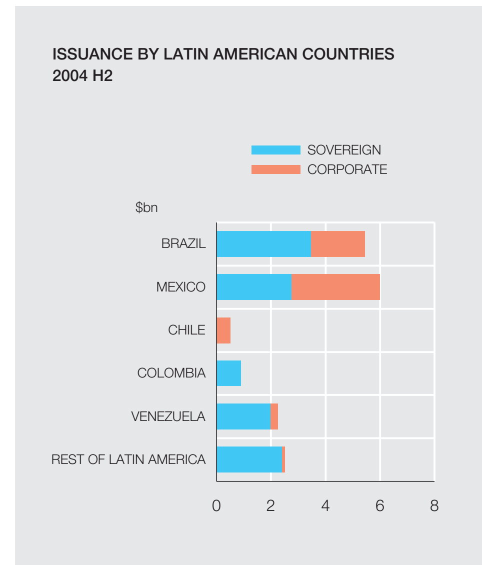
The conjunction of upward pressures on the exchange rate and prices, in a setting of economic buoyancy, gave rise to certain monetary and exchange-rate management dilemmas, which were reflected in the differing pace and trend of the build-up in reserves across countries (see Chart 12). In any event, this build-up continued, with even greater intensity in the second half of the year than in the first, with foreign reserves climbing by 7% in the region as a whole. In Brazil, Peru and Mexico, pressures on the currency translated in the second half of the year into a large build-up in reserves, greater than in the first six months, and, at the same time, into a notable appreciation of their currencies, as indicated. In Argentina, where the pressures on prices are becoming pressing, the pace of accumulation of reserves fell notably in the second half of the year. In all these cases, the increase in reserves tended to be sterilised. Chile, on the contrary, continued to pursue a free-float policy and its reserves held stable.

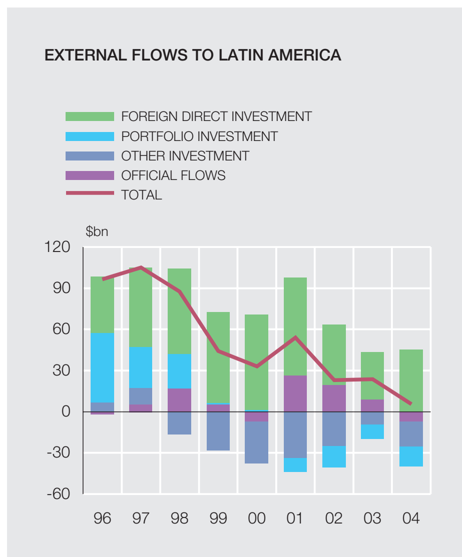
The improvement in public finances in Latin America led to a narrowing of the budget deficit for the whole area by 0.7 pp in 2004 to 1.2% of GDP, and to a widening of the primary surplus to over 3% (see Chart 13). The improvement was across the board, and particularly intense in Argentina, where the central government primary surplus rose to 3.9% of GDP, far above the commitment made in the IMF programme. Brazil increased its primary surplus once again in 2004, also by more than 0.3 pp above the 4.25% target agreed with the IMF. Mexico was very close to achieving a balanced budget, and in Chile, where a fiscal rule is in place, the favourable cyclical situation and the copper boom were conducive to bringing about a substantial surplus. Underpinning these favourable figures were the strong growth of revenue (see Chart

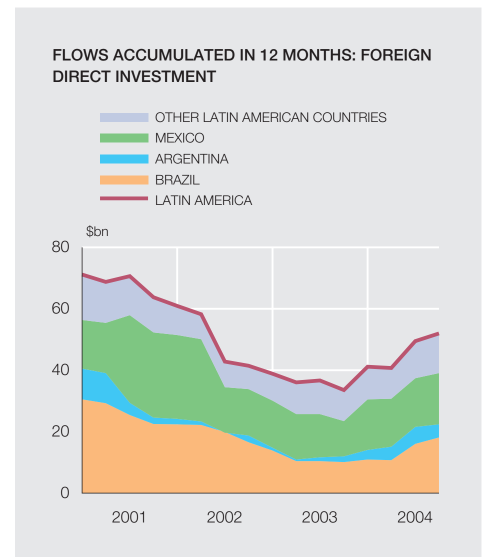
EXTERNAL CAPITAL FLOWS
$bn

CHART 11









SOURCES: JP Morgan, IMF and national statistics.

a. Quarterly average.
b. Data to February and estimation for March 2005.

