Introduction

Despite the bout of financial volatility in May and June, the Latin American economy accelerated during the first half of the year. Although the year-on-year growth rate of the region as a whole was 4.1% in Q2, notably down on Q1 (5.4%), the quarter-on-quarter rates recorded in both periods had not been attained since 2004, the best year of the last 25 for Latin America. Underpinning the upturn was the recovery in the two main economies, Brazil – despite the interruption witnessed in Q2 – and, above all, Mexico. This performance, along with the very gradual moderation in Argentina and Venezuela, has notably reduced the growth dispersion in the region in relation to recent years, as shown in Chart 1. The chart also highlights the fact that most countries in the region are maintaining a high cruising speed. However, the most notable feature of recent developments in Latin America was the sufficiency with which its economies overcame the considerable financial turbulence last spring. The episode markedly affected several emerging countries, especially those with sizeable external imbalances (see Chart 1). But it was only moderately felt in the Latin American countries, with the possible exception of Colombia, in marked contrast to previous episodes. In any event, the financial indicators temporarily underwent notable corrections. The conclusion that may be drawn from this episode is doubly positive, since it shows the improvement in these countries' economic and financial fundamentals and, at the same time, it indicates the need to take such improvement further, which paves the way for the economic authorities not wavering in their commitment to economic discipline.

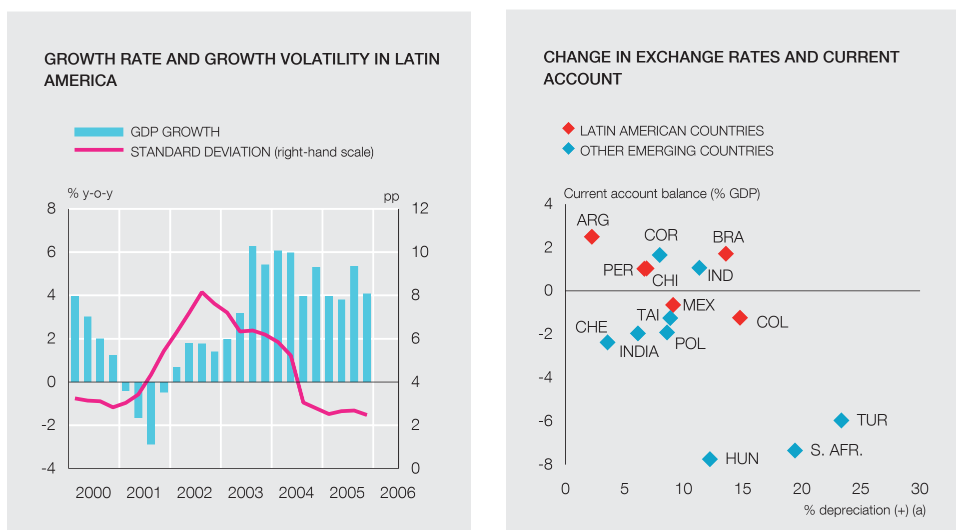
During the first half of 2006, economic activity benefited from a further firming of domestic demand, based on the strength of consumption, since the behaviour of investment was volatile and differed from country to country. The strong pick-up in credit, which is growing at a very high rate and across the board, is playing a significant role in this expansionary cycle. Although the export boom persists, the negative contribution of net external demand increased once again and, in some countries, there are incipient signs of the external sector flagging. The inflation rate continued on its declining path at the overall level, although it is only in Brazil that the downward cycle of interest rates continues, a significant exception on the global board. The aggregate fiscal deficit continued its convergence towards equilibrium, underpinned by the persistent strength of revenue, and without the electoral cycle having exerted any relevant adverse impact on the countries concerned.

The financial markets rose only to fall and then rise again. After starting the year in very favourable conditions, significant losses were posted in May and June, but the markets then subsequently recovered to a large extent. The fact that the bout of turbulence had a limited impact shows the progress made in reducing vulnerability, to which the authorities have contributed very actively; but it is also clear that vulnerability remains latent. The novel position of being a lender to the rest of the world – reflected in the current account surplus in many countries (see Chart 1) – appears to have softened the effects of the turbulence and has allowed reserves to continue being built up, the domestic costs of which, however, are becoming increasingly evident in some countries.

The economic outlook for the coming quarters remains favourable, and the sound financial conditions, the tethering of inflation – which has translated into a notable decline in real interest rates recently – and the ongoing robustness of the labour market provide most countries with a sound foundation for the sustained growth of domestic demand. The external economic environment should also support this favourable outlook. Nonetheless, it should be stressed that the volatility in the second half of the year has been associated with the entrenchment of

GDP, EXCHANGE RATE AND CURRENT ACCOUNT
Year-on-year change and percentage points

CHART 1



SOURCE: National statistics.

a. Change between maximum and minimum reached from January to August 2006.

a global financial environment of diminished liquidity and has left investors feeling warier. Both factors make it more likely for emerging markets to be subjected to bouts of volatility in the near future.

Against this background, it is important that the Latin American countries should not only shore up their macroeconomic and financial fundamentals but that they should be resolute in pushing through a reform agenda. The dichotomy between healthy discipline in the macroeconomic sphere and measures aimed at increasing market interventionism and at reducing the legal security of investors is significant in several countries in the region. In this respect, the changes in composition that are taking place in the two South American trade blocs – founded on different concepts in respect of trade integration – increase the risk of protectionist pressures and of contagion to other domestic economic policies.

