HALF-YEARLY REPORT ON THE LATIN AMERICAN ECONOMY

Half-yearly report on the Latin American economy

Introduction

Activity in Latin America was firm in the first half of 2005, as shown by the Q2 growth rate of 4.9% year-on-year. The forceful pace of expansion in late 2004 therefore moderated somewhat, coming more into line with the maturity of the region's business cycle and with the gradual closing of output gaps (Chart 1 gives an estimate of the gap for the area as a whole). The economic outlook remains favourable, against a benign external backdrop; the regional growth rate is forecast to stabilise at robust rates, of somewhat more than 4% for the year as a whole. If these forecasts are borne out, Latin America, for the first time in a decade, will have achieved two consecutive years of significant per capita income growth, at around 3.5% per annum. It should be noted that the economic fundamentals vary significantly across Latin American countries and that this dynamism is occurring in parallel with a general strengthening of their chronically fragile domestic and external financial position and with a (still limited) recovery in rates of investment. Yet cautious optimism about the sustainability of medium-term growth is warranted, provided that the external environment remains favourable. The coincidence of this upturn with the start of an intense phase in the region's electoral cycle (analysed in Box 1) is fortunate because, in most countries, it reduces the risk of a strengthening of support for platforms opposing economic reform. However, the improvement in the economic situation did not prevent the proliferation of bouts of political instability in the first half of the year in various countries of the area, or only scant progress being made in the reform process. A certain complacency regarding the economic and financial situation may have contributed to this lack of progress.

Domestic demand moderated slightly, but external demand, and exports in particular, continued to perform well, which was notable given the backdrop of currency appreciation and stabilisation of raw material prices. As a result of these different developments, domestic demand contributed less to growth than expected and external demand also reduced growth by less than expected. The strength of Latin American exports meant that, in dollar terms, they continued to grow faster than world trade, as seen in Chart 1, and they may even have grown faster than Asian exports, traditionally the most dynamic among those of the emerging countries. Also notable is the fact that inflationary pressures are contained in most countries, despite the continued rise in energy prices and the already positive output gaps in many countries and in the area as a whole. Thus, in Latin America as a whole, overall and underlying inflation have held at low rates, especially for the current stage of the cycle, although they are somewhat higher than at the beginning of the decade (see Chart 1). This moderate price behaviour enabled the cyclical upswing in interest rates in the two main countries of the region, Brazil and Mexico, to be halted. As a result, their interest rate cycle was decoupled from that of the United States, which continued to gradually withdraw its monetary stimulus.

Despite the raising of official interest rates by the Federal Reserve, global liquidity remained high and the search for returns dominated the financial scene. This reduced the level of financial vulnerability, as did the attractiveness of the debt issued in local currency, against a backdrop of upward exchange rate pressures. Thus, the continuation of the process of debt restructuring to achieve less vulnerable structures, the ongoing accumulation of foreign reserves and the persistence of a large external surplus in the area as a whole, despite the advanced stage of the cycle, helped to reinforce the fundamentals of financial stability. Only within this favourable framework can two striking events in the last half-year be explained: the very favourable external reception of the bonds issued by Argentina as part of the restructuring of its

INTERNAL AND EXTERNAL CONDITIONS FOR LATIN AMERICA GROWTH
Rate of change and percentage

CHART 1

SOURCES: IMF, national statistics and in-house data.

a. 2005: inflation data to August and output gap estimate. The output gap is calculated as the difference between actual and potential output, in percentage points of potential GDP. This is stimated using the Hocrick-Prescott filter.
b. Change in goods exports in current dollars, 2005. IMF stimates for Asia. Data to May for the World and Latin America.

debt, which brought its debt spreads into line with Brazil's; and the limited impact that the delicate political situation of the latter country has had on its financial indicators.

In short, given the economic and financial developments within and outside Latin America, the opportunity offered by current circumstances to entrench and press ahead with the reduction of economic and financial vulnerabilities must continue to be grasped, in order to enable the upswing to continue. Externally, however, there persists the risk that if energy prices remain at historically high levels they may ultimately weaken the area's economic prospects considerably. As for the medium term, the stagnation of reforms discernible recently in the region is a cause for concern. With slack at low levels in several countries, the maintenance of satisfactory growth rates requires an increase in the potential growth rate, for which purpose perseverance with the reform process is essential.

Economic and financial developments in the area

EXTERNAL ENVIRONMENT

Many of the trends that shaped the external environment of the Latin American economies in 2004 have continued during 2005.

On one hand, the growth of the world economy has remained firm (albeit somewhat more moderate than in 2004), basically underpinned by the dynamism of the United States and China (see Chart 2). The continued rise in oil prices, which reached highs of more than $70 per barrel at the end of August (70% above the levels at the beginning of the year), has so far had only a mild effect on the global growth outlook.

On the other, the Federal Reserve has continued its policy of gradually withdrawing the monetary stimulus, with official interest rates reaching 3.75% in September, a cumulative rise of 275 basis points (bp) since they began to be raised in June 2004. However, with global liquidity at high levels, long-term interest rates in the United States held at very low levels, of around 4.25%, i.e. 50 bp below the levels prevailing when the rise in official rates began. This has

As reflected in the accompanying table, all the main Latin American countries except Uruguay are to hold presidential and/or parliamentary elections between 2005 Q4 and the end of 2006. Historically, elections in Latin America have been a substantial factor of uncertainty for international investors. Fortunately, this does not so far seem to be the case judging by the highly favourable recent developments in financial indicators. This box analyses the reasons for the potential concern that arises on markets in respect of elections, along with the differential factors in place on this occasion.

A distinction should be drawn between two time perspectives in order to explain the impact of the electoral cycle on agents' expectations. The first concerns the policies pursued by the government in the run-up to elections, and the second the expectations of policy change in the post-electoral period.

As regards pre-electoral policies, there is also evidence, as is the case for the developed countries, that Latin American governments have tended to adopt more expansionary fiscal policies in the period prior to elections so as to maximise their re-election options[1]. Moreover, structural reforms, especially the most unpopular ones, are not usually undertaken with elections on the horizon, owing both to the difficulties of finding ground for consensus at such times and to the potential electoral cost they may entail. At the current juncture an increase in public spending (analysed in the corresponding section of the main text) is being witnessed in most of the countries, but this is being accompanied by a parallel rise in revenue. Furthermore, the pick-up in spending is also the outcome of the severe contraction in this variable in prior years, whereby it should not be attributed in its entirety to the holding of elections. In any event, even while accepting that fiscal policies may be adopting a somewhat less restrictive stance this year, structural fiscal imbalances have not been substantially impacted (see also Box 3). The reason is that the need to maintain fiscal discipline has been assimilated in recent years by most countries in the area. And this is an initial differentiating factor when comparing with the past. It might also be pointed out that the differences along the political spectrum regarding commitment to fiscal orthodoxy, which were clear-cut in the past, have tended more recently to become blurred[2]. In connection with reforms, these have actually stalled recently, due partly to the imminent elections (as in Colombia and Mexico), but also because of the greater reluctance seen in recent years (in most of the countries) to deepen reform programmes, given voters' evident scepticism about the results of reform. Nonetheless, while there are clearly parties or candidates who openly advocate a reversal of reforms, their electoral prospects are not favourable in most countries, a fact to which the timely reactivation of the region's economies in the past two years has also contributed.

Although greater fiscal discipline and convergence by the different parties towards the principles of economic stability mark a difference from the past, the essential factor behind investors' greater ease in the run-up to the forthcoming electoral cycle is that the different indicators of vulnerability for the region's countries are in a considerably more favourable position than in previous pre-electoral periods. To illustrate this point, the accompanying chart compares the current situation of various vulnerability indicators with the corresponding indicators in a similar phase of the previous electoral cycle. The improvement is particularly appreciable in the cur-

1. Rogoff and Sibert (1988) show this evidence for the developed countries, and Kraemer (1997) and Amorim et al. (2001) do so for the Latin American countries.

2. Empirical evidence that parties on the political left have tended to pursue more expansionary policies is found both for the developed countries [Alesina, Roubini and Cohen (1997)] and for the Latin American countries [Ames (1987) and Borsani (2000)].

ELECTORAL CALENDAR IN LATIN AMERICA

	2004	
COUNTRY	Date	Type of election
Argentina	October 2005	Parliamentary
Chile	December 2005	Presidential and parliamentary
Venezuela	December 2005	Parliamentary
Bolivia	December 2005	Presidential
Colombia	March 2006	Parliamentary
Peru	April 2006	Presidential and parliamentary
Colombia	May 2006	Presidential
Mexico	July 2006	Presidential and parliamentary
Bolivia	July 2006	Parliamentary
Brazil	October 2006	Presidential and parliamentary
Venezuela	December 2006	Presidential

SOURCE: Banco de España.

rent-account balance, which will be in surplus in 2005 for the third year running. That is set against the – in certain cases burgeoning – deficits recorded in the run-up to the previous elections. Other indicators, such as debt service as a proportion of exports, the ratio of interest on public debt to revenue and the index of speculative pressures, which takes into account the volatility of exchange rates, interest rates and reserves, also show a generalised relative improvement, except in Argentina in the case of debt service. The prefinancing secured by many States on the international financial markets for the coming months or the setting aside of funds for the repayment of debt maturing before the elections (as Mexico has done) also contribute to reducing risks, as does the notable build-up of international reserves. Finally, the observed reduction recently in the contagion of financial or other problems in the region's countries is also a factor that alleviates vulnerability in the current situation.

In sum, unlike in the past, the closeness of elections should not prompt substantial concern on financial markets, owing to the greater commitment of most candidates and parties to economic discipline and to the lesser vulnerability of the economies in the current circumstances. However, looking to the medium term, what may prove worrying is the lack of reforming momentum that incoming governments may show in the light of the disillusionment with the result of past reforms. Accordingly, the new governments and parliaments elected should desirably harness their recently acquired legitimacy at the polls to reactivate and redefine the programme of reforms, which are essential for successfully increasing the growth potential of their economies.

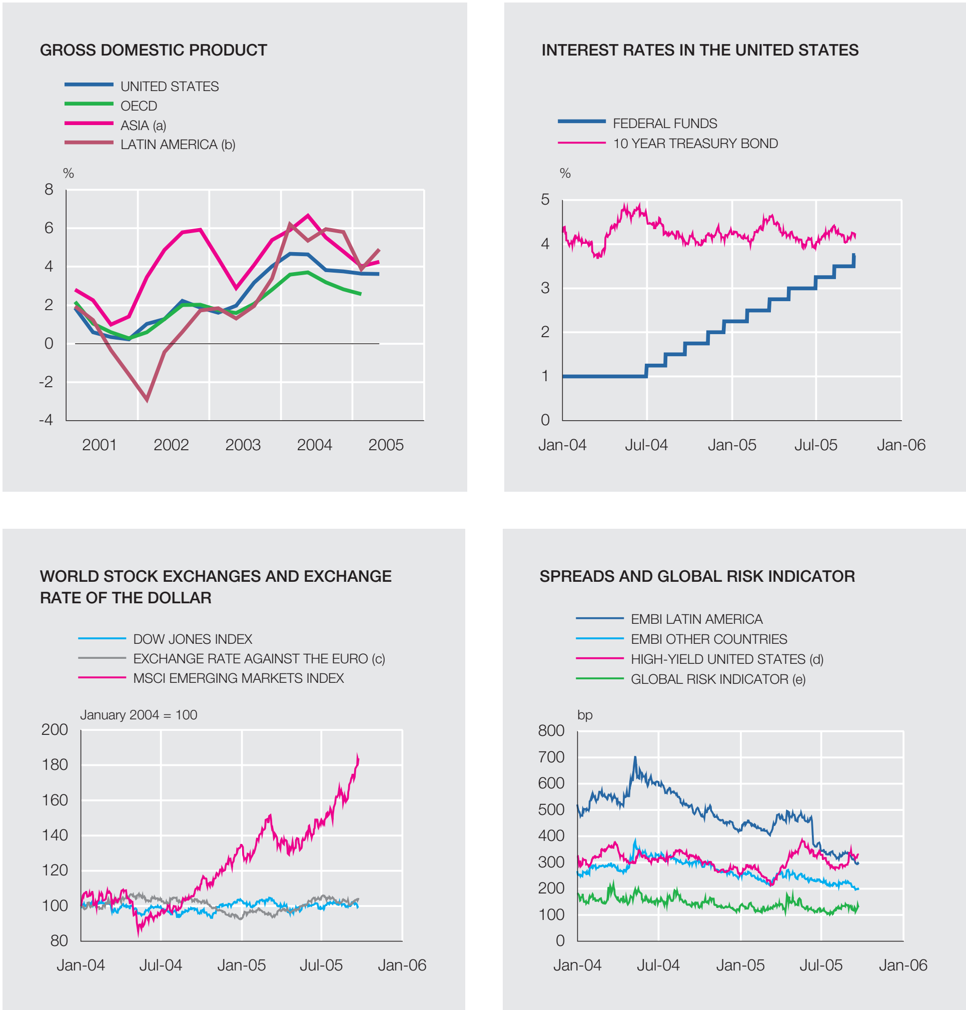
INDICATORS OF VULNERABILITY IN PRE-ELECTORAL PERIODS
Percentages and indices