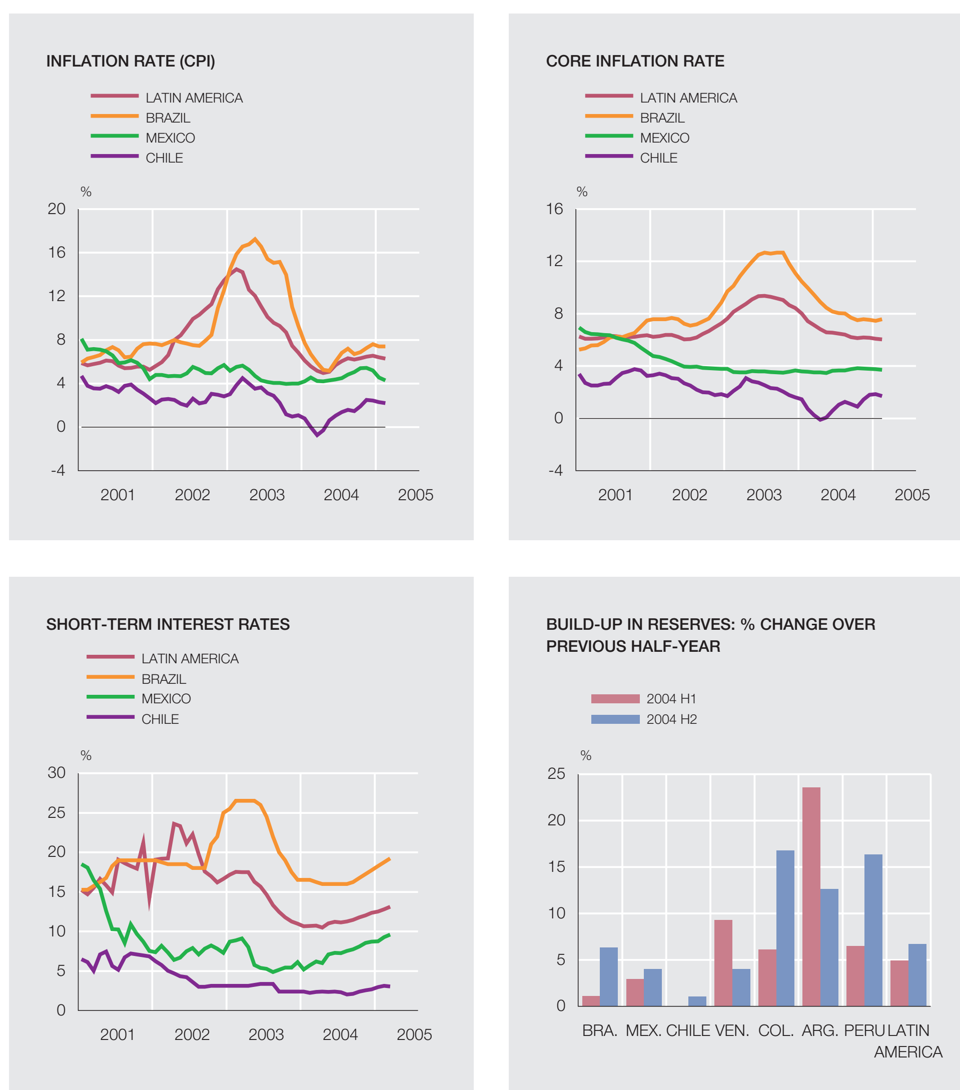
13), the rate of which was close to 12% in real terms for 2004 as a whole, though something of an acceleration could be seen in the final quarter. In some cases, the deficit reduction was very substantially driven by export proceeds from oil (Mexico and Venezuela), minerals (Chile and Peru) and, in Argentina's case, by the high withholdings on exports still applied in this country. Primary expenditure also increased strongly in real terms, albeit to a lesser extent (8.8%), and it quickened in the second half of the year, thanks in some cases to the comfortable margin by which fiscal targets had been met.

STRUCTURAL REFORMS AND TRADE INTEGRATION

The improved economic and financial situation did not provide for resolute headway in seeing through structural reforms. The main exception was, once again, Brazil; although progress there was less significant than that of the previous year, far-reaching reforms were approved. These included most notably the legislation on bankruptcy, which affords creditors greater legal security, and plans for public-private partnerships aimed at promoting investment in the

INFLATION, SHORT-TERM INTEREST RATES AND RESERVES
Year-on-year change and percentage

CHART 12



SOURCE: National statistics.

public interest and safeguarding it from cyclical oscillations. In other countries there was some progress in terms of the development of the financial sector, related above all to mutual funds, as in Chile or Mexico; in this latter country, however, reform remains at a standstill in all other respects. There was scant headway on the fiscal front, principally in countries in a fragile situation, such as Colombia and Ecuador. The inability of the Ecuadorian authorities to approve reforms led to the suspension of its programme with the IMF. Finally, there were significant legislative changes in Argentina and Venezuela, but many were either relatively ineffective or marked a step backwards in the process of reform.

There was no relevant progress in the field of trade integration. The Free Trade Area of the Americas (FTAA) did not manage to start up on 1 January 2005, as had been scheduled. The lack of progress in negotiations during the course of last year make this delay necessary, and signs of a solution are not perceptible. Nor was it possible to finalise the agreement between MERCOSUR and the EU, and perhaps the only headway of note was in the Central American Free Trade Area, in closer relations between MERCOSUR and the Andean Community, and in the proliferation of trade and financial negotiations between China and several Latin American

LATIN AMERICA: COUNTRIES WITH AN EXPLICIT INFLATION TARGET TABLE 2

	2004			2005
	Target	Achievement	Reason	Target
Country				
Brazil	5.5 + - 2.5	Yes	December 2004: 7.6%	4.5 + - 2.5
Mexico	3 + - 1	No	Systematically above 4%	3 + - 1
Chile	3 + - 1	No	Below target: lower than 2% until October 2004	3 + - 1
Colombia	5 + - 1	Yes	December 2004: 5.5%	3.5 + - 1
Peru	2.5 + - 1	Yes	December 2004: 3.5%	2.5 + - 1

SOURCE: National central banks.

countries. It should also be underscored that the WTO Multifibre Arrangement ceased to be in force on 1 January, meaning freer access for Chinese textile exports to world markets. Some Latin American economies, which had enjoyed privileged access to developed markets under the previous arrangements, will be harmed by the new situation.