Economic and financial developments

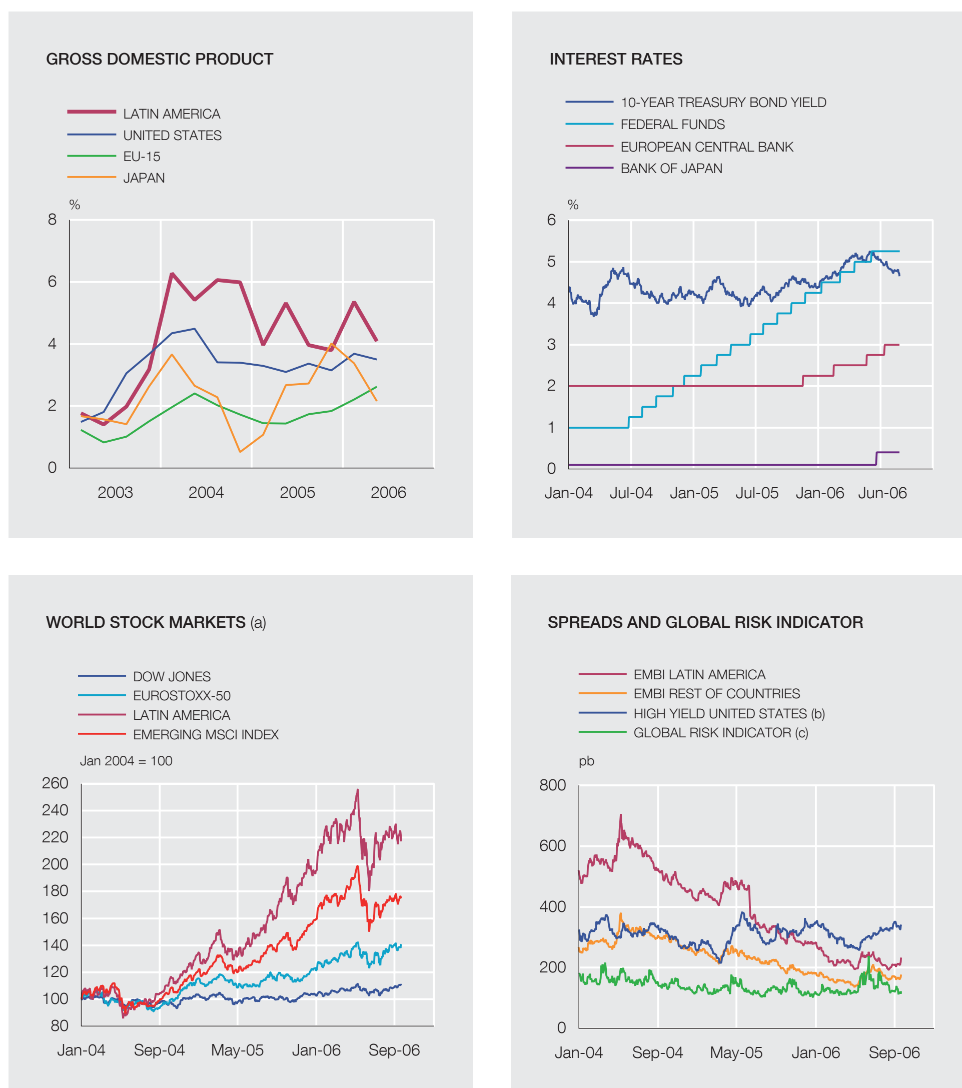
EXTERNAL ENVIRONMENT

During the first half of the year an economic environment of robust growth was maintained, although there was an episode of intense global financial volatility. This affected above all some emerging countries, against a backdrop of diminished global liquidity and a reassessment of expectations concerning growth and inflation in the industrialised countries.

Growth trajectories diverged from one country to another, with a more balanced growth scenario discernible in terms of areas (see Chart 2). There were signs of a slowdown in the United States during Q2 (GDP growth dipped from 5.6% to 2.6% in annualised quarterly terms); China continued to show strong dynamism, not exempt from risks of overheating; the Japanese economy confirmed an expansion in growth in Q2, albeit at a more moderate rate than in Q1; and, at the same time, the signs of dynamism shown in the euro area economy in previous months firmed. Against this background, the US Federal Reserve raised its official interest rate on two further occasions (May and June) to 5.25% and, since then, there has been a pause following more than two years of uninterrupted rises; Japan emerged from a prolonged phase of zero interest rates, applying the first official rise in six years in July; and the ECB raised its official interest rate on two occasions, to 3%.

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. Indices in dollars.
b. B1 rated Bond.
c. Implied volatility in CBOE options.

The conjunction of a rise in US inflation with preliminary signs of a possible reduction in growth triggered a period of uncertainty concerning the future course of both variables. That gave rise to a brief but intense (in some areas) bout of global financial instability in May (see Chart 2). This episode followed another more localised one in March, driven by the tightening of monetary conditions in Japan. The change entailed a move into a phase of stricter global liquidity conditions, since Japan had been a leading provider of liquidity to the global system in recent years.

Accordingly, during the first half of 2006 US long-term interest rates were on a rising trend that was only interrupted in May, coinciding with an episode of volatility, whereby the abnormally low level of such rates since the start of the last upward cycle was mitigated to some extent. Nonetheless, since mid-June, when expectations firmed that the Federal Reserve would take a pause in the process of rate rises, the upward movement in long-term rates was corrected.

They currently stand at below 5%, a low for the past six months, which makes for a yield curve with a clearly negative slope. Stock markets in the main developed economies were also affected by the volatility in May, although this downward movement was subsequently reversed on the main equity markets, and the US and European markets have now regained their levels as at the start of Q2. In the past six months, the exchange rate of the dollar against the euro depreciated significantly, by around 6%, and stood at around 1.27 in September. This course of the dollar coincided with the expectations of a narrowing of rate spreads relative to the other economies and with signs of a slowdown in the US economy; however, during the episode of financial stability, the dollar appreciated moderately on the back of its safe-haven status. Oil and other commodities posted an additional rise. In the case of oil, the price of a barrel of Brent once again hit an all-time high at over $78 in the first fortnight of August, although in late September it dipped once more to around $60. Metals, meanwhile, stood at highs for the previous years. The price of copper (which is relevant in economies such as Chile), for example, increased by 23% from the start of Q2.

Financial volatility was more marked in the emerging markets, which underwent one of the most turbulent periods of recent years in terms of certain variables. The stock markets witnessed the most severe correction, with declines which, in the aggregate of the emerging countries (see Chart 2), amounted to 25%, and the exchange rates of some countries also depreciated notably. It should be stressed that this episode came about after a favourable phase, which had run almost uninterruptedly for three and a half years. The economies most affected were precisely those in which the stock market boom had been most intense, e.g. India and the Persian Gulf countries, and those in a more vulnerable position from the standpoint of the external sector, such as Turkey (see Chart 1). In contrast, China stood out in that its financial variables were not impacted by the episode.

In any event, the episode was short-lived. As from June, there was a positive and sharp reaction on the emerging markets, in parallel to that in the developed countries, whereby sovereign spreads resumed previous levels practically across the board, especially in Latin America. The sovereign spreads for Asia and emerging Europe were, exceptions aside, still above the levels recorded at the start of Q2. Moreover, stock markets have also strengthened in a generalised fashion following the period of volatility, although they are still far from regaining the high levels prior to the turbulence.

ECONOMIC ACTIVITY AND DEMAND

The Latin American economy enjoyed a recovery in the opening months of 2006 (see Chart 3 and Table 1). In this period the year-on-year growth rate increased to 5.2%, although in Q2 it has eased off across the board to around 4.1% in the area as a whole. Nonetheless, quarter-on-quarter rates were comfortably above 1% in both quarters (1.5% in Q1 and 1.4% in Q2), notably higher figures than those of the previous six-month period (see Chart 3). The improvement in activity in the area as a whole can be explained by the recovery in Mexico and Brazil; in the latter case, however, the Q2 figure was rather disappointing. Continuing high growth rates in Argentina, Venezuela and Uruguay, confirmed by the favourable Q2 data, were also notable, and growth was strong in Colombia, Peru and Chile. Nonetheless, in these last two countries activity eased off, with signs that it might further slacken in the coming quarters, despite the excellent behaviour of the price of copper.

The higher frequency indicators included in Chart 4 corroborate to some extent the favourable outlook for the coming quarters. Consumer confidence has tended to stabilise at a high level, while retail sales are moving on a slightly declining path. Moreover, although the high growth rates of industrial production attained in Q1 have eased off, this variable has accelerated in recent months in countries such as Mexico and Colombia.

LATIN AMERICAN GDP
Year-on-year changes, unless otherwise specified

CHART 3

SOURCE: National statistics.

The strength of growth has chiefly been the result of the firming of domestic demand. Its average contribution to year-on-year growth in the six-month period stands at 6.5 pp, regaining the buoyancy seen in 2004, although there was something of a downturn in the last quarter (see Chart 5). Chart 6 shows that private consumption remained robust and even continued to trend upwards in some countries such as Brazil and Mexico. In this latter economy, a fundamental factor in recent months has been the sound behaviour of the labour market. In contrast, employment in Brazil slowed, although compensation has continued growing at a good pace in real terms. Real wages tended to quicken, attaining rates of around 5% in the area as a whole, driven by the increase of more than 10% in Argentina and Venezuela, and employment growth stabilised at 4%. However, the unemployment rate held stable in recent quarters, owing to the ongoing increase in the participation rate. Gross fixed capital formation, which had risen notably in Q1 to a growth rate of 16% for the region as a whole, was checked across the board (a year-on-year rate of 9.7%); the recent collapse in investment in Chile was particularly acute. Apart from this case, the decline in investment, which has traditionally been