SOURCE: Banco de España.

a. The "last elections" figures refer to the values of the variables when the same time remained prior to the holding of the last elections as remains from 2005H2 to the next elections.
b. Annual change in the index of speculative pressures, which shows the change relative to a baseline date in the exchange rate, the interest rate and reserves, weighted in a proportionately inverse way to their variance.
An increase denotes greater depreciation pressures on the exchange rate, upward pressures on the interest rate and downward pressures on reserves.

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

CHART 2



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

a. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore and Taiwan. Latest figure without Thailand.
b. 2005 Q2: estimate.
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.

given rise to a notable flattening of the yield curve, as can be seen in Chart 2. The existence of a widening short-term interest-rate spread between the United States and the euro area contributed, along with the persistence of sharp divergences in the growth of these two areas, to the appreciation of the dollar against the euro, which has been partly reversed in recent months. For their part, stock market developments have been mixed in the developed countries. In the United States indices hardly rose, owing to the substantial downward correction in April, attributable, among other factors, to the financial problems of certain car firms; European markets, by contrast, performed more favourably, with cumulative rises of nearly 15%.

All these factors continued to exert a favourable impact on financial conditions in the emerging markets, where sovereign spreads once again hit a low in mid-September (of around 250 bp) and where, with certain exceptions such as China, stock markets peaked. Eastern Europe continued to be the region where stock market rises were most significant. Moreover, the course of the dollar and of long-term interest rates eased concerns about a sudden adjustment

LATIN AMERICAN GDP CHART 3
Year-on-year change, unless otherwise specified

SOURCE: National statistics.

a. Estimate.

of global imbalances; however, it did so seemingly only temporarily, since imbalances continue to build up and the risk of a disorderly correction remains latent over the medium term. In this connection, one might wonder to what extent the uncertain future effect of the rise in oil prices may have reinforced the flattening of the long-term yield curve, and whether it would not be heralding, as it has on past occasions, a significant slowdown in activity in the coming years. If a scenario of considerably lower global growth were finally to materialise in the emerging countries, including the Latin American economies, that would not only reduce external demand; in addition, the progressive reduction of global liquidity would probably combine with a diminished appetite for risk, with adverse consequences for the emerging financial markets.

ECONOMIC ACTIVITY

The pace of economic activity in Latin America slowed moderately in 2005 Q1, dipping from 5.8% at end-2004 for the seven main economies as a whole to 4.9% in 2005 Q2 (see Chart 3 and Table 1). Although the decline in the year-on-year rate reflected, especially in Q1, the sub-

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

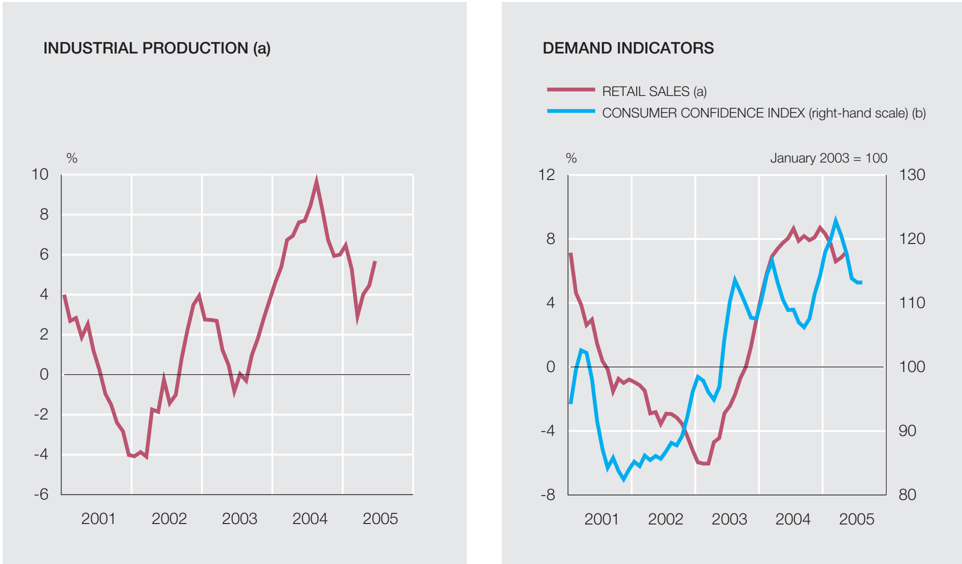
	2002	2003	2004	2003		2004				2005	
				Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
GDP (year-on-year change)											
Latin America (a)	-0.2	2.1	5.9	1.9	3.4	6.0	5.6	6.0	5.9	4.0	4,9 (b)
Argentina	-10.9	8.8	9.0	10.2	11.7	11.3	7.1	8.7	9.3	8.0	10.1
Brazil	1.9	0.5	5.0	-0.2	0.9	4.1	5.6	5.9	4.8	2.7	3.9
Mexico	0.8	1.4	4.4	1.0	2.1	3.9	4.1	4.6	4.9	2.4	3.1
Chile	2.2	3.3	7.0	3.1	3.3	4.6	5.3	7.0	7.3	6.1	6.5
Colombia	2.3	4.0	4.2	4.5	4.8	4.2	4.8	3.2	4.4	3.8	...
Venezuela	-8.2	-7.7	17.9	-7.1	6.6	34.0	14.0	14.2	12.1	7.5	11.1
Peru	4.9	3.8	4.8	3.0	2.9	4.9	3.6	4.7	6.6	6.1	5.7
Uruguay	-11.1	2.5	12.4	7.5	15.8	14.3	12.4	12.7	10.0	7.2	7.6
CPI (year-on-year change)											
Latin America (a)	9.3	10.9	6.0	9.6	7.7	5.6	5.2	6.3	6.5	6.4	6.6
Argentina	25.9	14.9	4.4	5.2	3.7	2.4	4.1	5.4	5.7	8.2	8.8
Brazil	8.4	14.8	6.6	15.2	11.4	6.8	5.5	6.9	7.2	7.4	7.8
Mexico	5.0	4.6	4.7	4.1	4.0	4.3	4.3	4.8	5.3	4.4	4.5
Chile	2.5	2.8	1.1	2.7	1.1	0.0	0.5	1.5	2.3	2.3	2.8
Colombia	6.3	7.1	5.9	7.1	6.4	6.2	5.7	6.0	5.8	5.2	5.0
Venezuela	22.2	31.4	21.7	29.6	26.3	24.0	22.4	21.5	19.5	17.0	16.3
Peru	0.2	2.3	3.7	1.9	1.9	3.0	3.4	4.4	3.8	2.2	1.8
Uruguay	14.0	19.4	9.2	15.0	10.7	9.3	9.2	10.0	8.1	5.6	4.5
PUBLIC-SECTOR BALANCE (% GDP)											
Latin America (a) (c)	-5.1	-2.0	-0.8	-1.9	-2.0	-1.6	-1.6	-0.8	-0.8	-0,7 (b)	-0,7 (b)
Argentina	-1.3	0.4	2.6	0.5	0.4	1.1	2.0	2.7	2.5	2.6	1.9
Brazil	-10.3	-3.6	-2.5	-3.7	-3.6	-3.3	-4.0	-2.8	-2.5	-2.4	-2.1
Mexico	-1.1	-0.7	-0.3	-0.6	-0.7	-0.4	-0.7	-0.2	-0.3	-0.5	-0.5
Chile	-0.8	-1.4	2.2	-1.1	-1.4	-1.1	0.3	1.1	2.2	3.1	4.0
Colombia	-3.6	-2.6	-0.6	-2.9	-2.6	-2.4	-0.8	0.3	-0.6	…	…
Venezuela	-1.0	0.2	-2.6	1.8	0.2	…	…	…	…	…	…
Peru	-2.1	-1.8	-1.3	-1.7	-1.8	-1.5	-1.0	-1.1	-1.3	-1.1	-0.5
Uruguay	-4.9	-4.6	-2.5	-5.1	-4.6	-3.9	-2.0	-2.4	-2.5	-2.0	-2.2
PUBLIC-SECTOR DEBT (% GDP)											
Latin America (a)	54.4	54.4	50.9	54.7	54.4	53.6	50.1	50.8	50.2	50.5	49,7 (b)
Argentina	140.0	141.0	119.9	131.0	129.9	133.0	111.0	120.7	120.3	122.3	…
Brazil	55.5	57.2	51.7	56.9	57.2	55.6	54.2	52.0	51.7	51.3	51.0
Mexico	24.0	24.7	23.3	24.8	23.5	23.5	23.8	23.2	21.6	22.9	21.9
Chile	15.7	13.3	10.9	15.0	13.5	13.4	12.0	12.0	10.4	10.3	9.0
Colombia	50.1	50.9	47.5	49.8	48.1	48.7	47.5	46.4	43.8	46.9	…
Venezuela	45.1	56.9	53.5	48.5	56.9	43.1	45.1	49.8	53.5	48.2	49.9
Peru	46.9	47.7	45.0	46.9	47.0	45.8	40.2	42.6	42.3	42.1	36.2
Uruguay	92.7	108.3	100.8	108.9	108.3	94.6	96.0	101.5	118.6	99.1	…
CURRENT-ACCOUNT BALANCE (% GDP)											
Latin America (a)	-0.2	0.8	1.2	0.8	0.8	1.3	1.1	1.2	1.2	1.2	1,1 (b)
Argentina	9.7	6.1	2.2	6.6	5.4	4.6	3.1	2.7	2.1	1.8	…
Brazil	-2.0	0.8	1.9	0.7	0.8	1.0	1.5	1.7	2.0	2.2	2.2
Mexico	-2.3	-1.5	-1.1	-1.6	-1.4	-1.2	-0.9	-0.8	-1.0	-1.2	-1.1
Chile	-0.9	-1.5	1.5	-1.4	-1.5	-0.5	0.9	1.2	1.5	1.2	0.6
Colombia	-2.0	-1.7	-1.0	-1.6	-1.5	1.2	-1.3	-1.2	-1.0	-0.7	…
Venezuela	7.7	13.4	13.7	12.4	13.4	15.9	14.3	13.6	13.7	14.4	16.6
Peru	-2.0	-1.7	0.0	-2.0	-1.8	-1.1	-0.8	-0.2	0.0	0.3	0.5
Uruguay	3.4	0.5	-0.8	0.7	-0.3	-0.2	-0.2	-0.6	-0.8	-1.6	…
EXTERNAL DEBT (% GDP)											
Latin America (a)	59.1	46.7	42.7	48.8	46.7	45.3	42.2	43.4	40.6	39.6	38,2 (b)
Argentina	165.6	119.8	112.3	124.1	119.8	121.4	101.4	110.8	107.4	108.4	…
Brazil	57.3	40.1	33.3	42.7	40.1	38.7	37.9	35.3	31.7	29.8	28,2
Mexico	21.3	22.1	20.5	22.8	22.1	21.2	21.5	21.5	19.1	20.0	18.3
Chile	62.0	54.8	46.7	59.6	54.8	47.9	46.1	48.0	43.6	43.1	41.1
Colombia	47.6	44.9	41.3	47.0	44.9	42.6	41.2	38.7	36.3	34.3	…
Venezuela	48.4	48.3	44.1	46.5	48.3	39.5	42.0	41.6	43.4	38.0	40.9
Peru	49.0	48.3	45.3	48.6	48.3	47.2	42.1	43.7	42.5	42.6	36.5
Uruguay	85.9	98.0	87.6	93.7	98.0	84.2	80.9	100.7	103.1	99.4	…

SOURCE: National statistics.

a. Aggregate of 8 represented countries.
b. Estimation.
c. Data from 2004 onwards excluding Venezuela.