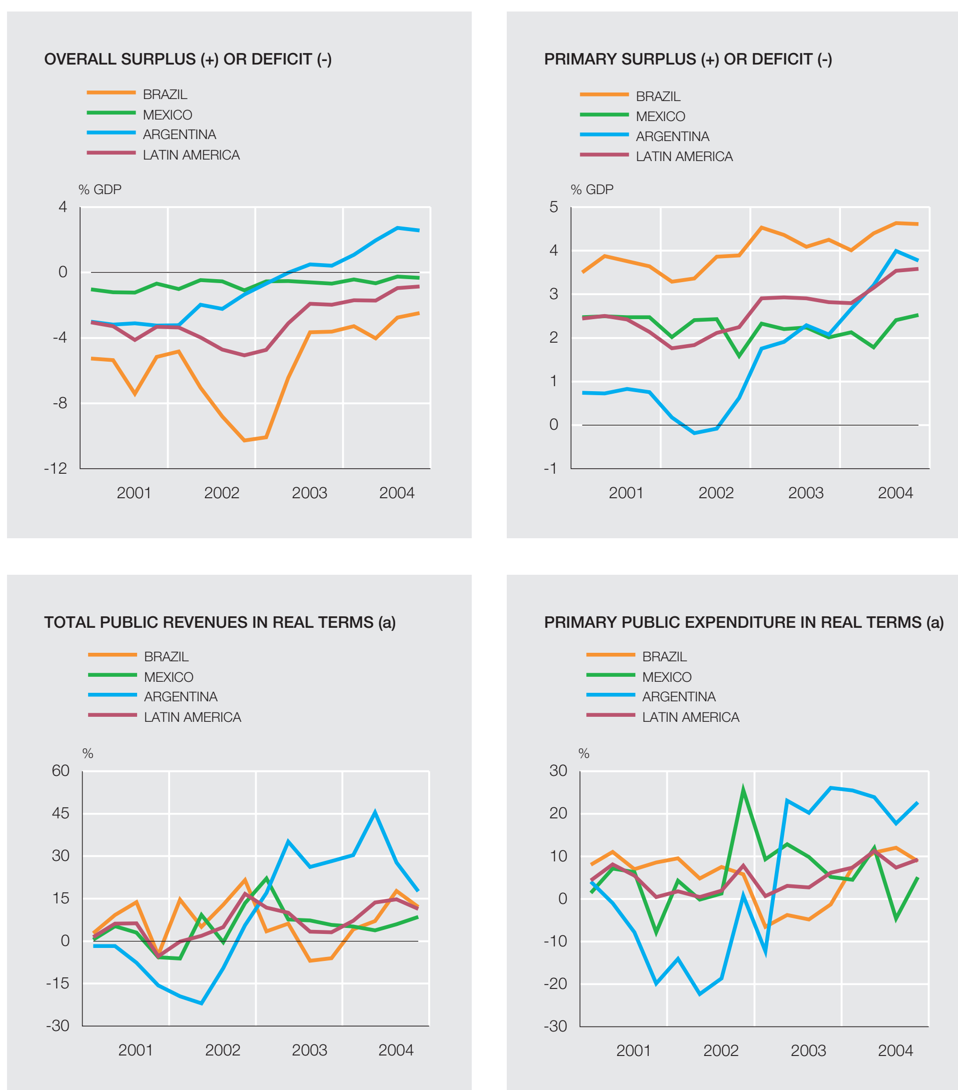
Developments in the main countries

In *Brazil*, the strength of activity during the second half of the year took root. GDP grew 6.2% year-on-year in Q3 and eased to 4.9% in Q4, closing the year with growth of 5.2%, the highest rate since 1994. In addition, domestic demand took over from external demand as the engine of growth, entailing a significant change in its composition (see Chart 5). On the demand side, the expansion in private consumption (4.2% for the year) and in investment (10.9%) was salient, while on the supply side, the 5.3% growth in industry was noteworthy. The growing contribution of domestic demand was underpinned by the strength of the labour market. Employment posted growth figures of over 3% during the year, which were even higher in the industrial sector. This prompted a decline in the average unemployment rate of almost 1 pp, to 9.6% at the end of the year, while real wages picked up notably, albeit without reaching their 2002 levels (see Charts 6 and 14). Prices trended less favourably. The inflation rate quickened from the summer onwards and ended the year at 7.6%, close to the upper limit of the target band (8%). It was driven by price rises in the more volatile components, since underlying inflation turned downwards. This situation, against the background of highly buoyant domestic demand and the downward stickiness of inflation expectations for 2005, led the monetary authorities to tighten the monetary policy stance notably. As a result, official interest rates were increased by 325 bp from September 2004 to March 2005, to 19.25%, with real interest rates following in their wake (see Chart 14). The inflation rate stabilised in the first two months of 2005 (7.4%).