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

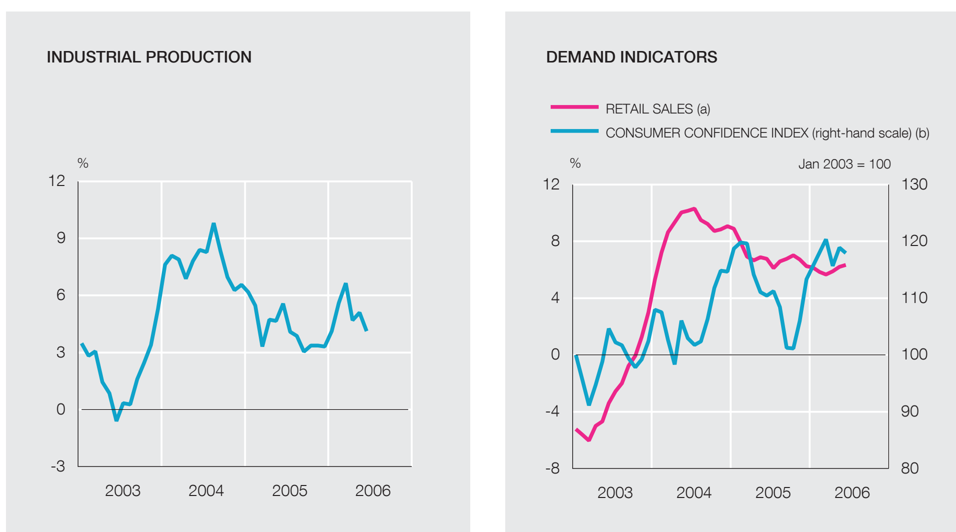
	2003	2004	2005	2004		2005				2006	
				Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
GDP (y-o-y change)											
Latin America (a)	2.1	6.0	4.3	6.1	6.0	4.0	5.3	4.0	3.8	5.4	4.1
Argentina	8.8	9.0	9.1	8.7	9.3	8.0	10.4	9.2	9.0	8.8	7.9
Brazil	0.5	5.0	2.3	5.9	4.8	2.7	3.9	1.0	1.4	3.4	1.2
Mexico	1.4	4.2	3.0	4.5	4.8	2.4	3.3	3.4	2.7	5.5	4.7
Chile	3.9	6.2	6.4	6.9	7.4	6.6	7.2	5.8	5.8	5.3	4.5
Colombia	4.0	5.0	5.2	3.8	4.2	4.5	5.9	6.6	3.9	5.5	5.9
Venezuela	-7.7	17.9	9.3	14.2	12.1	6.6	10.7	9.5	10.2	9.9	9.2
Peru	3.8	5.2	6.4	4.8	7.2	5.9	5.9	6.3	7.7	7.3	6.0
Uruguay	2.5	12.0	6.6	12.4	9.5	6.6	7.6	6.0	6.2	7.7	9.1
CPI (y-o-y change)											
Latin America (a)	10.9	6.0	6.3	6.3	6.5	6.5	6.7	6.0	6.0	5.8	5.1
Argentina	14.9	4.4	14.1	5.4	5.7	8.2	8.8	9.8	11.7	11.6	11.4
Brazil	14.8	6.6	6.9	6.9	7.2	7.4	7.8	6.2	6.1	5.5	4.3
Mexico	4.6	4.7	4.0	4.8	5.3	4.4	4.5	4.0	3.1	3.7	3.1
Chile	2.8	1.1	3.1	1.5	2.3	2.3	2.8	3.3	3.8	4.1	3.8
Colombia	7.1	5.9	5.1	6.0	5.8	5.2	5.0	4.9	5.1	4.2	4.0
Venezuela	31.4	21.7	16.0	21.5	19.5	17.0	16.3	15.4	15.2	12.6	11.2
Peru	2.3	3.7	1.6	4.4	3.8	2.2	1.8	1.2	1.3	2.4	2.3
Uruguay	19.4	9.2	4.7	10.0	8.1	5.6	4.5	3.9	4.8	6.4	6.4
PUBLIC-SECTOR BALANCE (% GDP)											
Latin America (a) (b)	-2.0	-0.8	-0.8	-1.0	-0.8	-0.7	-0.5	-0.5	-0.8	-0.8	-0.6
Argentina	0.4	2.6	1.5	2.7	2.5	2.6	1.5	1.2	1.5	1.7	2.3
Brazil	-3.6	-2.5	-3.1	-2.8	-2.7	-2.6	-2.8	-2.9	-3.3	-3.9	-3.4
Mexico	-0.7	-0.3	-0.1	-0.2	-0.3	-0.5	-0.5	0.0	-0.1	0.1	0.4
Chile	-1.4	2.4	4.8	1.9	2.4	3.3	4.1	4.6	4.8	6.5	6.9
Colombia	-2.6	-0.6	-0.5	0.3	-0.6	-0.6	-0.7	-1.7	-0.5	…	…
Venezuela	-4.3	-2.7	2.6	-5.8	-2.7	-0.1	3.2	5.3	2.1	…	…
Peru	-1.8	-1.3	-0.7	-2.1	-2.0	-2.2	-2.5	-2.6	-2.8	-2.8	-3.0
Uruguay	-4.6	-2.5	-1.6	-2.4	-2.5	-2.1	-2.2	-2.0	-1.6	-0.9	-1.1
PUBLIC DEBT (% GDP)											
Latin America (a)	54.4	49.8	42.4	50.6	49.8	50.3	42.4	42.8	42.4	42.0	26.5
Argentina	141.0	125.7	70.7	120.6	120.2	121.6	66.2	66.6	66.8	66.5	…
Brazil	57.2	51.7	51.5	52.0	51.7	51.3	51.4	51.5	51.5	51.6	50.4
Mexico	24.7	23.0	22.3	22.9	21.3	22.7	21.6	22.6	20.8	21.7	21.3
Chile	13.3	10.8	7.5	11.8	10.3	10.0	8.7	7.9	7.1	6.5	5.7
Colombia	50.9	46.7	46.7	46.5	44.4	46.6	44.6	43.3	45.5	44.4	…
Venezuela	56.9	53.5	48.7	49.8	53.5	47.6	49.2	50.6	48.7	37.9	…
Peru	47.7	44.3	37.7	42.2	41.5	42.0	35.0	38.0	36.9	36.4	30.7
Uruguay	108.3	100.7	82.9	101.5	100.7	78.1	80.3	81.6	82.9	75.6	…
CURRENT ACCOUNT BALANCE (% GDP)											
Latin America (a) (c)	0.8	1.3	1.7	1.3	1.3	1.3	1.3	1.5	1.7	1.9	1.9
Argentina	6.1	2.3	3.1	2.8	2.2	1.9	1.6	2.4	3.0	3.6	3.4
Brazil	0.8	1.9	1.8	1.7	1.8	1.9	1.7	1.6	1.6	1.5	1.3
Mexico	-1.5	-1.0	-0.6	-0.8	-0.9	-1.1	-1.0	-0.9	-0.6	-0.1	-0.1
Chile	-1.5	1.7	0.6	1.4	1.7	1.4	1.0	0.6	0.6	1.0	1.6
Colombia	-1.7	-1.0	-1.6	-1.2	-1.0	-0.8	-0.7	-1.5	-1.7	-1.6	…
Venezuela	13.4	13.7	22.4	13.6	13.7	14.4	16.9	20.4	22.4	23.6	24.2
Peru	-1.7	0.0	1.4	-0.2	0.0	0.3	0.7	0.9	1.4	1.1	1.6
Uruguay	0.5	0.3	0.0	0.2	0.3	-0.2	0.0	-0.1	0.0	-0.2	…
EXTERNAL DEBT (% GDP)											
Latin America (a)	46.7	40.2	27.2	42.9	40.2	39.4	30.6	29.2	27.2	26.8	…
Argentina	119.8	112.4	62.4	110.8	107.6	107.5	61.8	61.2	59.0	60.6	…
Brazil	40.1	33.3	21.3	35.3	31.7	29.8	25.5	22.6	19.7	18.5	…
Mexico	22.1	20.4	16.8	21.3	18.9	19.9	17.6	17.2	15.4	16.7	…
Chile	54.8	46.3	39.0	47.2	43.0	41.8	39.7	38.4	34.9	34.3	32.7
Colombia	44.9	40.5	31.3	38.7	36.7	34.0	30.8	29.5	30.0	28.5	…
Venezuela	48.3	44.1	41.7	41.1	43.4	36.9	40.1	39.5	41.2	33.8	31.5
Peru	48.3	44.8	36.1	43.2	42.0	42.6	35.4	36.4	35.3	34.5	28.8
Uruguay	98.0	87.6	67.9	85.6	87.6	66.4	66.7	66.6	67.9	60.6	…

SOURCE: National statistics.

a. Aggregate of 8 represented countries.
b. 2006 H1: estimation.
c. 2006 Q2: estimation.