SUPPLY AND DEMAND
Year-on-year change and level

CHART 4



SOURCE: National statistics

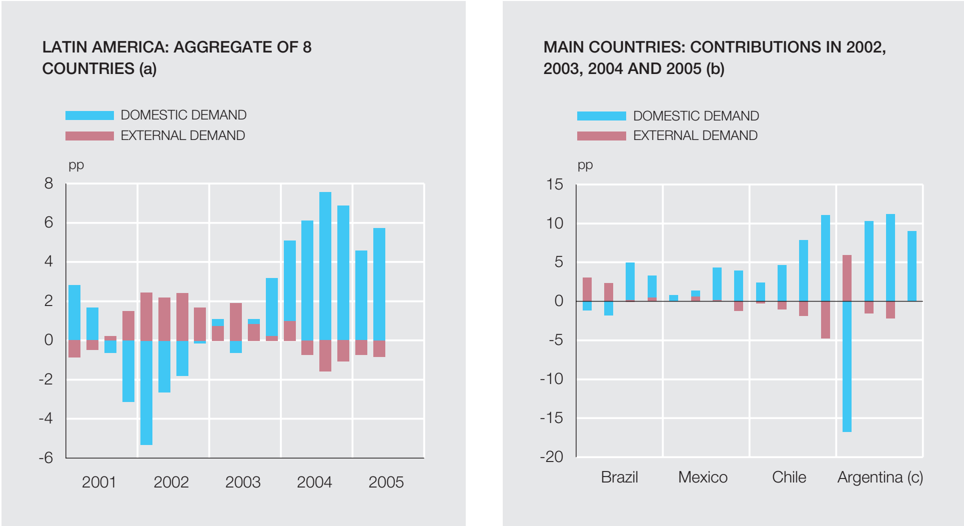
a. Quarterly moving averages.
b. Index. Quarterly moving average.

stantial base effect arising from the considerable buoyancy of the Latin American economies in early 2004, quarter-on-quarter rates were also cut, edging down from 1.2% in the two closing quarters of 2004 to an average of 0.8% in the first two quarters of 2005 (see Chart 3). The most frequent supply and demand indicators depicted in Chart 4, which can also act as leading indicators, have moderated in recent months, but have tended to hold at high rates. These factors, along with the pick-up in activity for the region as a whole in Q2, point to the pace of growth stabilising at a robust rate (albeit one somewhat lower than the exceptional rates recorded in 2004) of slightly over 4% for 2005 as a whole.

While in 2005 Q1 all the economies in the region saw growth – measured in year-on-year terms – slow, growth in Q2 has been uneven, which might augur cross-country divergences in cyclical developments, these having been fairly uniform in recent years. Continuing strong dynamism, and indeed recovery, can thus be seen in the Andean countries and in Chile, while the Q2 figures in Mexico (where a negative quarter-on-quarter rate was posted) and developments in the other most frequent indicators point to a diminished pace of activity. Interpreting conjunctural developments in both Argentina and Brazil proves more complex. Some data denote continuing dynamic activity, while others, along with other considerations such as the impact of the political crisis in Brazil on agents' confidence, might prompt a slowdown over the rest of the year.

The robustness of domestic demand, the driver of the acceleration in activity the previous year, has tended to firm, albeit at somewhat lower levels, in the first half of 2005. Domestic demand contributed 4.6 pp to growth in Q1, and an estimated 5.7 pp in Q2, compared with the figure of almost 7 pp contributed at end-2004. Private consumption remained robust (although it showed signs of weakening in Mexico), underpinned by the entrenched high rate of job creation (3.8% year-on-year). There was a notable pick-up in the labour market in certain countries, where recent developments had been unfavourable, despite the cyclical upturn. Notable in this respect were Chile, where the rise in job creation enabled the unemployment rate to be signifi-

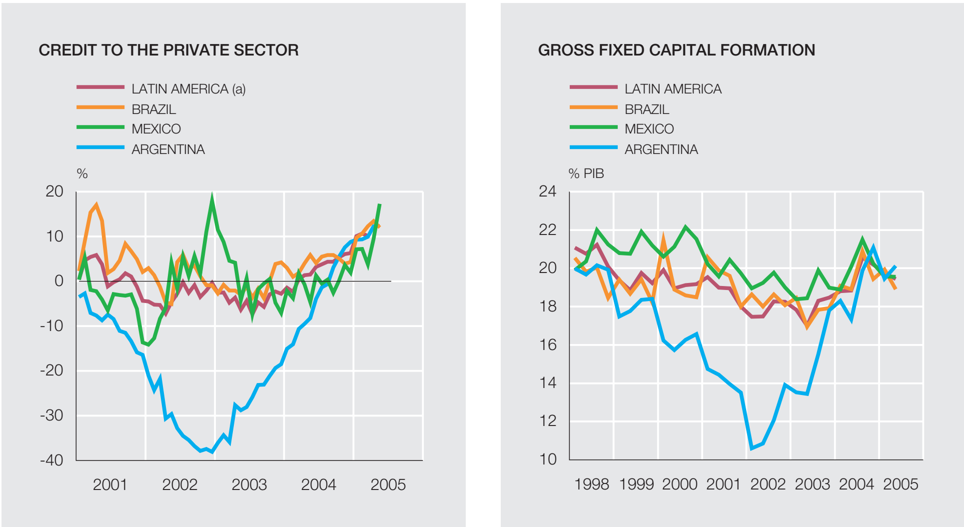
CONTRIBUTIONS TO GDP GROWTH CHART 5



SOURCE: National Statistics Offices

a. Q2 data: estimate.
b. First half of 2005.
c. Domestic demand in 2002: -16.7pp.

CREDIT AND GROSS FIXED CAPITAL FORMATION
Year-on-year changes and percentage of GDP CHART 6



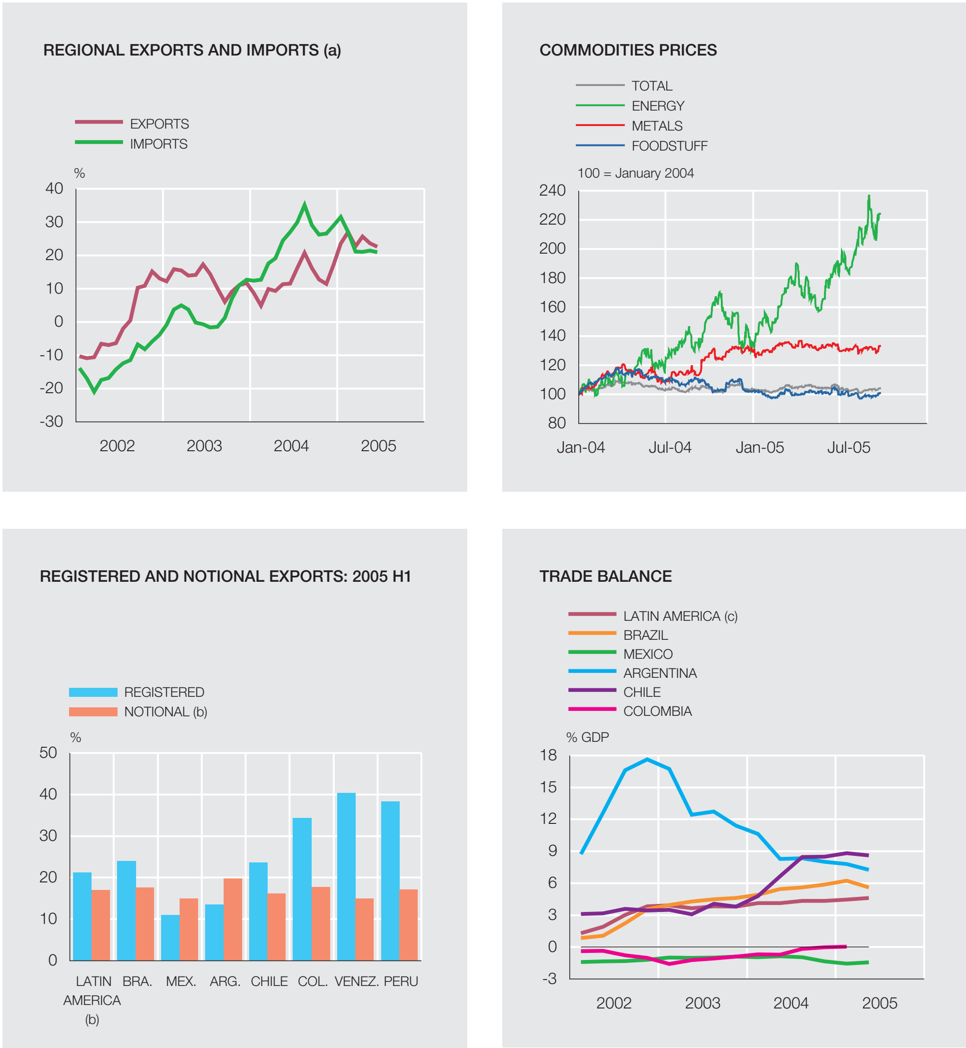
SOURCES: National statistics

a. Weighting of the seven main countries.

cantly reduced, and Colombia, where a prolonged period of net job destruction in industry apparently came to a halt. Nonetheless, the real growth of wage income fell below 2% for the area as a whole. The buoyancy of consumption was also underpinned by the recovery in credit to the private sector in most countries (see Chart 6), particularly in Brazil, Mexico (where it quickened from what were already notable rates) and Argentina, meaning that the real growth rate of such credit stood at 14% for the region as a whole at the end of the first half of the year, compared with 1.5% a year earlier. Also conducive to credit availability was private investment, which was favoured by continuing bright economic expectations, by the sound performance of the external

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

CHART 7



sector and by high capacity utilisation. As a result, the investment/GDP ratio has increased to almost 20% in the area as a whole (see Chart 6), although the rate prevailing in the late nineties has not been regained and the performance across countries has been uneven; in some, such as Mexico and Brazil, it was affected by the raising of interest rates in recent quarters.