For the first time in many years, the Brazilian economy enjoyed high economic growth coupled with a positive current-account balance (1.9% of GDP), driven by a trade surplus of 5.7% of GDP. Rounding off this scenario are sound fiscal results, enhanced by revenue growth (10.6% in real terms) and the sound performance of the financial variables, which gave rise to a 0.3 pp increase in the primary surplus (4.6%) and to a reduction in the budget deficit of more than 1 pp (to 2.5% of GDP). Also, the debt ratio fell by 5.3 pp to 51.9% of GDP. Against this background, the holding of local elections in October and difficulties in the governing coalition were scarcely reflected in the financial indicators. Indeed, risk premiums stood at the end of the year below 400 bp, the lowest level since late 1997, and the exchange rate appreciated notably, markedly so in early 2005. The exchange rate of the real against the dollar stood at below 2.60, a level not seen since August 2002 and which entails an appreciation of close to 20% from the low for the year in May. In March, however, there was a significant correction both in spreads and in the exchange rate. Lastly, the financial programme signed with the IMF in Sep-

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

CHART 13



SOURCE: National statistics.

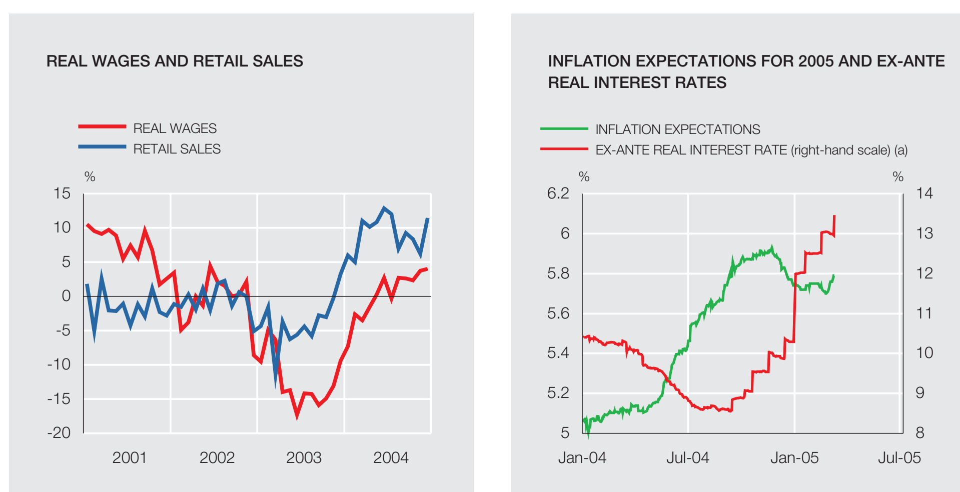
a. Deflated by CPI.

tember 2002 concluded in March, and the Brazilian authorities have announced that they will not be negotiating a new programme.

In *Mexico,* economic activity progressively accelerated during 2004. Average growth was 4.4% during the year, but the year-on-year rate was 4.6% in Q3 and 4.9% in Q4. These figures, the highest for the past four years, were underpinned by domestic demand. Among its components, private consumption firmed and investment, particularly in capital goods, rose strongly after three years of contraction. The acceleration in activity was due mainly to manufacturing output, since the rise in both services and construction was smaller, though the latter sector continued to post the highest growth. Turning to the labour market, the pick-up in employment resulted in growth of 3.5% in Q4, up from 1.3% at the close of 2003. The high growth of employment in the 'maquila' industries was also prominent (7.1%). The current-account deficit was the same in relative terms as in 2003 (1.3% of GDP), though its composition was different. The deficit on the trade balance widened by 48% on 2003, which translated into a contribution of external demand to growth of scarcely 0.3 pp. However, the increase in remit-

BRAZIL CHART 14

Year-on-year changes and percentages



SOURCE: Banco do Brasil.