SUPPLY AND DEMAND
Year-on-year changes and levels, 3-month moving average

CHART 4

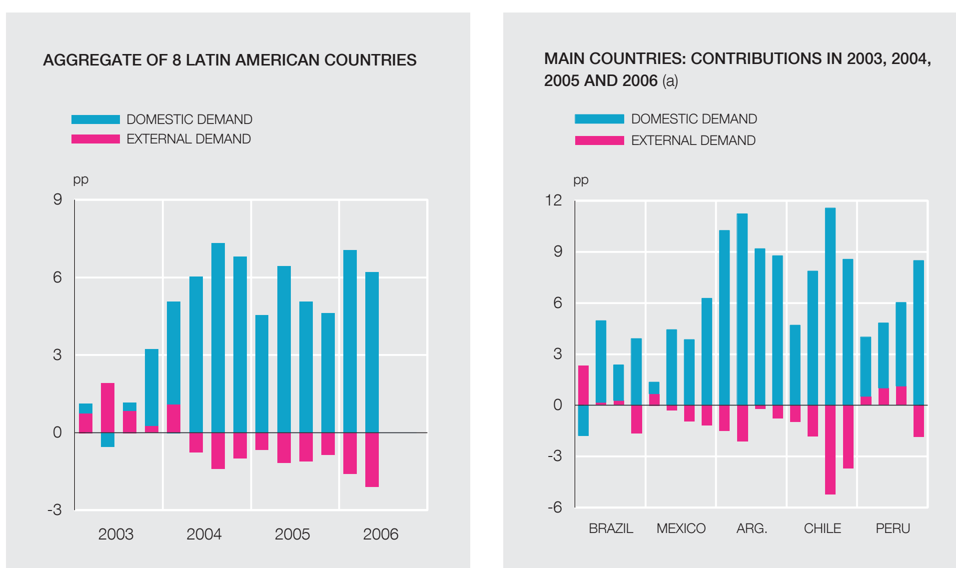


SOURCE: National statistics.

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

CONTRIBUTIONS TO REGIONAL GROWTH
Percentage points

CHART 5



SOURCE: National statistics.

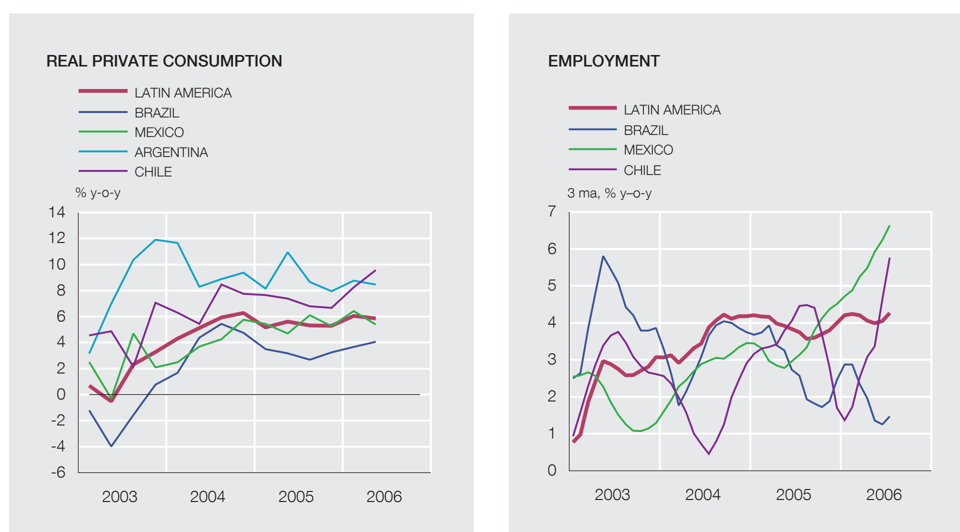
a. Information available to date.

highly sensitive to financial conditions, might be attributed in some countries to the episode of volatility, therefore conceivably making it a temporary phenomenon.

In addition to a sound economic outlook and a favourably performing labour market, both consumption and investment are being sustained by the downtrend in real interest rates in most of the countries in the region in recent years (see Chart 7). This is contributing, among other factors, to the greater availability of financing for households and firms, which is translat-

PRIVATE CONSUMPTION AND LABOUR MARKET
Year-on-year change and 3-month moving average

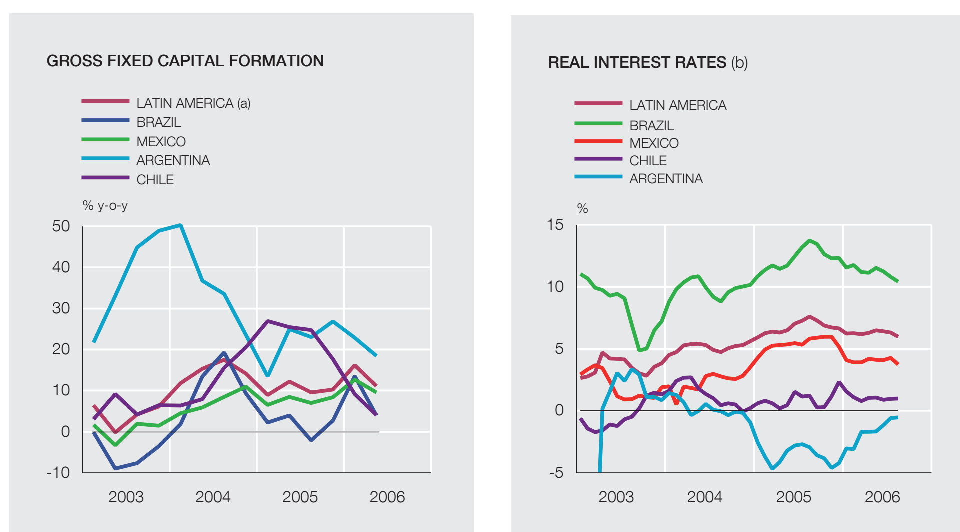
CHART 6



SOURCE: National statistics.

GROSS FIXED CAPITAL FORMATION AND REAL INTEREST RATE
Year-on-year rate and percentage

CHART 7



SOURCES: IMF and National statistics.

a. Seven largest economies.
b. Short-term interest rate minus inflation rate.

ing into a notable recovery in credit in the region, the recent trend and determinants of which are analysed in Box 1. In the first half of the year, bank lending to the private sector remained strongly dynamic across the board, with real year-on-year growth of 20% for the region as a whole (see panel 1 in the Box). In the main countries, growth rates held at over 10%; there was a fresh acceleration in Argentina and Colombia, and a sustained growth rate of close to 50% in Venezuela. At a more detailed level, the first signs of a recovery in mortgage lending were seen in Argentina, and this same credit component performed exceptionally in Mexico.