The contribution of external demand to GDP growth turned negative as from 2004 Q2 (see Chart 5) and subtracted 0.8 pp from growth in the area in 2005 Q2. However, the sound performance of exports was notable, holding steady at a growth rate of over 20% (measured in dollars) in the first half of the year (see Chart 7). This came about despite the slowdown in the growth of world trade (see Chart 1), the stabilising of commodity prices (except energy and, for instance, copper prices, which continue to post highs) and the appreciation of most of the countries' real effective exchange rates. The comparison between the growth of registered and notional exports – the latter defined as the weighted increase in the main trading partners' demand for imports – highlights the sound performance of foreign trade. As can be seen in Chart 7, the growth of registered exports outpaced that of notional exports by 5 pp. The performance of the Andean countries was particularly favourable, and only in Mexico and Argentina did exports grow less than the demand for imports of their trading partners. The growth of imports tended to stabilise or slow moderately, in step with the pause in domestic demand in

Q1. As a result, taking the regional outlook, the growth rate of imports was once again slightly below that of exports as from March, although both rates were above 20%. In the most dynamic countries, such as Chile or Venezuela, imports remained on a rising path, but in the other countries they stabilised or turned moderately downwards.

The persistent dynamism of the external sector translated into the maintenance and even the widening of the trade surplus in the region, which exceeded 4% in the first half of the year. Several countries in the area managed to continue to improve their trade balances, some most significantly, such as Brazil, Venezuela and Peru. And Colombia has recently brought its trade accounts into balance, after four years of deficits (see Chart 7). Conversely, the Argentine and Uruguayan trade surpluses (the latter very ample) progressively narrowed. Finally, in Mexico the deficit stabilised at around 1% of GDP. This favourable progression in the area as a whole, along with the ongoing growth of remittances, has maintained the current-account surplus at over 1% of GDP for the regional aggregate, which provides the external position with greater room for manoeuvre to face the maturing of the business cycle without generating substantial external imbalances.

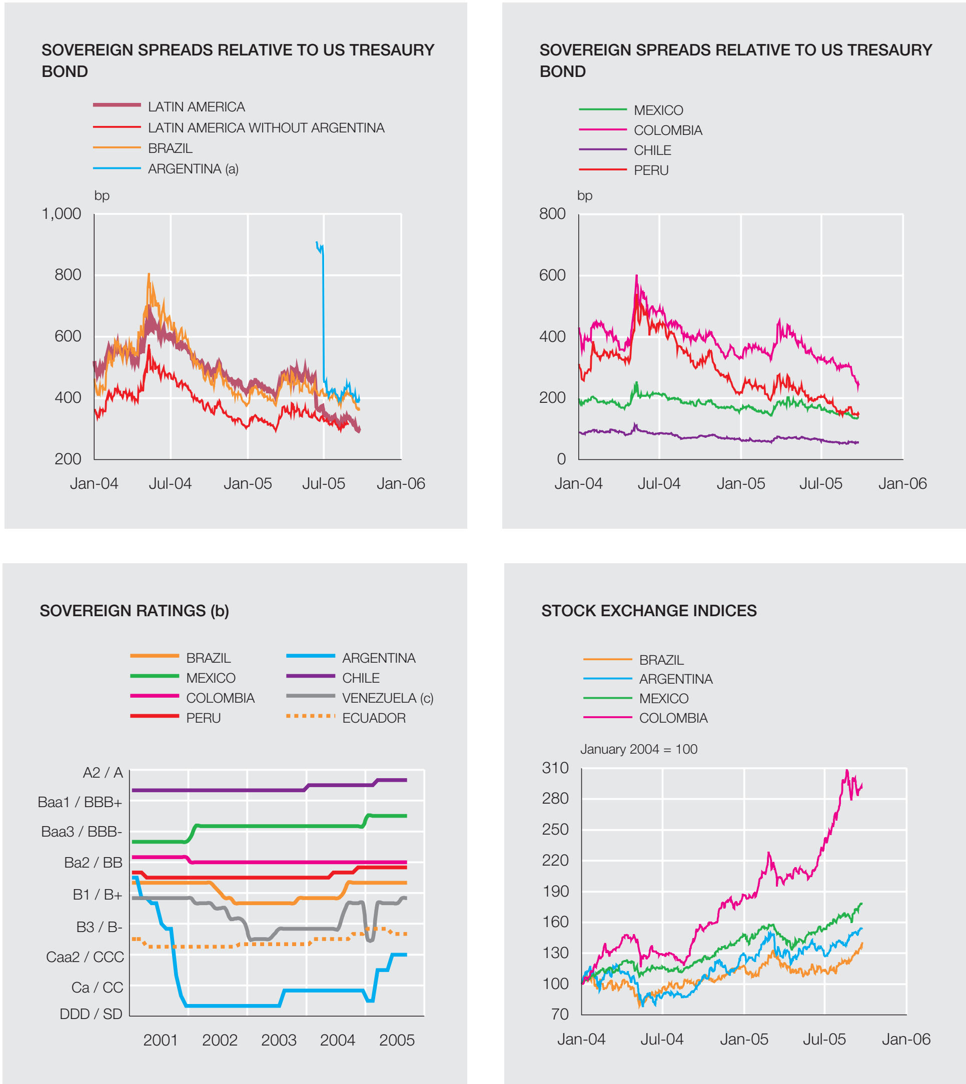
FINANCIAL MARKETS AND EXTERNAL FINANCING

Developments on international financial markets to September 2005 continued to be clearly favourable for Latin America, and the successive rises in official interest rates by the US Federal Reserve did not have a lasting effect on the course of sovereign spreads. Abundant global liquidity and the search for returns, along with the holding of commodities prices at high levels and, generally, the firming of sounder economic and financial underpinnings, all retained international investors' interest in the region. Accordingly, despite the political uncertainty in several countries, the impact on the area's financial markets was limited and did not give rise to a crisis in confidence or to sharp adjustments in asset prices, as had occurred in other circumstances. Even locally, the impact was limited, in contrast to the sensitivity to unfavourable news that had characterised the Latin American bond markets some years earlier.

One of the consequences of these favourable financial circumstances in the region was the growing development of the markets for local-currency debt and the foreign participation in such markets, and another was the generalisation in the area of several debt management operations by sovereign issuers. There was a notable reduction in Brazilian foreign-currency or dollar-indexed debt, which currently stands at below 4%; Peruvian debt to the Paris club was repaid, financed in the local market; and Colombian foreign debt was exchanged for domestic debt. All these measures are geared to reducing the vulnerability of debt structure to market risk and refinancing risk, which should be viewed favourably.

Sovereign spreads (see Chart 8) remained on a declining course during the first half of the year and early in the second half, taking the regional EMBI index to a historical low, slightly below 300 bp in mid-September, compared with 420 bp at the start of the year, i.e. a reduction of almost 30%. Indeed, the only general upward correction came about with the rise by around 50 bp in US long-term interest rates in March, which prompted a widening of the region's differentials by around 100 bp, a very moderate amount in historical terms. While this development was favourable, it needs to be qualified by the entry into the EMBI index in June of the new bonds issued following the restructuring of Argentine debt. That meant not only a narrowing of Argentine bond spreads, but also an increase in the weight of this country. Stripping out Argentina from the EMBI index, the regional spread would scarcely have altered between end-2004 and mid-September, as can be seen in the chart. In any event, the convergence that has taken place between the Argentine and Brazilian sovereign spreads is also notable, despite Argentina defaulting on debt less than four years ago. That would seem to suggest that investors have a relatively short memory when the search for returns prevails over risk considerations, as is the case at the current juncture.

SOVEREIGN SPREADS AND STOCK EXCHANGES CHART 8
Basis points and indices



SOURCE: JP Morgan.

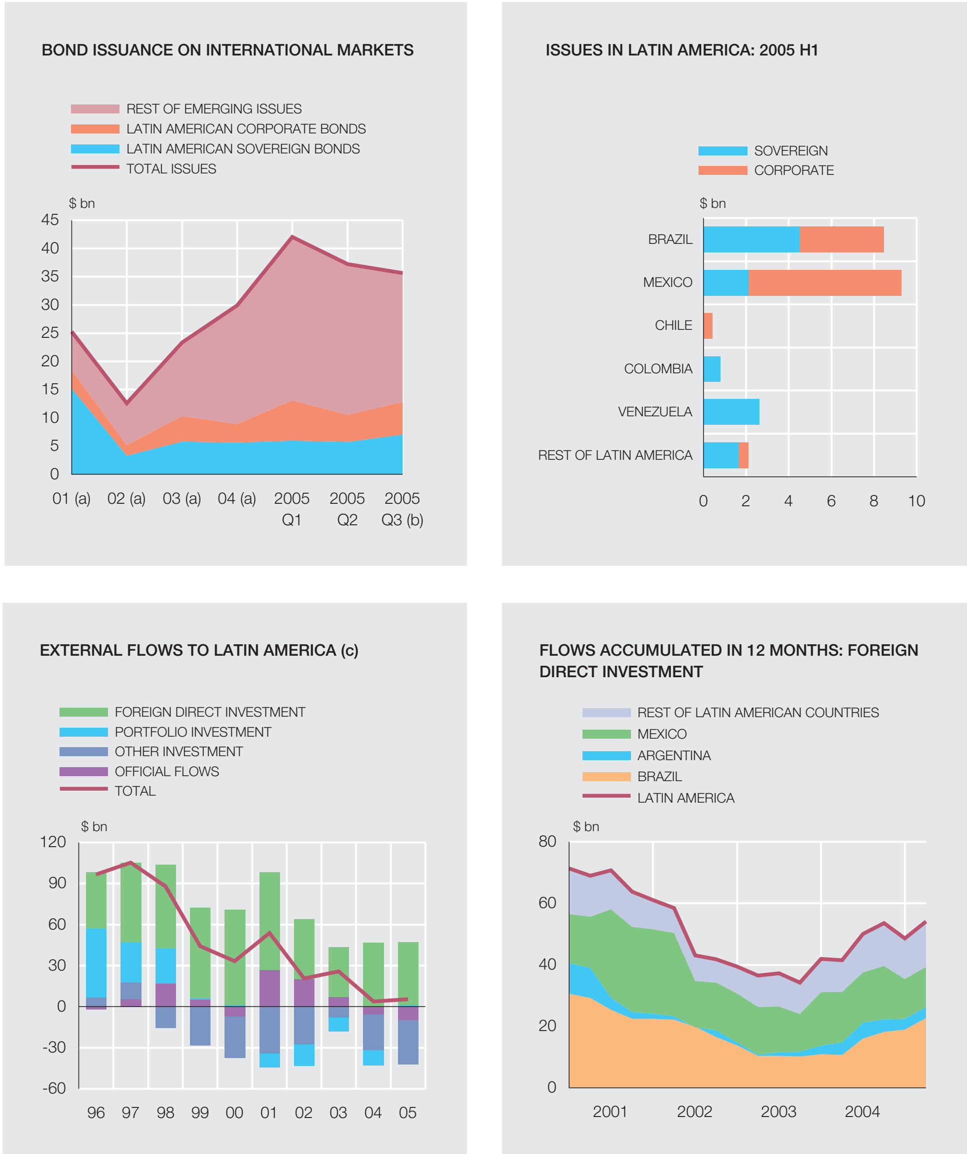
a. On 11 June 2005, the new restructured Argentine bonds joined the EMBI.
b. Simple mean of the ratings of Moody's, Standard and Poor's and Fitch IBCA.
c. In January 2005, Standard and Poor's downgraded Venezuela debt to selective default (SD) for technical reasons.

The narrowing of spreads was particularly striking in Peru (by up to 40%, standing in mid-September at around 150 bp), Colombia and Uruguay, while in Brazil and Ecuador there was a moderate widening compared with the start of the year, which shows the limited but not negligible impact of the political problems in both countries on their financial variables. However, the past few weeks' sound performance enabled Brazil to attain annual – and very close to all-time – lows in mid-September. Sovereign ratings did not undergo many changes during the half-year period (see Chart 8). Ecuador and Venezuela experienced upward and downward revisions, whereby both countries remained practically where they were at the end of last year, while Argentina saw the substantial upgrading of its sovereign rating confirmed in June following the restructuring of its debt. Mexico, in January, and Chile, in March, benefited respectively from an upgrading by the two main rating agencies and by the third-ranked agency.