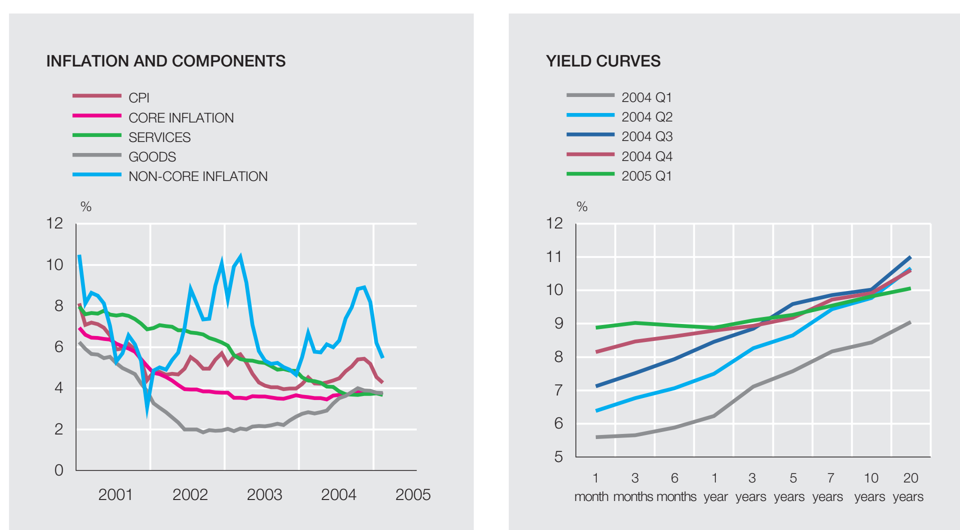
a. Calculated as SELIC interest rate minus 1-year-ahead inflation expectations.

tances ($16.6 bn, 24% up on 2003) explains the stability of the current-account deficit. The budget deficit during 2004 fell by 0.2 pp to 0.2% of GDP, thanks especially to oil revenues, which grew by 14.5% in real terms in relation to 2003. In the monetary domain, inflation held in 2004 above the upper limit of the central bank's target range (4%). This rise in inflation, which has undergone a partial correction since December, was associated with the more volatile components (see Chart 15), since underlying inflation held relatively stable. Notwithstanding, and to prevent this temporary increase becoming permanent were it to be incorporated into inflation expectations and into wage bargaining, the Mexican central bank tightened its monetary policy stance repeatedly, raising the "corto" twelve times. The central bank's intention that this liquidity constraint should feed through to short-term rates led these rises to be supplemented in the final months by certain other operational decisions, with the result that short rates have increased by over 4.5 pp since January 2004. The yield curve has also flattened notably, a sign that the market considers that the end of the restrictive monetary policy cycle is near (see Chart 15). Despite the rise in short-term interest rates, the financial markets performed soundly. There was an annual rise of 46.9% on the stock market, credit expanded strongly and the exchange rate appreciated as from May, standing at a level of close to 11 pesos to the dollar.

Following eight quarters of strong growth, activity in *Argentina*, far from weakening, resumed strong momentum in the second half of the year. GDP growth rose to 8.3% in Q3 compared with the same quarter a year earlier and quickened to 9.1% in Q4. The year 2004 thus concluded with growth of 9%, 0.2 pp up on 2003, whereby GDP would be only 3% below its 1998 peak (see Chart 16). As in previous periods, private consumption and investment were the main drivers of growth. Across the different sectors, growth spread notably to activities that had shown little dynamism during previous upturns, such as the car industry. The agricultural industry also remained buoyant, despite the volatility of certain export prices, such as those of soya and maize. As regards the external sector, Q4 saw a pick-up in real exports which helped soften the impact of the high growth rates of imports on the trade balance. Thus, although it remained negative, the contribution of the external sector improved relative to the first half of the year. The current account ended the year with a surplus of 2.1% of GDP, far below the level in 2003 (5.8%). An acceleration in public spending was also perceptible in

MEXICO
Year-on-year changes and percentages

CHART 15



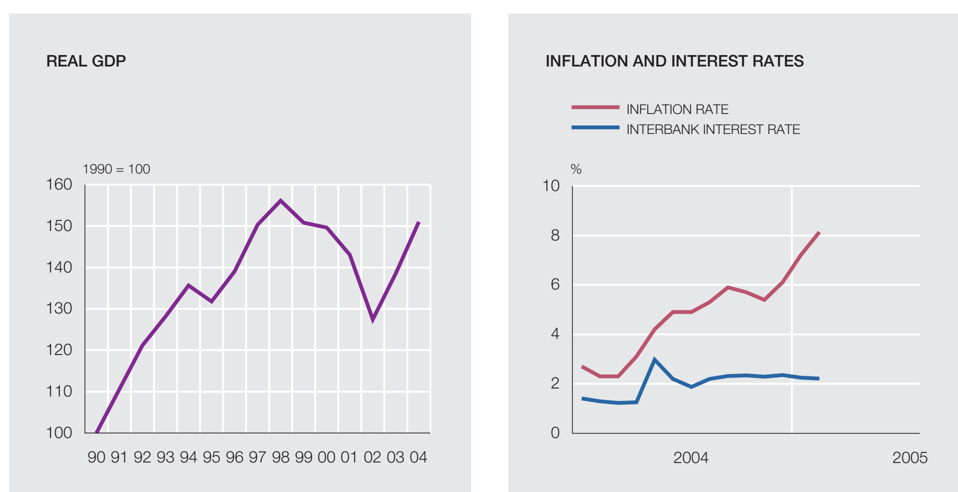
SOURCE: Banco de México.