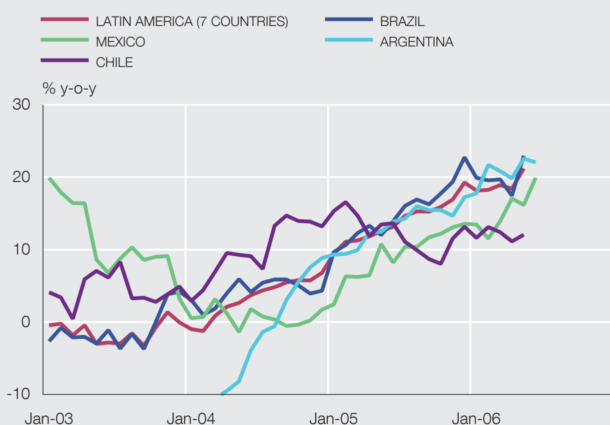
The negative contribution of external demand to growth continued to increase, widening to 2 pp in Q2 (see Chart 5). Of particular note were Brazil and Peru, where the contribution of external

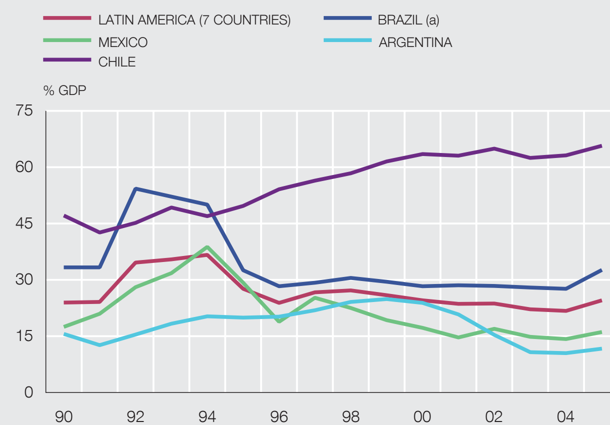
Since early 2004, and after a long period of stagnation, bank lending to the private sector in Latin America has been growing at a high rate (see panel 1). However, lending – which amounts to scarcely 25% in terms of GDP in the region as a whole – remains relatively undeveloped, in general, and its weight has hardly increased in the past ten years (see panel 2); indeed, declines have been seen in the ratio in Argentina, Colombia and Mexico. The scant banking intermediation is better seen in panel 3, which shows the lending/GDP ratio relative to per capita income and in comparison with other emerging countries. With the exception of Chile, lending is far more underdeveloped in Latin America than in the other countries. This scant financial depth is all the more worrying when it is considered that banks are the biggest source of funds for the private sector (individuals and corporations alike) in the region, given the limited development of capital markets.

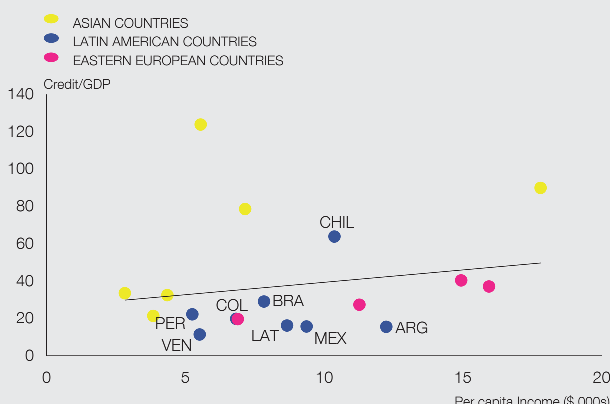
Among the possible explanations for this meagre development of lending in Latin America are the recurrent financial crises the region has undergone. Crises not only curtail lending substantially, but also, the process of recovery is very prolonged. Panel 4 depicts the lending/GDP ratio in each country, taking as a point of reference the year in which the respective crisis began. Although there are usually situations of excess credit in the run-up to crises, it is striking that in no country have the pre-crisis lending ratios been regained, even though more than a decade has passed in some cases. In fact, some of the recent strong growth in lending may be attributed to the recovery from previous financial crises. Adding to this is the fact that bank lending is also positively correlated with the business cycle, although there is no consensus in the literature on the direction of causality. The past few years have proven very favourable from the standpoint of economic growth for the region, so the cyclical factor is another of the reasons behind the recovery in lending since early 2004.

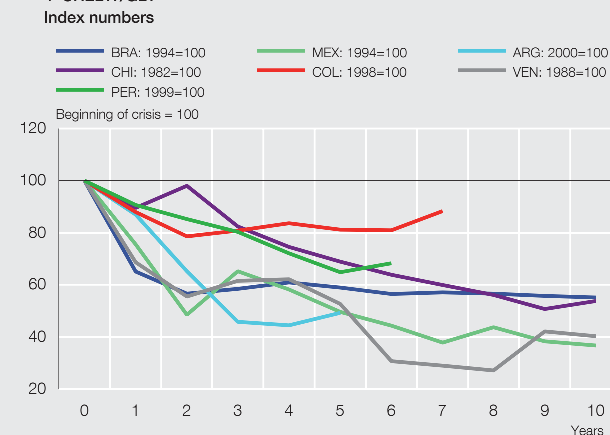
Besides past crises and the cyclical factor, credit supply and demand in Latin America have historically been limited by a series of structural factors, most of which have developed favourably. These include most notably:

1. The macroeconomic framework, which has improved substantially in recent years, with inflation rates under control in most









Source: IFS.

a. The figure for 1993, affected by a hyperinflationary process, is omitted.

countries, a better fiscal performance and a surplus on the current account balance.

2. Volatility and financial vulnerability, which have been alleviated by the reduction in debt and in currency mismatches, associated with the excessive dollarisation of previous periods (although dollarisation is still very high in some countries such as Peru).

3. The crowding out of private-sector borrowing by the public sector, which is now a less relevant factor owing to the consolidation of public finances, the development of local capital markets - outside the banking sector - and better access to foreign markets.

4. The quantity and quality of creditors' information and the transparency thereof, which has also improved. Notable in this area is the publication of financial stability reports by various central banks.

5. Stricter regulatory frameworks and more prudent risk assessment policies, which should reduce the likelihood of financial crises.

6. The effectiveness of creditors' rights, where substantial progress has been made with the approval of several bankruptcy laws, although similar headway has not been made in respect of interpretation by the legal system.

7. Access to credit for excluded sectors. In this area, progress is limited by deep-seated factors in the region, such as the marked informality of the labour market and inequality in the distribution of income. Even so, specific policies have recently been implemented aimed at extending access to credit, such as "payroll credit" (payment of wage-linked credit) in Brazil or the extension of micro-loans.

Favourable developments in these factors might be contributing to a higher trend growth of lending, the momentum behind which may be added to the combination of cyclical motives and to the recovery from crises. Despite these factors, it should be considered whether the strong growth rates in lending observed might be fuelling a fresh episode of excess credit, like those that usually precede a banking crisis. However, credit excesses are usually accompanied by signs in the form of macroeconomic imbalances (current account deficit, overvalued currencies, increases in the relative price of non-tradable goods, etc.) and financial imbalances (external debt, excessive dollarisation of liabilities), which are not currently discernible in the region. Nor are sizeable financial imbalances clearly perceptible and, as indicated, supervision and regulation have improved. Indeed, the identification of vulnerabilities in past crises has been conducive to more prudent behaviour in the current circumstances, especially as regards exposure to foreign exchange risk on bank balance sheets.

In sum, while private-sector bank lending may be expected to post more moderate growth rates in the coming years as the cycle matures and the recovery from previous financial crises runs its course, the conditions are in place for lending to maintain high trend growth allowing for convergence of the lending/output ratio towards the levels of countries with a similar economic standing. Structural improvements are also helping enhance market instruments and institutions, such as the lengthening of loan maturities, the emergence of domestic markets for local-currency-denominated public debt in some countries and, above all, the reduction in financial costs and in real interest rates. In order to continue along these lines, there is a need to entrench the improvements in the macroeconomic environment and to shore up institutional conditions and supervisory and regulatory mechanisms.