Stock markets performed favourably during the period (see Chart 8), with the regional index posting a rise of around 30% in dollar terms from January to mid-September, far above the

EXTERNAL CAPITAL FLOWS
$bn

CHART 9



SOURCES: JP Morgan, IMF and national statistics.

a. Quarterly average
b. Data to July and estimate for August and September 2005.
c. 2005: estimate.

return on the industrialised countries' stock markets, and particularly the United States. The increases in local currency were more limited, owing to the appreciation of almost all the region's currencies. Moreover, the amount of the average rise masks mixed behaviour across the different countries' stock markets, with most substantial rises in Colombia (of over 50% in local currency to mid-September), and somewhat more moderate increases in the other countries (between over 30% in Peru and over 10% in Chile). Conversely, Venezuela, despite strong economic growth and its high oil output, underwent a decline of around 30%, owing to the scant attractiveness of the local stock market in a context of financial restrictions.

The favourable financing conditions were conducive to the placement of government and private paper on debt markets. In the first half of the year, Latin America issued almost $24 billion on international markets, one-third more than in the same period in 2004 (see Chart 9). Since there was a sharper pick-up in issues in the other emerging areas, this increase did not prevent the weight of Latin American issues relative to the total for emerging markets from falling below 30%, continuing on the recent declining trend. Chiefly behind this would be the relative stagnation of international sovereign issues by the countries in the area, which amounted to $11.6 billion, up scarcely 6% in the first half of the year compared with 2004. On this occasion, the trend observed is not the outcome of market-access difficulties; rather, as earlier discussed, it reflects the recent efforts by governments to reduce the vulnerability of their financial position, which entails a shift in supply towards local markets. In parallel, there was also a relative increase in local-currency issues, both on domestic and international markets, although in this latter case they do actually appear in the statistics shown. In contrast to international sovereign issues, private-sector issues took off strongly in the first half of the year ($12 billion), up 70% on the previous year, leading them to exceed sovereign issues. To the fore in this respect was Mexico, where corporate bonds totalling more than $7 billion were issued, 40% more than the previous year.

On the available data, which are usually inexact and subject to continuous revisions, net capital flows to Latin America would have picked up somewhat in 2005 (to $5.4 billion) in relation to their very low level in 2004 (only $3.7 billion -- see Chart 9). There has been a notable recovery in private flows, which have climbed from $9.5 billion to $15.2 billion, the bulk of which foreign direct investment, with $46.2 billion; portfolio flows have turned positive again (albeit marginally) after four years of declines; and other private flows, including bank loans, have undergone a sharper rate of outflow compared with 2004 ($32 billion). Conversely, the deficit in respective official flows has widened to almost $10 billion, reflecting the region's improved financial and balance-of-payments situation. As analysed in detail in Box 2, it should be underscored that, although IMF credit to the Latin American countries has diminished notably, after peaking in 2003, its weight in the IMF loan portfolio has continued to increase.

PRICES AND MACROECONOMIC POLICIES

Price developments in the region were relatively favourable in the first half of 2005, as shown in Chart 10. The annual inflation rate eased slightly during the period from 6.5% at end-2004 to 5.8% in August. The underlying rate performed similarly, and posted the same figure in August 2005. The declining trend of inflation was not followed in Chile, although it departed from very low rates. Conversely, inflation in Argentina has quickened since end-2004, and is approaching 10%. Restrained inflationary pressures, despite the buoyancy of activity, the rise in energy prices and, in certain cases such as Brazil and Argentina, limited slack all account for the improved anti-inflationary credibility in most of the countries and, more circumstantially, for the appreciation of the Latin American currencies in effective terms.

Indeed, exchange rates generally continued on their appreciating trend against the dollar (see Chart 10), with the aggregate for the area rising by more than 7% to mid-September. The rise was particularly notable in the cases of the Brazilian real (over 10%), the Colombian peso and the Mexican peso. As a result, several currencies posted highs, such as the Peruvian sol, which stood at its highest level for the past seven years, and the Brazilian real, which recorded a five-year high. The strength of the dollar in the first half of the year relative to the other main currencies also meant that the nominal effective appreciation of the Latin American currencies was even higher, totalling 9.6% for the region as a whole in the nine months to September. As can be seen in Chart 10, this appreciation was compatible with the ongoing build-up of reserves, which has in fact accelerated for the area as a whole, standing at 8% for the six-month period. The overall performance, however, masks notable divergences. While the pace of accumulation of reserves quickened notably in Venezuela and Brazil, it was checked in Colombia. In Argentina, despite inflationary pressures, reserves grew by more than 15% in the first half of the year. Argentina supplemented its interventions with certain exchange controls aimed

The priority mission of the International Monetary Fund to safeguard the stability of the international monetary system has focused in recent decades on promoting and restoring the financial stability of developing countries, through economic programmes involving sizeable financial resources. As can be seen in the accompanying table, Latin America has been one of the regions that has benefited most from IMF credit, accounting for an average of 34% of funds in the past decade. This box describes the changes in and composition of such credit during this period.

IMF credit draws principally on the contributions of the member countries, in the form of a quota, which make up the General Resources Account (GRA). Resources are channelled in the main through three credit facilities: the Stand-By Arrangements (SBA), the Extended Fund Facility (EFF) and the Supplemental Reserve Facility (SRF). These three facilities are the usual financing instruments available to the Fund to support its members in the event of balance-of-payments problems. The SBA is the basic facility, and has a duration of 2 to 2 1/2 years, while the EFF is used for longer-term needs (those requiring more structural reform), and the SRF is designed for those cases in which there is a need for short-term and large-scale financing. In addition to credit from the GRA, the fund extends concessional financing to low-income countries. This is channelled through the Poverty Reduction and Growth Facility (PRGF). In this case, the resources are drawn from the bilateral contributions of a large number of members and of the IMF itself, and they are held in a trust fund administered by the institution.

Between 1995 and 2005, 57 financial programmes were extended to the region for a total amount of almost $300 billion, i.e. around 50% of Latin American GDP in 2004. Among these loans, 37 were instrumented as SBA, compared with 6 EFF, 5 SRF and 9 PRGF. Further, 37% of these resources were initially conceived under a precautionary arrangement, whether with the intention of preventing a crisis or following a conventional programme as a strategy to exit from such a programme. That means that, at the time of applying, the authorities expressed their intention of not making use, in principle, of the resources granted to them. The high proportion accounted for by these preventive programmes suggests there is high potential demand for insurance facilities that reinforce the IMF's range of instruments and whose establishment is currently being debated in various international fora.

The chart supplements the information in the table and highlights the importance of IMF credit to Latin America and its close relationship to the recurrence of financial crises. Indeed, the latest figure available (end-June 2005) discloses a peak in IMF credit exposure to Latin America, at 45% of the total. This figure is far higher than that of 14% in 2000, when there was a strong regional expansion, or of 24% in 1998, the year of the Russian crisis and the adjustment to the Asian crisis. Nonetheless, in quantitative terms, the current outstanding balance of credit to Latin America (24.5 billion in SDRs, approximately $36.3 billion) is substantially lower than the peak reached in 2003 ($47.7 billion), following the series of crises which affected the region in the two years from 2001, owing to the net disbursements made thereafter.

Most Latin American countries have borrowed resources from the IMF in the period under study. Among the main countries, the only exceptions were Chile and Colombia. Of note in the initial period was the volume of credit extended to Mexico in the wake of its 1995 crisis, which was settled in 2000. On the latest available figures, at the end of the first half of this year, Brazil ($20.7 billion and 26.5% of the IMF's total outstanding credit) and Argentina ($11.2 billion and 14.3%) headed the list of main recipients of IMF credit. Only Turkey ($17.8 billion and 22.7%) has similar debt levels. The high concentration of credit (75% is distributed among these three countries plus Indonesia) is a feature that arouses some concern as regards the Fund's financial situation. Financial concentration is, moreover, exacerbated in this case by regional concentration, as three of the five countries with most IMF debt (Uruguay is in fifth position, with 3.1%) are in Latin America.

The accompanying chart tracks each country's indebtedness as a proportion of its financial contribution (or quota) to the IMF, depicting

WEIGHT OF LATIN AMERICAN ECONOMIES IN THE TOTAL VOLUME OF IMF CREDIT

	Average for period	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
(% IMF credit)												
LATIN AMERICA	34.46	43.17	39.54	26.15	23.38	25.96	13.76	31.74	39.97	44.68	44.87	45.80
ARGENTINA	11.36	9.91	10.40	8.27	5.79	5.67	7.86	18.56	14.96	14.52	14.60	14.37
BRAZIL	11.93	0.23	0.11	0.04	5.13	11.18	2.75	11.07	21.74	26.50	25.93	26.57
MEXICO	6.81	25.57	21.96	12.80	8.91	5.66	0.00	0.00	0.00	0.00	0.00	0.00
VENEZUELA	1.10	3.62	3.63	2.28	1.30	0.94	0.32	0.00	0.00	0.00	0.00	0.00
PERU	0.76	1.54	1.53	1.42	0.96	0.93	0.87	0.51	0.25	0.13	0.11	0.10
URUGUAY	0.99	0.03	0.01	0.00	0.17	0.20	0.23	0.19	1.87	2.26	2.78	3.11
REST OF LAT. AM. AND CARIBBEAN	1.51	2.26	1.89	1.33	1.12	1.38	1.73	1.40	1.15	1.27	1.45	1.64
MEMORANDUM ITEM: IMF CREDIT ($ bn)												
WORLD TOTAL	83.15	60.65	61.26	76.64	97.27	83.80	71.88	87.28	102.66	104.76	90.52	77.93
LATIN AMERICA	28.79	26.18	24.22	20.04	22.75	21.75	9.89	27.70	41.03	46.81	40.62	35.69

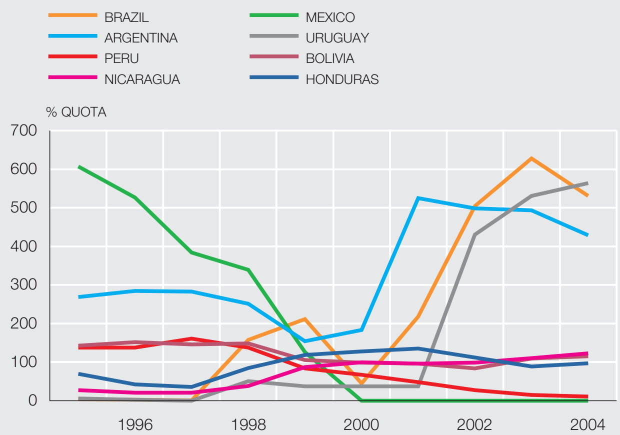
those countries that have exceeded 100% of this contribution at some time. Under this criterion, too, Brazil and Argentina are among the most indebted Latin American countries, with 530% and 430%, respectively, of their quota, although Uruguay heads the list with almost 565%. Historically, debt in terms of the IMF quota was greatest in Brazil (628% in 2003), followed by Mexico (607% in 1995). Since that year, only the four countries mentioned in this paragraph have exceeded 300% of their quota, this figure being the normal access limit to financing set by the IMF. As to the persistence of indebtedness, Argentina is to the fore with an average of 337% of its quota over the past decade.

Credits on this scale represent a considerable amount of the IMF-indebted countries' financial obligations. Thus, by end-2005, Uruguay will have to make over 1.5% of its GDP to the IMF as payment of principal and interest, while Argentina will pay 1.1% and Brazil 0.74%.