the closing months of 2004, associated with several measures to increase public-sector wages and investment in infrastructure. Nonetheless, the trend of revenue meant that, for 2004 as a whole, there was a consolidated surplus equivalent to 5.5% of GDP, far above the 3% target agreed with the IMF. The favourable economic performance made for a reduction in unemployment to 12.6%. Against this background, however, inflationary pressures increased at the start of 2005, with the year-on-year rate of inflation standing at 8.1% in February (5.8 points up on the start of 2004). The central bank did not substantially alter its monetary policy stance (see Chart 16), since the 25 bp increase in the intervention rate was offset by a reduction in reserve requirements and the maintenance of a strong rate of build-up of international reserves, which stood at $20.8 billion. These interventions (in co-ordination with those of the public-sector banks) contained the appreciating tendency of the peso. Nonetheless, following the latest inflation figures, the monetary authority has brought the acquisition of foreign currency to a halt and has stepped up the absorption of liquidity through the placement of BCRA bills. The exchange of defaulted debt concluded at the end of February (see Box 2), whereafter Argentina resumed talks with the IMF, with a view to negotiating a new programme.

In *Chile,* activity quickened in the second half of 2004 with growth around 7% in the last two quarters of the year, making for a rate of 6.1% for 2004 as a whole. While private consumption and exports remained robust, the buoyancy of investment increased. Turning to the labour market, employment resumed a growth rate of over 3% year-on-year in Q4, following the weakness seen in mid-2004; in terms of unemployment, however, progress was more limited. The significant rebound in public revenue, owing both to the acceleration in growth and to the rise in the price of copper, led, along with the control of public spending, to a fiscal surplus of 2.2% of GDP in 2004, compared with a deficit of 0.4% in 2003. The current account posted a surplus of 1.5% of GDP in 2004, the result of a record surplus on the trade balance (of around 10% of GDP), due largely to the exceptional improvement in the terms of trade (see Chart 17). The strong growth of domestic demand since the middle of the previous year translated into a rise in prices of over 2%, up from the negative rates at the start of last year. That allowed the monetary authority to increase its benchmark interest rate very gradually to 2.75% (with four 25 bp rises from September 2004), after having kept it for most of the year at a historical low in both nominal and real terms.

ARGENTINA
Index, year-on-year change and percentage

CHART 16



SOURCE: National statistics.

Colombia stood apart from the trend in the rest of the region in the second half of 2004, since activity slowed, albeit moderately. In Q3, its year-on-year growth rate fell to 3.1%, and growth for the year as a whole was 4%, unchanged on 2003. Activity was held back by the sluggishness of investment and of exports. Despite lowe r growth, there were further improvements in the labour market, reflected in a decline in the unemployment rate to a low since 1998. In the fiscal domain, although primary expenditure experienced double-figure growth in the second half of 2004, the rise in revenue provided for a reduction in the central government deficit of the order of 0.5 pp to 4.4% of GDP. This progress was not supported in the structural reform arena, since the tax reform submitted by the government had to be withdrawn owing to a lack of parliamentary backing, resulting in another setback for the strategy of improving the country's fragile fiscal position. Inflation, after rising in the summer months, progressively fell to 5.5% at the end of the year, as a result of which the central bank's target (6%) was met. In early 2005 there was a further reduction in inflation to 5.3%. The containment of inflation and the appreciation of the peso allowed official interest rates to be cut by 25 bp to 6.5% (see Chart 17), in contrast once again with the rest of the region, and also induced a strong build-up in reserves.

In *Peru,* activity quickened in the second half of 2004, especially in Q4 (6.8% in year-on-year terms), meaning the annual increase was 5.1%. The forceful pace of activity was driven by domestic demand, particularly by investment, and by exports. Against this background, Peru posted an exceptional current-account surplus in the second half of the year. The fiscal imbalance declined in 2004 to 1.3% of GDP. Inflation held above 4% throughout the second half, leading the central bank to raise official rates twice. The year-on-year inflation rate has, however, fallen in recent months, returning within the central bank's target range. Sound financial and macroeconomic data, the country's intention to settle part of its external debt and the approval of the pension reform for civil servants prompted an improvement in Peru's sovereign rating and expectations that it might enjoy investment-grade status, from which only Chile and Mexico have benefited to date in the region.

Venezuela's year-on-year growth rate remained in double figures in the last two quarters of 2004 (14.1% and 11.2%, respectively), which led to an annual rate of 17.3% and to a recovery of the output level prior to the crisis, against a backdrop of greater social stability following the August referendum. Nonetheless, the interventionist measures of the executive branch have

Argentina concluded in late February the exchange of its defaulted debt with a participation rate of 76%, which was greater than expected by most analysts. Given the sizable haircut implicit in the terms of the exchange (estimated at around 70% in present value terms), this operation will provide for a reduction in Argentine public debt of 50 pp of GDP, i.e. by almost 40%, as can be seen in the chart. Thus, although the Argentine debt ratio will remain at a very high level (72% of GDP), the low cost of the new bonds and their long maturity entail notable alleviation for Argentina's financial sustainability position, at least over the coming years.