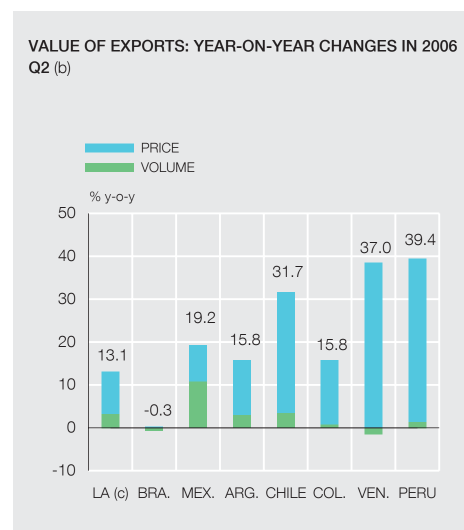
demand turned negative. After a prolonged period of extraordinary expansion (since 2002) exports began to show some signs of easing (see Chart 8). On National Accounts data, they grew by scarcely 3% in volume terms in the area as a whole. The strength of Mexican exports was prominent, as was the decline in Brazil's exported volume, after a long period of dynamism. However, favourable developments in prices, which account for virtually all of the increase in Chilean, Peruvian and Venezuelan exports, raised their growth above 13% in value terms. Imports stabilised at a slightly higher growth rate than that of exports, underpinned by the strength of domestic demand.

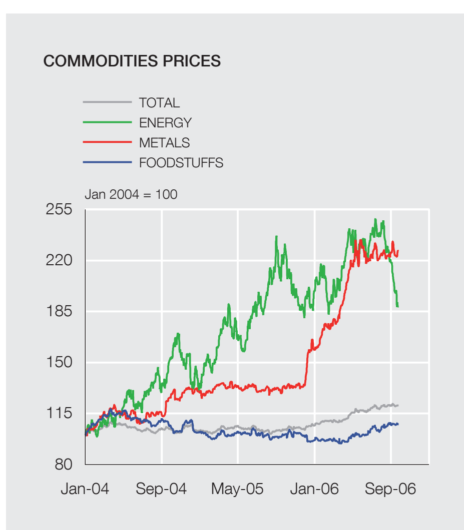
Despite this greater subtraction from growth of external demand and as a result of the favourable behaviour of relative prices, the trade balance for the area as a whole widened once again to 4.5% of GDP, after holding stable for more than two years at a surplus of 4%. Across the different countries, the trend of the deficit in Mexico was notable, having halved to 0.5% of GDP in recent quarters, while in Chile the trade balance doubled to over 14% of GDP, driven by changes in the price of copper. As a result, the current account surplus continued to widen, drawing close to 2% of GDP in the region as a whole. Salient developments included the widening of the surplus in Argentina and the elimination of the deficit in Mexico, to which the ongoing growth of remittances

EXTERNAL ACCOUNTS AND DETERMINANTS

CHART 8

Year-on-year changes, indices and percentage of GDP





SOURCES: National statistics and Banco de España.

a. 3-month moving average. Customs data in US dollars.
b. National Accounts data, in local currency.
c. Aggregate of 7 largest economies.

was conducive. In Chile and Peru, changes in the trade balance scarcely bore on the current account balance, owing to the fact that greater revenue from commodities exports also leads to a strong deterioration in the incomes balance. In any event, it remains notable that all the countries are running an ample current account surplus (or a very small deficit) at such an advanced phase in the business cycle. The exception is Colombia, where there has been some deterioration in the current account deficit in recent quarters, though it is still short of 2% of GDP.

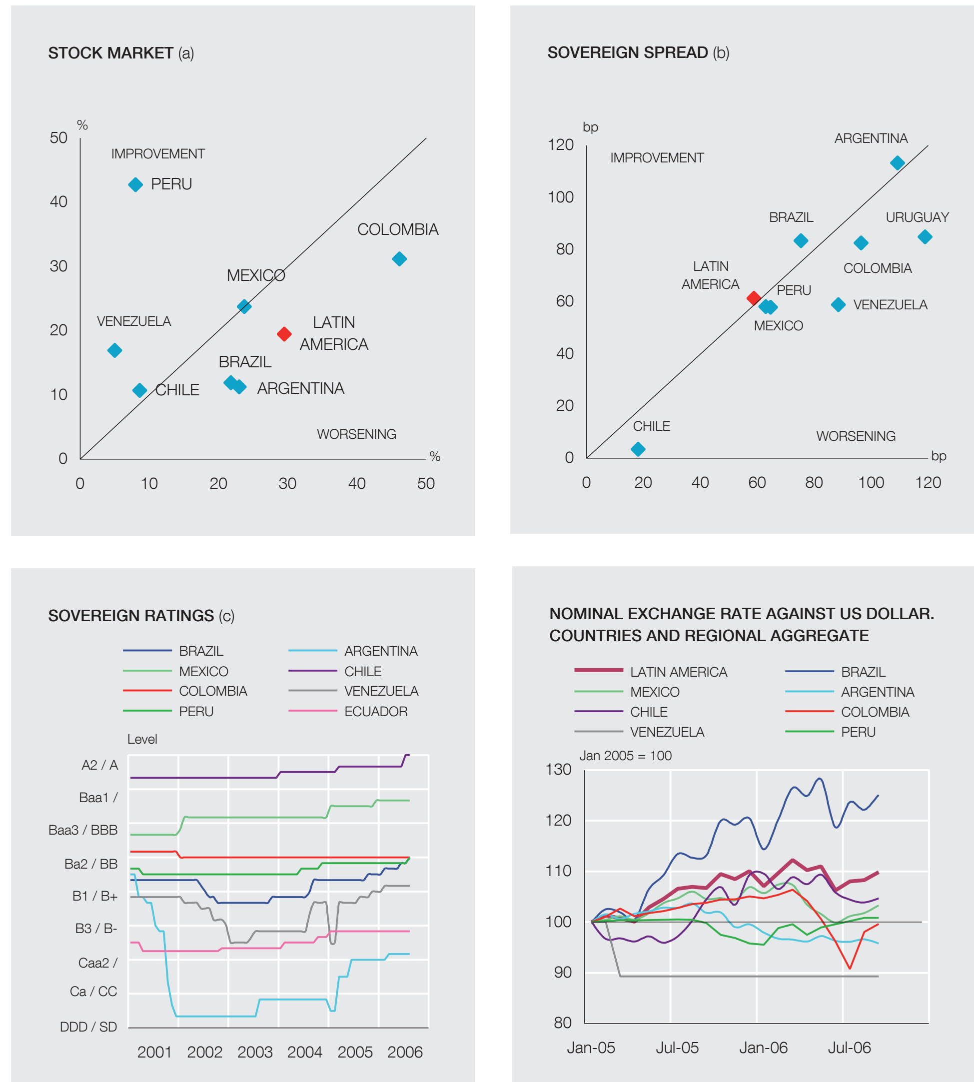
FINANCIAL MARKETS AND EXTERNAL FINANCING

Financial markets in the region were marked by the bout of instability that began in May. This saw a fall-off in capital inflows to Latin America and other emerging markets and simultaneously affected, albeit to differing degrees of intensity, all the countries in the area and the main financial indicators: the stock market, sovereign spreads and exchange rates. Nonetheless, as significant as the deterioration in the indicators in May was their rapid and robust recovery subsequently, which has allowed many of the Latin American countries to regain the levels

SOVEREIGN SPREADS, STOCK MARKETS, RATINGS AND NOMINAL EXCHANGE RATE AGAINST THE DOLLAR

Basis points and indices

CHART 9



SOURCES: JP Morgan, Bloomberg, Moody's, Standard and Poor's and Fitch.

a. Worsening: change from annual high to Q2 period of turbulence and the low observed during this period. Improvement: change from that low to subsequent high.
b. Worsening: change between maximum spread observed during Q2 turbulence and the yearly minimum spread until then. Improvement: change between that maximum and the subsequent minimum.
c. Simple average of ratings from Moody's, Standard and Poor's and Fitch.

observed before the turbulence, and in some cases to better them (see Chart 9). This reaction may be viewed in a most favourable light, especially when considering that, with the odd exception, the recovery in the Latin American economies has been sharper than that in other emerging economies. Contributing to this has been the reduction in financial vulnerabilities in recent years, generally prompted by sounder external positions, a reduction in financial costs and imbalances, and greater macroeconomic discipline, which have reinforced the resilience of these economies.