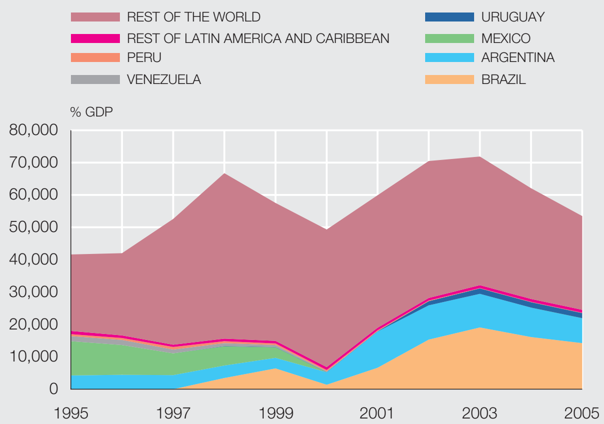
To conclude, Latin America can be seen to have been – and still is – the main destination for IMF funds, accounting for over 40% of such resources. Most of the credit extended to these economies has been geared to alleviating balance-of-payments requirements, brought about by these countries' dependence on external financial flows and by the volatility of these flows. Nonetheless, their improved economic and financial fundamentals in recent years are providing for the reduction (at a brisk pace in some countries) in credit to Latin America. In some cases, such as Brazil, this accelerating reduction is a means of reaffirming its independent commitment to economic discipline.

POSITION VIS-A-VIS THE IMF
Percentage and levels

DEBT AS A PERCENTAGE OF QUOTA (a)



TOTAL USE OF CREDIT (b)



SOURCE: IMF.

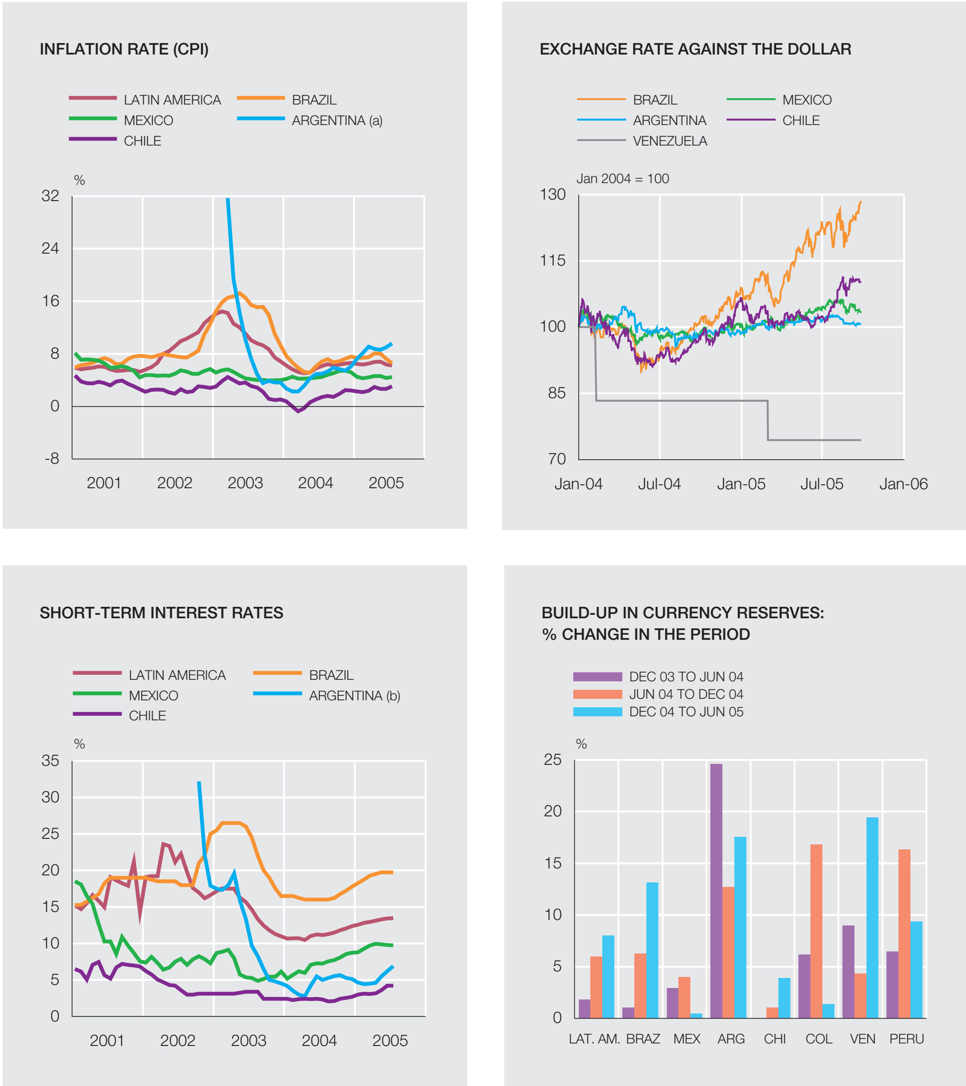
a. Included are the Central and South American countries that have exceed on one or more occasions their quota, excepting Guyana.
b. The figure for 2005 is for June.

at restricting capital inflows, in contrast to the lifting of the previous controls in Colombia and implementation of further liberalising measures in Brazil.

The containment of inflationary pressures in most of the countries and the dampening effect of currency appreciations on prices meant that during the course of the period the upward cycle of interest rates embarked upon in Mexico and Brazil during 2004 was interrupted. Into Q3, both countries have begun to lower interest rates (in August and September, respectively). Significantly, for the first time in many years, monetary developments in Mexico have been explicitly decoupled from those in the United State and, moreover, instruments alternative to the traditional "corto" are being used to bring about changes in interest rates. In contrast to this situation, the pace of rate rises intensified in Chile, though rates still remain at lower levels, while interbank rates have climbed notably in Argentina in recent months.

INFLATION, EXCHANGE RATES, SHORT TERM INTEREST RATES AND RESERVES CHART 10

Year-on-year rate of change, index values and percentages



SOURCE: National statistics.

a. Above 18% from May 2002 to May 2003.
b. Above 30% from July 2001 to November 2002, except in December 2001.

Budget deficits continued falling to around 0.7% of GDP towards mid-year (see Chart 11), while primary balances stabilised, since the reduction in Argentina (where it is still above 3% of GDP) offset the increase in Brazil, where it exceeded 5% half-way through the year. Behind these developments was a certain moderation in revenue, in real terms, which was particularly marked in Argentina, and the stabilisation of real spending at around 10%. All these figures indicate that the principle of fiscal discipline is taking root. In recent years, as analysed in Box 3, fiscal policy has ceased to play the procyclical (and therefore economic-fluctuation-amplifying) role that traditionally characterised it, and has adopted a neutral or slightly counter-cyclical stance. Nonetheless, if this incipient stabilising behaviour is to be sustained in the current expansionary phase, the fiscal authorities will have to resist the temptation to increase spending in the run-up to the electoral cycle now commencing.

STRUCTURAL REFORMS AND TRADE INTEGRATION

The firming of macroeconomic policy discipline contrasts with the halt in the structural reform process perceptible in the region and which may be attributed to several factors. The first,

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

CHART 11

SOURCE: National statistics.

a. Deflated by the CPI.

reiterated in previous reports, is the disillusionment with past reforms, which the latest recovery in growth has not wiped out; the second is the above-mentioned start of the electoral cycle, which means that the most important and difficult economic matters will be put to the back of political agendas; the third factor is the political instability, related in part to the two foregoing factors, which affected a good number of countries to differing degrees, namely Ecuador, Peru, Bolivia, more recently Brazil, and also Mexico. Finally, it may be assumed that the improved economic situation and the excellent financing conditions may tend to give rise to complacency in economic policy management and weaken the momentum of reform, since reforms tend in some cases to be unpopular since their favourable effects are only fully seen in the medium and long run.

In respect of trade integration, only discrete advances were seen, without progress being made on the most substantive processes. Mention should be made of the approval of the Central America Free Trade Agreement (CAFTA) by the US Congress, the agreements on energy integration in the Southern Cone, and the signing of a free trade treaty between Chile and

Traditionally, macroeconomic policies in Latin America have not been able to perform the expected cycle-stabilising role for different reasons. For one thing, monetary policy focused in the nineties on combating the legacy of high inflation, indeed of hyperinflation, from the eighties. But, moreover, from the second half of the nineties, the conduct of the economic authorities was subordinated to mitigating the impact of the various financial crises that affected the region. The presence of fixed exchange rate arrangements, though they were key to the transition to a lower inflation regime, contributed to further restricting the room for manoeuvre of monetary policies. Fiscal policies also faced difficulties stabilising the cycle, owing principally to the fragility of public finances, in conjunction with their dependence on external financing[1].

However, the recent economic adjustment prompted by the successive financial crises the region underwent in the period 2002-2003 resulted in an expansionary period in which a series of circumstances are in place that are conducive to macroeconomic policies being able, in principle, to adopt a more stabilising role. This period is characterised by a combination of high economic growth and a phase of financial stability and declining financial costs. Furthermore, the region's fiscal authorities have shown greater awareness of the importance of fiscal discipline for bolstering sustained growth processes. At the same time, the gradual adoption of monetary arrangements based on direct inflation targeting against the background of flexible exchange rates, at least de jure, gives monetary policy greater scope for implementing stabilising measures.

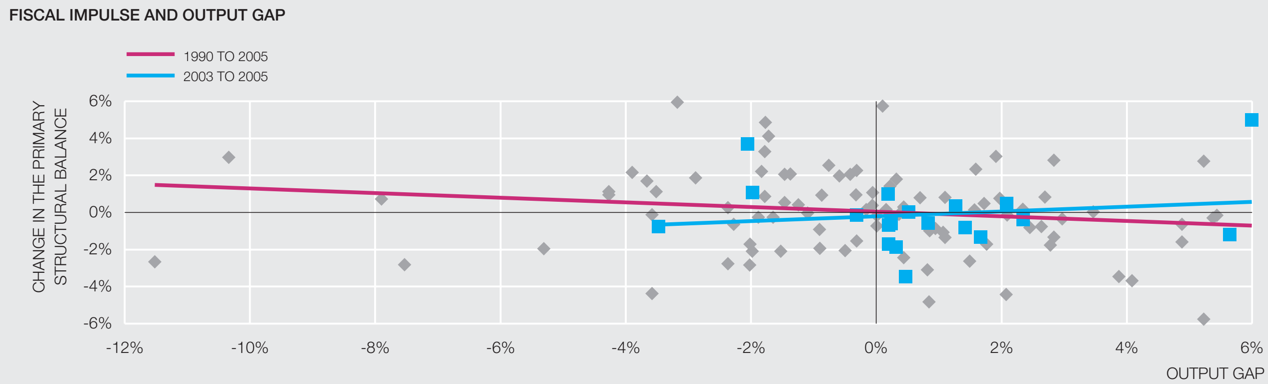
This box focuses on the stabilising role played by fiscal policy. The accompanying chart details the estimates of changes in the primary structural balance and in the output gap for the seven main countries in the region in the period 1990-2005. This latter variable proxies the cyclical position of the economy, while the change in the primary structural balance, which excludes interest payments and the impact of the cycle on the revenue components that are deemed to be affected by it, is one of the commonest indicators of fiscal policy stance. An increase in the primary structural balance indicates that fiscal policy is adopting a contractionary stance, and vice versa. A positive correlation between both variables means that contractionary (expansionary) fiscal policies coincide with cyclical upturns (downturns) and, therefore, they contribute to stabilising activity, by behaving in a countercyclical fashion. As can be seen in the chart and, more clearly, in the red regression line, there is a negative relationship between both variables for the whole of the period considered, which is very significant statistically. This result would confirm the hypothesis that the region's fiscal policy has tended to be procyclical, i.e. instead of contributing to stabilising economic fluctuations, it has tended to deepen them.