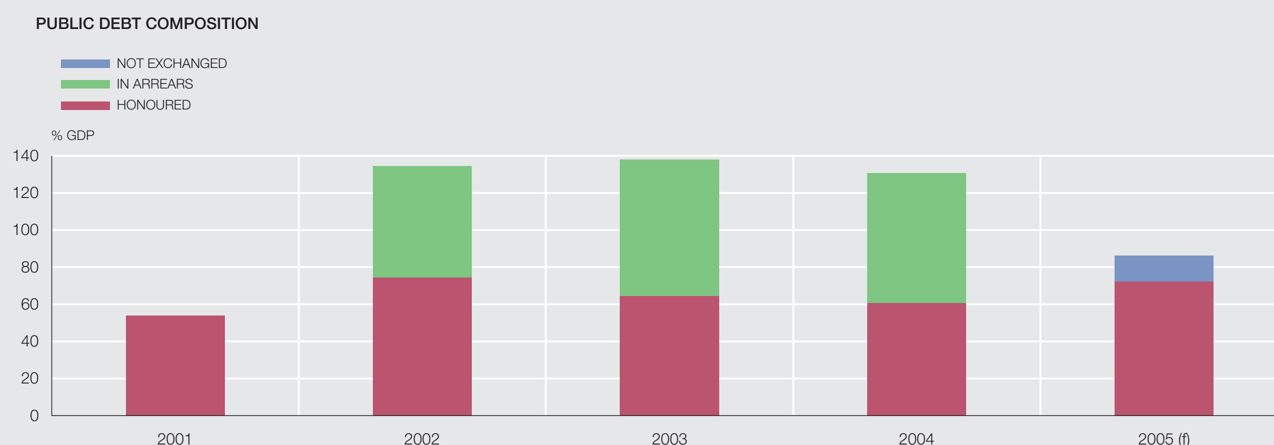
This restructuring process has attracted the attention of the international financial community since, in late 2001, the moratorium on debt was declared. There are several reasons for this attention. First, it has been the biggest default in history, characterised moreover by great complexity, and resolving it - steps towards which began officially with the Argentine government proposal in Dubai, in September 2003 - has taken a long time. Second, Argentina's prominent role in the development of the international markets for emerging debt during the nineties, and the involvement of international financial institutions in the country, account for the relevance of the debt restructuring process in Argentina as part of the debate on the reform of the international financial architecture.

Negotiations were marked by the fierceness of the respective positions of the Argentine government and the private creditors. From the standpoint of the country in default, a debt restructuring process poses the need to strike a balance between the alleviation stemming from the restoring of debt sustainability and the advisability of compensating as far as possible for the breach of contract vis-à-vis the creditors, thus easing the way for the country's future readmission on international markets. In other recent sovereign restructuring processes, this balance has taken the form of debt reductions no greater than 30% or 40% and the re-opening of financial markets within a period of one to five years. By contrast, the Argentine authorities, due among other factors to the high level of the country's debt (132% of GDP at end-2004), adopted a strategy geared to attaining a most significant reduction in debt, which gave rise to a very wide gap between the terms proposed by the government and the demands of creditors. International financial institutions remained relatively removed from the final stages of the negotiation process and played a limited role - conditioned, above all, by the reservations of the Argentine authorities - in helping draw positions closer together.

Against this background, the proposal for the exchange of the defaulted debt launched in June 2004 was criticised by creditors owing to its unilateral nature. But the broad outline of the offer did not change significantly when it was made firm: $81.8 million of eligible debt in default would be exchanged for par bonds (without a nominal discount), quasi-par bonds (in pesos and with a nominal discount of 33%) and discount bonds (with a nominal haircut of 66%, but a shorter term and bigger coupons than the foregoing bonds). So as to maximise the nominal saving on the exchange and to encourage prompt participation by domestic retail and institutional creditors (those most interested in par and quasi-par bonds, respectively), the amount to be issued of the first two types was limited, giving priority to the first orders received. All the securities will have separately tradeable coupons, whose payments will depend on the future course of GDP.

After several delays which raised fears of a possible cancellation of the operation, the offer was set in train in mid-January and the period for the receipt of the attendant orders expired on 25 February. With an effective haircut of around 70%, the impact of the exchange on the amount and structure of Argentine debt will be most significant (see table 1), since the country will simultaneously obtain a substantial nominal haircut, a reduction in interest and longer redemption terms. The reduction in the amount of nominal debt (around 43%) means that such debt will, on government projections, fall from $191.2 billion (132% of GDP) before the exchange to $125.2 billion (72% of GDP) in 2005. Annual interest in the coming years will stand at around 2% of GDP (one-quarter of their value in 2001), while the

PUBLIC DEBT DEVELOPMENTS IN ARGENTINA BEFORE AND AFTER DEBT RESTRUCTURING
Percentage of GDP



SOURCES: Banco de España and Ministerio de Economía de Argentina.

new bonds will not begin to be redeemed until 2024. The share of local-currency and inflation-indexed debt in the total will increase to 37% after the exchange, compared with scarcely 3% in 2001.