The first two panels of Chart 9 depict the marked oscillation that stock markets and sovereign spreads have undergone in recent months. On average in the region, stock markets fell – in local currency terms – by almost 30%, with a notable decline of close to 50% in Colombia, this

being the market where the recovery was also sharpest. In August, most of the countries had already recouped much of what they had lost, although the area aggregate still showed a fall of around 10% on the prior highs. Only Chile, Venezuela and Peru posted annual highs subsequently. The Peruvian index has most risen in 2006 (over 110%), due in part to overcoming the electoral uncertainty that had overshadowed market performance to January.

Sovereign spreads trended in parallel with stock markets. The regional sovereign spread, measured by the regional EMBI index (see chart 2), which posted an all-time low of around 190 bp before the May turbulence, widened by over 25% (almost 60 bp) to over 250 bp. The countries where the spread most widened were Argentina and Uruguay, although it was Colombia, with a rise of over 90 bp, that posted a proportionately higher increase. From June, movements reversed to the point of an improvement on previous levels in countries such as Brazil and Argentina, and an approximation to such levels in the remaining countries. The exception was Chile, where the spread did not recover. Indeed, the regional aggregate once again posted an all-time low in August, although subsequently it rose slightly again.

The foreign exchange markets were also buffeted by financial turbulence and, although the signs of recovery in these markets were clear, few currencies – among which the Mexican peso – recovered their previous levels. The strength of the Peruvian peso was notable over the April-September period, standing at a high for the year (a 3% appreciation in the past two quarters). In contrast, the Colombian peso and the Chilean peso underwent the heaviest depreciations during this period, of around 5% and 2.5% respectively. This interruption in the rising course of currencies was, in some cases, welcomed by the authorities, since the fears of an excessive exchange rate appreciation had been becoming increasingly patent in certain areas.

It is interesting to note that the countries most affected by the turbulence were those where capital inflows to the stock market had been most intense in recent years, which makes it reasonable that the reversal should have been more forceful in these countries. This is particularly the case of Colombia, whose stock market rose by 900% from January 2002 to May 2006, by far the biggest rise in the region. Nonetheless, this is also the only country running a current account deficit and a very downwardly sticky public debt ratio of close to 50% (unlike in other countries, as shown in Chart 13). That draws a parallel between Colombia and other emerging countries severely affected in this episode (see Chart 1), marking a note of caution that is valid for the entire area despite the robust recovery in train.

In any event, despite the volatility of the period, there was an improvement in several countries' credit ratings in the region (Brazil in June and September, Peru in August and Chile in July, as can be seen in Chart 9).

On IMF forecasts, net capital flows to the region will be nil in the year as a whole, unlike the case for the past two years, in which the balance was negative (see Chart 10). As forecast net private flows are very similar to those last year (somewhat over $12 billion), equilibrium will be obtained by the lower negative balance of official flows. This reduction will come about despite the fact that the figure includes Argentina's cancellation of IMF loans (made last year, but recorded in January), Uruguay's partial cancellation and other cancellations with other agencies by various countries, such as that of Mexico with the IDB and the World Bank, and that of Brazil with the Paris Club. Box 2 analyses the importance of the role played by IMF programmes in the recovery of private flows to Latin America and other emerging economies.

THE CATALYSING EFFECT OF THE IMF ON PRIVATE CAPITAL FLOWS TO LATIN AMERICA AND THE EMERGING ECONOMIES

BOX 2

Among other objectives, the financial programmes of the International Monetary Fund (IMF) pursue the recovery of private capital flows to beneficiary countries. There are three fundamental channels through which the IMF may reinforce foreign investors' confidence and, therefore, catalyse private flows: liquidity, conditionality and signalling. The liquidity provided by the IMF raises the recipient's ability to pay and thus reduces the likelihood of it defaulting. The conditionality associated with the IMF programmes and compliance therewith increases investors' confidence in emerging countries' economic policies. Finally, the subscription to and renewal of programmes gives an IMF seal of approval to the recipient's macroeconomic policies, inducing a positive signalling effect to foreign investors.

However, the catalysing effect of IMF programmes on private flows is difficult to discern empirically, and some studies even conclude that entering into an agreement with the IMF is associated with a withdrawal of private capital from the country. The catalysing effect appears only in very specific cases, such as the countries that apply to the multilateral agency from a good starting position, or that have access to international credit markets.

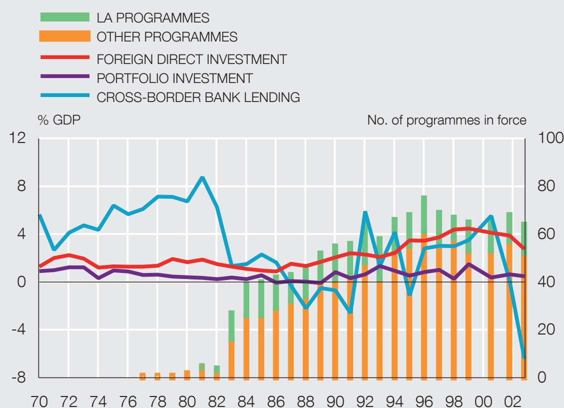
These results have been justified questioning the three above-mentioned channels. Thus, if the greater liquidity provided by the IMF does not immediately restore foreign investors' confidence in the recipient country, its only purpose would be to fuel a further outflow of capital. Regarding conditionality, in most cases the IMF programmes exert a contractionary effect on activity, at least in the short term, which would reduce the country's ability to pay. Finally, the signing of an agreement with the IMF may alert foreign investors to a country's problems, insofar as they may suspect that the government and the IMF have more information than them about the scale of the problems.

A recently published paper[1] analyses the question in detail, distinguishing between types of private flows and between types of programmes signed with the IMF. Panel 1 offers a summary description of the sample used in this paper. The programmes in force increased substantially after the 1982 debt crisis, and they peaked at 75 in 1996 (of a total of 156 countries, i.e. that year almost half all nations were under an agreement with the IMF). The programmes most used are Stand-by Arrangements (SBAs) and Poverty Reduction and Growth Facilities (PRGFs). These are long-term concessional programmes, with a stronger component of structural conditionality than other types of agreements. The other programs considered are less recurrent: Extended Fund Facility (EFF)-type programmes (geared to crisis resolution but with a longer life than SBAs) and preventive programmes, which are similar to the latter (and characterised, therefore, by conditionality) but in which the signatory country undertakes not to make any withdrawal of funds unless a financial crisis breaks out. Regarding the different types of flows, foreign direct investment received as a percentage of GDP is on a growing trend with little volatility and portfolio flows are very small (they do not exceed 1.5% of GDP in any year), while bank loans display high volatility, predominating especially at the start of the sample and petering out at the end. With these data, considering other determinants of private capital inflows in the emerging economies, and adjusting for potential endogeneity and selection bias in the estimations, the results (in the accompanying panel) are somewhat more favourable than those obtained to date by other studies.