The reason behind this behaviour lies in the structural fragility of public finances, which arises in episodes of financial instability. Such episodes have a direct and immediate impact on economic activity, since they cause a current-account adjustment which is usually generated through a sharp curb on domestic demand. At the same time, doubts arise on the markets about the sustainability of public finances (which are already inherently vulnerable), and that leads to higher financing costs and, potentially, to closures of external financing. Under these circumstances, the fiscal authorities are obliged to rein in spending and to reduce borrowing requirements, and these restrictions run in parallel to and tend to exacerbate the adjustment of activity. Hence the procyclical bias in Latin American fiscal policy reflected in the chart and which has been backed by more rigorous empirical evidence.

Nonetheless, if we focus on the recent period of economic recovery (2003-2005), fiscal policy can be seen to have turned neutral, or

1. M. Gavin and R. Perotti (1997), «Fiscal policy in Latin America», *NBER Macroeconomics Annual 1997.* See also E. Alberola y J. M. Montero (2005), *Debt sustainability and procyclical fiscal policies in Latin America,* mimeo, Banco de España, from which the results used in the Box are also drawn.

FISCAL IMPULSE AND OUTPUT GAP IN LATIN AMERICA
Percentages



SOURCE: Banco de España.

slightly countercyclical, as inferred by the blue regression line. Had the previous behaviour been maintained, the fiscal position would have deteriorated; but, unlike in previous episodes, a stance of some caution appears to have been sustained, which may principally be attributed to the greater commitment to fiscal discipline in recent years. In any event, this greater discipline has been consistent with notable growth in public sector primary expenditure (7.5% in real terms in the period 2003-2004, and 10.8% in 2005 Q1 for the region as a whole, excluding Venezuela), favoured by the greater availability of revenue, and as a result of the recovery in expenditure levels, which had been strongly curtailed in the previous period of adjustment (2001 and 2002).

It would be desirable for budgetary caution to be maintained in the run-up to the elections that are to take place in most of the main countries of the area. Indeed, in some of these countries upward pressures on public spending can already be seen, whereupon the near future will be a good test for verifying the existence of greater fiscal discipline. In the context we are analysing, and provided that activity continues to grow firmly, this greater discipline should translate into improved primary structural balances. Beyond the short-term electoral horizon, the acid test of greater fiscal policy capability to exert a stabilising role will be in any future deterioration in financial conditions, whether for domestic or external reasons. In this respect, it should be stressed that public debt stocks are still high and have a vulnerable composition, making them sensitive to a deterioration in financial markets' sentiment. This means that simultaneous adjustments in spending and in activity are foreseeable in this case.

Precisely to avoid such adjustments, it is of paramount importance that, in the current favourable circumstances, a far-reaching and sustained effort should be made to shore up public finances through the reinforcement of the structural position of public finances. Note that this means, among other things, increasing the primary structural balance in the current upturn, which entails de facto compliance with the stabilising role assigned to fiscal policy.

three ASEAN countries. However, negotiations on the Free Trade Area of the Americas (FTAA) have ground to a halt, no further bilateral agreements were reached between the future members of the FTAA (the Andean Community with the United States, for example) and nor was it possible to finalise the agreement between MERCOSUR and the EU.

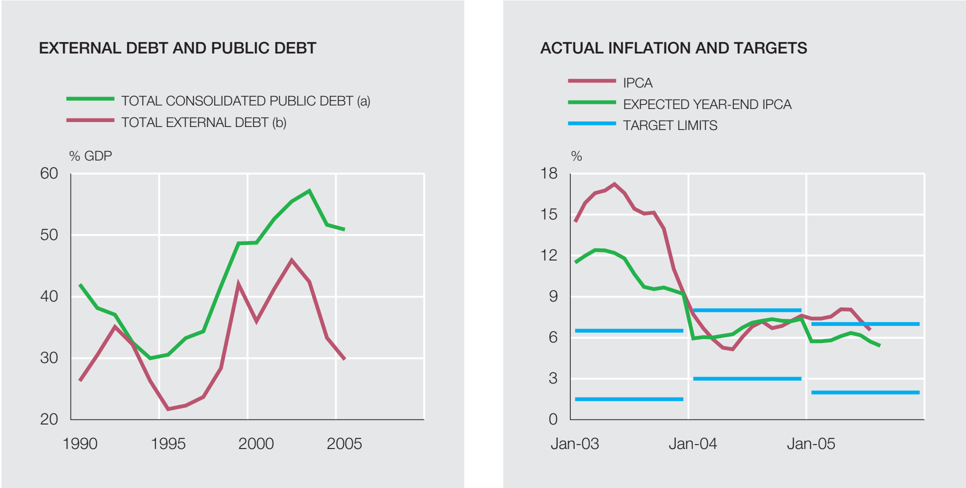
Developments in the main countries

In *Brazil*, the rate of expansion of economic activity stood at a rate of 3.9% in Q2 compared with the same quarter a year earlier, substantially up on Q1 (2.8%). Overall, that meant a slowdown in GDP during the first half of 2005 of almost 2 pp compared with the second half of 2004 (from 5.3% to 3.4% in year-on-year terms). Once again, domestic demand contributed the bulk of the growth (3.3 pp to the year-on-year rate in Q2), although external demand contributed positively again (0.6 pp). Exports remained strong despite the cumulative base effect and the appreciation of the real against Brazil's main trading partners (18% in the first half of the year). Private consumption continued to be underpinned by employment growth at over 3% and by the expansion of new forms of credit, which placed its real growth at over 12% in July. Nonetheless, owing to the rise in inflation, real wages were virtually flat in the first half of the year, in contrast to the improvement in purchasing power throughout 2004. The external accounts continued to perform exceptionally, with a trade surplus standing at over 6% of GDP and a surplus on the current-account balance of close to 2%. That provided for a significant reduction in the external debt ratio (see Chart 12), which breached the threshold of 30% of GDP for the first time since 1998. Fiscal discipline remains in place, as testified by the primary surplus, which closed the half-year period at 5.1% of GDP, above the target for the end of the year (4.25%). The high primary surplus, the favourable course of financial variables against a background of high growth and the improved management of public debt enabled the public debt/GDP ratio to be reduced (albeit by only half a percentage point) in the first six months from 51.7% at end-2004 to 51.2% in July. The scale of this cut is indicative of the resistance to further reductions following the substantial progress in previous years.

Year-on-year inflation stood at over 8% in April and May (see Chart 12), but turned down thereafter (6% in August) until reaching levels consistent with the targets set for 2005 (4.5% +

BRAZIL
Percentages and year-on-year changes

CHART 12



SOURCE: Banco do Brasil.

a. Latest figure: 30 June 2005.
b. Latest figure: 31 March 2005.

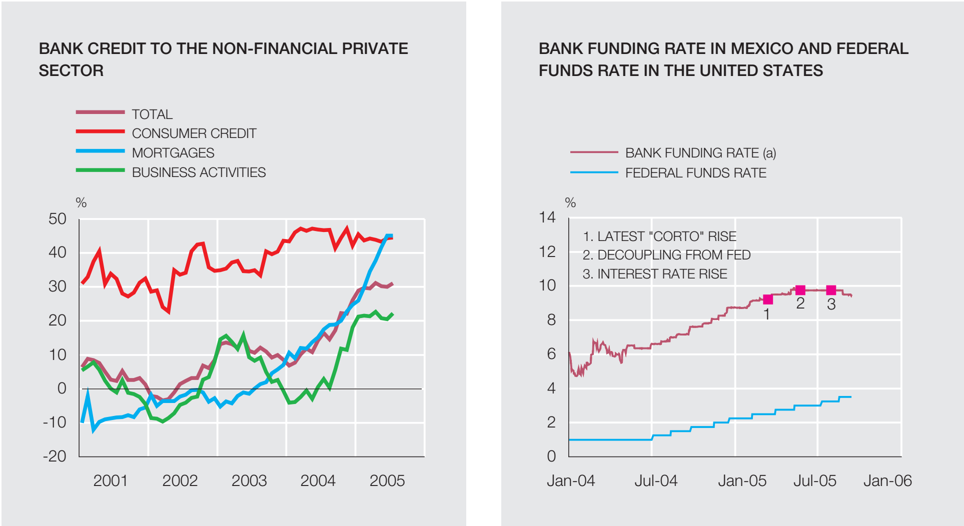
2.5%). Moreover, the course of underlying inflation and the appreciation of the real point to a declining rate in the coming months. Although the rise in prices was influenced by seasonal factors and the readjustment of administered prices, the downward stickiness of inflation expectations prompted the central bank to continue with the greater monetary constraints initiated in September 2004. That made for a further rise of 200 bp on official interest rates between January and May 2005, during which period they stood at 19.75%. After holding unchanged for several months, official interest rates were cut by one-quarter of a point at the last central bank monetary policy meeting in mid-September in the light of the favourable inflation developments and expectations subsequently witnessed.

The favourable course of the economy led the government to cancel ahead of schedule a portion of its debt with the IMF, after forgoing the renewal of the financial programme concluded in March 2005. Both decisions may be interpreted as a wish by the government to strengthen its independent commitment to macroeconomic discipline. This commitment is particularly important set against the political turbulence the country is experiencing, and which may persist over the year remaining to the next presidential elections. In any event, these political difficulties brought certain reforms, such as those relating to tax and central bank independence, to a halt. However, and thanks largely to the perception that macroeconomic discipline is ensured, the financial variables were scarcely affected by the political problems facing the government: risk premiums held at very low levels (at around 400 bp), the real appreciated against the dollar and the stock market posted gains of close to 20% from the start of the year.

In *Mexico*, economic activity slowed notably in the first half of the year, growing by 2.8% in the first six months compared with 4.7% in the previous half-year. While year-on-year growth was higher in 2005 Q2 (3.1%, against 2.4%), these figures mask the fact that, unlike in Brazil, there was no pick-up in Q2, since the quarter-on-quarter growth rate was negative in this period. In the first two quarters of 2005, the contribution of the external sector was negative of the order of more than 1 pp, maintaining the trend embarked on in 2004 Q4. Under domestic demand, the behaviour of the two main components during the first two quarters of the year was notably different. Whereas private consumption slowed, reaching a negative quarter-on-quarter growth rate in Q2, investment accelerated strongly in this period. The loss of economic dyna-

MEXICO
Real year-on-year changes and percentages

CHART 13



SOURCE: Banco de Mexico

a. Rate representative of bank and brokerage house wholesale operations, whether direct or overnight repo, with certificates of deposit, bank bills and bank acceptances.