Given the combination of a substantial debt reduction, which will contribute to easing fiscal sustainability in the coming years, and to a higher than initially expected degree of participation, the exchange may be considered as an important step towards finally bringing the Argentine economy back onto a normal footing. Nonetheless, this needs qualifying. First, the status of the non-exchanged bonds is a source of controversy. The amount involved here, which was not considered in the foregoing figures, is estimated at $ 24 billion (14% of GDP; see chart). Although the Argentine government does not envisage acknowledging any payment to these creditors, this decision might muddy Argentina's negotiations for a new financial programme with the IMF, the nature of which, in any event, has yet to be defined. Over a longer horizon, the Argentine authorities' management of the restructuring and the size of the haircut might be a persistent drain on investors' confidence, which might in turn limit the accessibility of international financial markets in the future and lead to a higher risk premium. Further, while the exchange lessens one of the burdens that was making the prolongation of the recovery in Argentina uncertain, the approval of structural reforms has yet to be secured. These are needed to correct the other underlying problems inherited from the crisis - some of which are deep-seated - and to strengthen the country's growth bases. Indeed, the conclusion of the restructuring process offers an opportunity to focus on such reforms which should be seized.

More generally, the restructuring of Argentine debt evidences a series of special characteristics, such as the effective haircut applied, a high proportion of non-exchanged debt and the extensive duration of negotiations, which may have implications for future instances of sovereign default, although this possibility is as yet difficult to assess.

IMPACT OF DEBT RESTRUCTURING ON TOTAL DEBT (a)

	$ bn	% GDP
Total debt before debt restructuring (including interest arrears)	192	132
Total debt after debt restructuring	125	72
Annual interest payments in 2001	10.1	8.0
Annual interest payments after debt restructuring	3.2	2.0
Debt in domestic currency in 2001 (% total)	3	
Debt in domestic currency after debt restructuring (% total)	37	

SOURCES: Banco de España and Ministerio de Economía de Argentina.

a. Non-exchanged debt excluded.

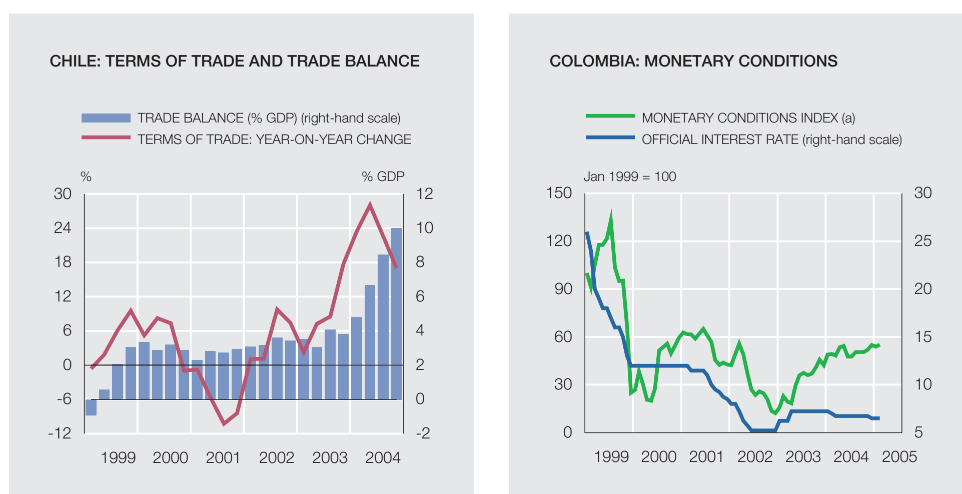
progressively taken root and have been reflected in the pressure on the central bank, on foreign investors (with the rise in oil royalties) and on the financial sector. In addition to the oil boom and the improvement in the labour market, the strong growth of activity is also the result of continuing high liquidity and of negative real interest rates, which arise in part from the restrictions in the financial market, particularly in respect of exchange controls. High oil prices also allowed a very comfortable external position to be maintained and for public spending to be increased most substantially (by around 20% in real terms for the year as a whole). Inflation fell gradually, but the related rates are still very high (16.9% in February). Finally, the expected devaluation of the bolivar (10.7%) took place on 3 March.

In *Uruguay,* where the government changed hands following the presidential elections, activity held on an expanding path in the second half of 2004 (growth of 10.2% in Q3 compared with the same period a year earlier) and ended the year at a rate of 12.3%. Inflation held on a declining course and closed the year at 7.6%, within the target range. Nonetheless, the fiscal and financial situation remains delicate. In *Ecuador,* activity grew strongly in the second half, driven by the oil sector. Although there is still no financial programme with the IMF, the support of this agency for the latest economic reforms, the management of fiscal policy and

CHILE AND COLOMBIA

Year-on-year change, percentage of GDP and level

CHART 17



SOURCES: National statistics and Banco de España.

a. Index calculated from real interest rate and real exchange rate of the economy, weighted by the degree of openness.

the announcement of the country's return to international markets, with the exchange of the bonds issued after the 1999 default, were conducive to the upgrading of its sovereign debt rating in January. Among the remaining countries in the region, the growth rate of activity in the *Dominican Republic* was positive in 2004 Q2 and Q3, and the new government unveiled an adjustment programme backed by the IMF. Notwithstanding, certain trade credits fell into arrears, which highlights the persistence of the banking crisis. Lastly, the political, social and economic instability in Bolivia worsened in the opening months of 2005 after a period of relative calm.

29.3.2005.