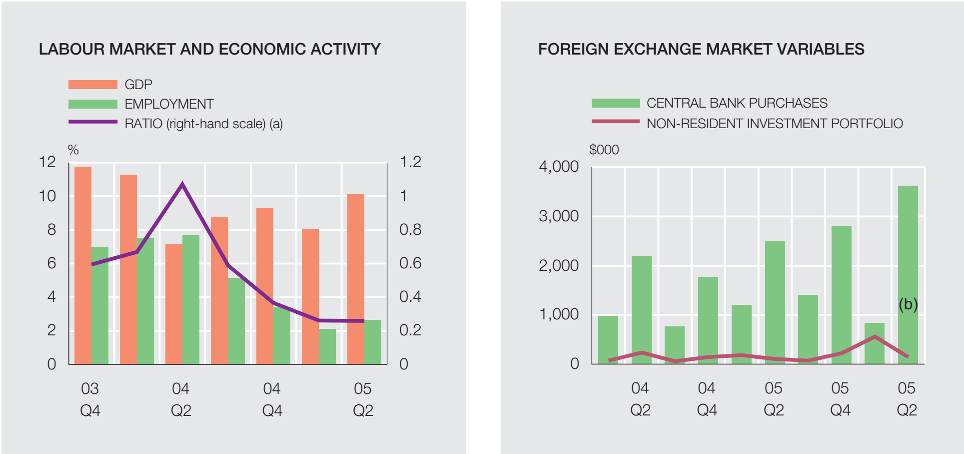
mism was scarcely seen in the pace of job creation, the year-on-year growth rate of which was still close to 3%. Conversely, credit to the private sector quickened, climbing from a year-on-year rate of 25% at end-2004 to 31% in July 2005, mainly because of the expansion of credit for house purchases (see Chart 13). The performance of the current-account balance was very different in the first two quarters of the year. While the Q1 data posted a high current-account deficit, the Q2 figures were practically in balance, something not seen since the same quarter in 1996. Overall, the current-account deficit in the first half of the year was equivalent to 0.7% of GDP, while in the same period in 2004 it stood at 0.5%. This slight increase in the deficit was due to the trade balance, since the improvement in the income balance (remittances rose by 18% on the first half of 2004) only offset the bigger deficit recorded in the services balance, owing to interest payments and profits paid abroad. On the basis of the figures for public finances in the first half of the year, the government may well be expected to meet its budget deficit target (0.2% of GDP) for 2005, assisted in part by the soundness of oil revenue.

In the final months of the period under study inflation fell, dipping in August to 3.9%, just below the upper limit of the central bank's target range (3% + 1%) and marking a historical low. A particularly positive development was the reduction in underlying inflation, which is drawing close to 3%, although this does not seem to have been mirrored in expectations. This more favourable inflation performance, coupled with the economic slowdown, explains why the Bank of Mexico abandoned the process of monetary policy tightening it had begun in early 2004 and which ran to June (see Chart 13). This process was channelled mainly via increases in the official "corto" rate (the main monetary policy instrument) and, subsequently, via increases in short-term interest rates in parallel with the US Federal Reserve, but without changes in the "corto". In late August, interest rates began to fall after the central bank announced the desired bank funding rate; once again, this occurred without altering the "corto". The gradual differentiation between movements in the "corto" and those in interest rates may be viewed as part of the process to redefine monetary policy arrangements that the Bank of Mexico has announced it is considering. Finally, the financial markets performed favourably during 2005, as witnessed by the appreciation of the peso against the dollar, the narrowing of the sovereign spread and the almost 10% rise on the stock market.

ARGENTINA

Year-on-year changes, elasticity and levels

CHART 14



SOURCES: National statistics and Banco de España.

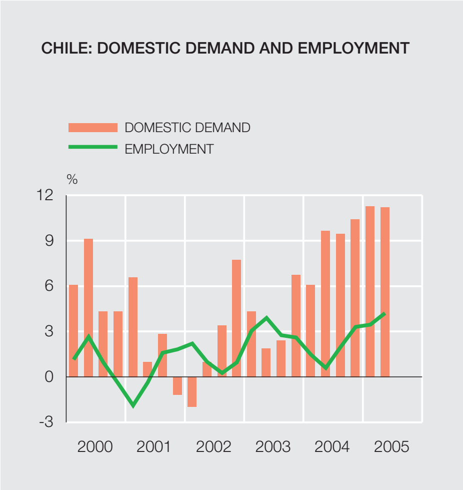
a. Annual change in employment divided by annual change in GDP.
b. Reinforcement of capital controls.

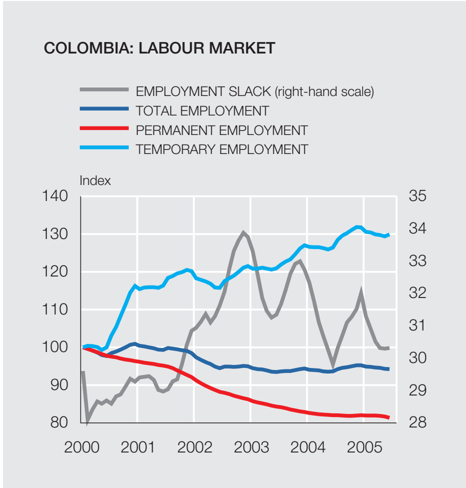
In *Argentina* there was a notable slowdown in growth in Q1, when the quarter-on-quarter rate fell to scarcely 0.8%, but it picked up again in Q2. In this period the year-on-year rate stood once again at over 10% (10.1% to be specific) and the quarter-on-quarter rate also exceeded 2%, a similar figure to the average for 2004. Investment, and particularly capital goods purchases, regained the firmness they had momentarily lost at the start of the year. Exports also rose, although the strength of imports meant that the net contribution of the external sector was virtually zero in Q2. In any event, the Argentine economy showed signs of having initiated a new phase of its cycle, marked by the progressive normalisation of key variables such as employment and by the emergence of renewed inflationary pressures. While labour market developments did not cease to be favourable, job creation is slowing, both in terms of growth and in relation to increases in output, as can be seen in Chart 14. Indeed, the reduction in the unemployment rate is partly attributable to the easing in the participation rate recently observed.

Despite the sound performance of exports, especially in volume terms (since export prices fell from the highs reached the previous year), the trade surplus continued to narrow, though it still stood at around 7% of GDP at the end of the first half of the year. This ample surplus enabled the sign of the current-account balance to remain positive at 2.8% of GDP. Public finances held in positive territory, although in recent months they felt the impact of the upcoming parliamentary elections. This led to successive rises in expenditure, such as increases in public-sector wages and in minimum pensions. Inflation grew significantly in 2005, and the central bank reacted with a moderate rise in its intervention interest rate – albeit one lower than that recorded in inflation expectations – and with the interruption of foreign exchange market interventions in the form of currency purchases. Nonetheless, concerns over the appreciating trend of the peso resulted in a resumption of such interventions towards the end of the half-year period, while capital controls were tightened, in order to temper the non-resident inflows observed at the start of the year (see Chart 14). Having concluded the defaulted debt exchange in February, Argentina resumed issues on capital markets, albeit for modest sums (some $1.5 billion in total) and concentrating on the domestic market and on peso-denominated issues. These securities, along with the new bonds delivered under the debt exchange, evidenced very narrow spreads if regard is had to the recentness of the default and to the fact that the outlook for the Argentine financial position in the medium run is far from satisfactory.

CHILE AND COLOMBIA
Year-on-year change and levels

CHART 15





SOURCE: National statistics

Activity in Chile eased off slightly in the first half of 2005, but it still sustained a growth rate of 6.1% in Q1 compared with the same quarter a year earlier and a somewhat higher rate of 6.5% in Q2. Domestic demand continued to quicken, accelerating to a rate of 11.2% in the first two quarters of the year (see Chart 15), essentially as a result of the strength of investment and, specifically, of the capital goods component. The labour market also contributed to sustaining domestic demand, with the growth of employment firming at over 4% in Q2. This acceleration in the pace of job creation ultimately allowed the unemployment rate to fall significantly and led to a rise in real wages, consigning their recent flatness to the past. The firming of domestic demand and the increase in copper-related revenue (63.8% year-on-year in the first half of 2005) resulted in a fiscal surplus of 2.9% of GDP in the first six months of the year. During this same period the current-account balance posted a surplus of 1.4% of GDP, somewhat down on the same period in 2004, owing essentially to a higher deficit in the income balance, since the trade balance continues to show a surplus of over 8% of GDP (see Chart 7). Inflation has accelerated notably in the year to date, the result of output growth outpacing potential growth and of higher oil prices. Following several quarters of very low rates, inflation stood at the centre of the central bank target range. Official interest rates continued to move upwards (seven 25 bp rises during 2005, up to 4%), and they are expected to continue doing so over the coming months.

In *Colombia*, the economy slowed by 0.5 pp in 2005 Q1 to 3.8%. The moderation in activity was less than in the rest of the region, probably because Colombia was not as far ahead in its cycle. The external sector showed signs of picking up following previous slackness, which was in contrast to the rest of Latin America. Some of the sluggishness of the sector would be due to the strength of the Colombian currency, which appreciated by 5% against the dollar. The improvement in the labour market was particularly noteworthy, since employment increased in year-on-year terms towards the end of the first half of the year for the first time since October 1993, although this improvement was associated with the higher creation of temporary jobs (see Chart 15). The budget deficit held at around 0.7% of GDP at end-2004, a historically low level. However, the government appeared to have relaxed its fiscal commitment in the closing months of the period, since the increase in primary expenditure stood above that of revenue in a pre-electoral year, structural reforms in the fiscal area were put back once again and the budget for 2006 includes a strong increase in expenditure, without specifying new sources of revenue. The resilience of the peso allowed inflation to fall below 5%, a rate unheard of in the past 40 years. Against this background, interest rates remained unchanged in the first three quarters of the year, while international reserves continued to post historical highs.

In Peru, growth in the economy has been persistently strong, despite the fact that activity grew at a somewhat lower rate in the first two quarters (6.1% and 5.7%, respectively, in year-on-year terms) than in 2004 Q4. The contribution of the external sector to growth remained positive, underpinned by the highly favourable export performance. This took the trade balance into surplus (5.6% of GDP), a position not enjoyed since 1989, and saw the current account continue in surplus. Despite the fact that high economic growth prompted year-on-year increases in employment of over 5% during 2004 Q2 and 2005 Q1, the unemployment rate appeared to have hit a floor at 9%. The fiscal performance was also favourable and inflation, after returning to the target range in Q1, continued on a declining path to 1.2% in August, 0.3 pp below the central bank's minimum target for the year. The central bank kept official interest rates at 3.75%. The financial markets also viewed developments in the country most favourably, and this has been reflected in the significant narrowing of the sovereign spread to a level similar to that of an investment-grade country such as Mexico, and in stock market rises outpacing the regional average.

In *Venezuela*, activity continued to grow strongly, albeit at a lower rate than the previous year (7.5% and 11.1% year-on-year, respectively, in the first half of 2005 and 2004). Domestic demand retained its robustness, investment most particularly. The strong negative contribution of the external sector was due to the close to 50% rise in imports in year-on-year terms. Nonetheless, the current-account surplus remained most ample at 16.6% of GDP thanks to the high price of oil, which accounted for more than 85% of foreign sales. In the fiscal domain there was a substantial rise in expenditure, supported by the increase in revenue. Contributing to the strengthening of fiscal resources was the increase in transfers arising on the build-up of reserves by the central bank, following the amendment of the legislation governing the workings of this institution, which entailed a curtailment of its independence. That enabled expenditure to be substantially increased. The exchange rate remained subject to capital controls, and there were no changes in parity following the 10.7% devaluation in February. Prices, which were also tightly controlled, posted an annual inflation rate of around 16% during the first half of 2005, and of below 15% in August. High oil prices and the perception that they were here to stay contributed to sovereign spreads standing once more at their lowest levels since early 1998, as well as to an upgrading of Venezuelan public debt. Conversely, the stock market underwent a decline of over 30% over the period, due partly to the diminished attractiveness of share purchases in companies that are also listed on foreign stock markets.

In *Uruguay*, the pace of expansion of activity eased from 11.4% in the second half of 2004 to 6.9% in the first six months of 2005. Inflation remained on a declining path and stood at 3.4% in August, below its target range (5%-7%). In *Ecuador*, political tensions resulted in the removal from office of the president. The new cabinet, headed by the former vice-president, changed the course of economic policy with measures such as the elimination of an oil-revenue-sustained fund set aside for the repayment of external debt and the suspension of loans from multilateral agencies and of the planned external debt exchange supplemented by new issues. Finally, in *Bolivia*, the social and political crisis worsened in the run-up to the summer, though the calling of early elections has calmed matters for the moment.