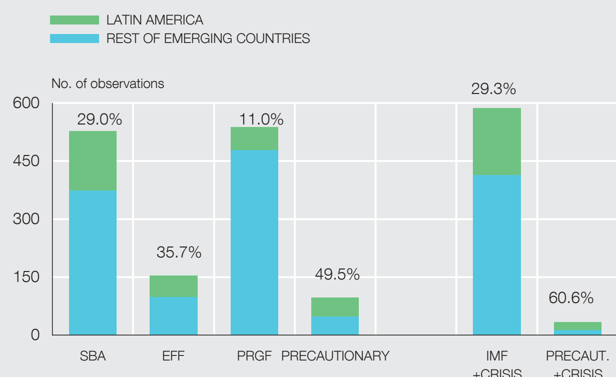
In fact, the signing of a program with the IMF would entail direct investment inflows for an amount equivalent to 0.4 pp of GDP, and this effect would be significant for the PRGF and EFF programmes. Regarding portfolio flows, at the aggregate level the effect is not significant, but it is in the case of EFFs. Finally, bank loans are discouraged both by the signing of an EFF and an SBA, whereby, overall, signing an agreement with the IMF would entail an outflow of this type of capital equivalent to 1.2% of GDP.

1. See Banco de España Working Paper no. 0617 "What kind of capital flows does the IMF catalyze and when?", by Javier Díaz-Cassou, Alicia García-Herrero and Luis Molina.

1 NET PRIVATE CAPITAL FLOWS AND IMF ARRANGEMENTS



2 GEOGRAPHICAL DISTRIBUTION OF PROGRAMMES (a)



SOURCE: Banco de España.

a. The percentage refers to the share of the Latin American countries in each of the types of programme or situation.

THE CATALYSING EFFECT OF THE IMF ON PRIVATE CAPITAL FLOWS TO LATIN AMERICA AND THE EMERGING ECONOMIES (cont'd)

The most positive results are for preventive programmes. The empirical results (see accompanying table) suggest preventive agreements have a greater positive impact than the rest: they would appear to raise direct investment received by a proportion 4.5 times greater than that of other agreements as a whole and, although they do not have significant effects on bank loans, at least the coefficient turns positive. The different effects, derived from the specific characteristics of these agreements, on the three above-mentioned channels might explain these better results. The liquidity effect would be mitigated, but the other two, above all the signalling effect, could be amplified.

It is worthwhile, finally, examining whether the external flows channelled towards the Latin American countries have responded differently to the signing of financial programmes with the IMF. The resort by the Latin American countries to IMF programmes is proportional to their representativeness; accounting for 35 countries of 156, i.e. 22.4% of the total, they give rise to 22.5% of the observations with an agreement with the multilateral agency in force. By type of programme, they were particularly active in the signing of EFFs and, especially, of preventive agreements (see panel 2).

If the previous exercise is repeated in the sub-sample of countries from the region, that gives the coefficients displayed on the right of the accompanying table. Hence, the effect of the programmes on direct investment is significantly greater than for the other emerging economies, something that stems from a very strong effect of PRGF-type programmes (5.5 pp of GDP, compared with only 0.6). EFF-type programmes, which are those most widely signed by the region, generate a bigger increase in portfolio investment than for the emerging economies as a whole (0.9 pp, against 0.4). In a negative sense, the effect of SBAs on bank loans is greater than in the sample as a whole. Finally, in the case of preventive programmes, the results are rather more unfavourable than for the emerging economies as a whole.

This last result may be due to the greater recurrence of crises in Latin America. Preventive programmes would, in principle, be designed for times of calm in the recipient countries, i.e. in the absence of a crisis. When a crisis breaks out, the presence of a preventive programme may exacerbate the outflow of capital, insofar as prior subjection to conditionality has not enabled the problems to be circumvented. In this respect, of the 33 observations in the sample where a crisis coincides with a preventive agreement in force, 20 belong to the region. Accordingly, the last line of the accompanying table shows the results for the preventive programmes in a sub-sample of crisis-free observations and these are compared with the same sub-sample in Latin America. The results improve for Latin America, but also for the sample as a whole, inferring that this is only a partial explanation for the results.

In conclusion, the catalysing effect of agreements with the IMF depends on the type of flow and on the programme in question. Medium- and long-term agreements, with a stronger component of structural conditionality (PRGFs and EFFs) tend to raise direct investment, and in the case of EFFs, portfolio investment too. If, moreover, the agreement is a preventive one, numerous catalysing effects can be found, particularly on direct investment. Against this background, Latin America shows more favourable behaviour in the case of direct and portfolio investment, except in the case of preventive agreements, which appear to exert a lesser catalysing effect.

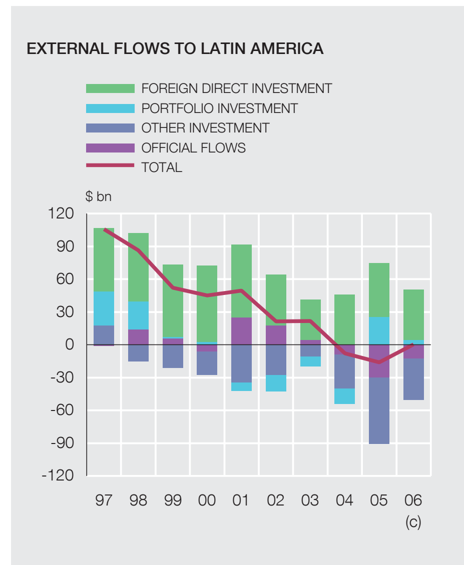
	Whole sample			LA sample		
	FDI	Portfolio investment	Cross-border bank lending	FDI	Portfolio investment	Cross-border bank lending
Dummy for IMF program	0.40 **	0.17	-1.20 ***	0.67 **	0.12	-1.69
Of which:						
— SBA/SRF	0.17	0.09	-1.24 ***	0.12	-0.25	-1.85
— EFF	0.66 *	0.45 **	-1.66 ***	0.41	0.91 ***	-2.19
— PRGF	0.61 **	-0.11	-0.19	5.50 ***	-1.22	0.30
— Precautionary: whole sample	1.79 ***	0.12	0.96	-0.12	-1.01 ***	0.60
— Precautionary: obs. without crisis	3.24 ***	0.56 *	0.74	0.40	-0.40	0.75

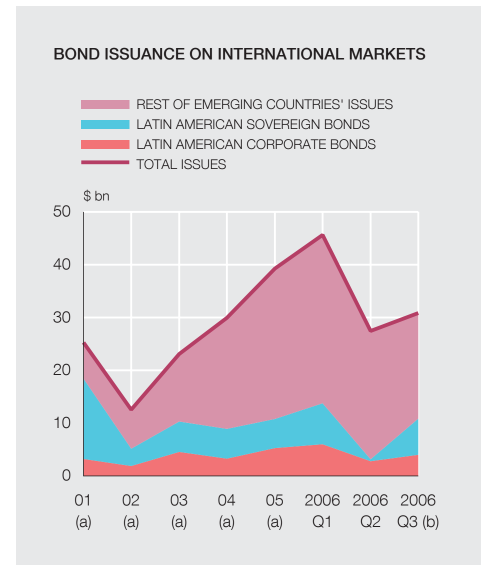
SOURCE: Banco de España

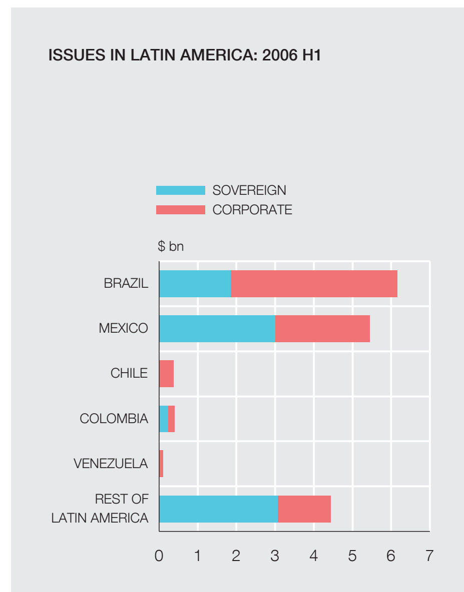
a. Fixed effects model. *, ** and *** imply that the coefficient for the dummy representing IMF programmes are significant at 10%, 5% and 1% levels, respectively.

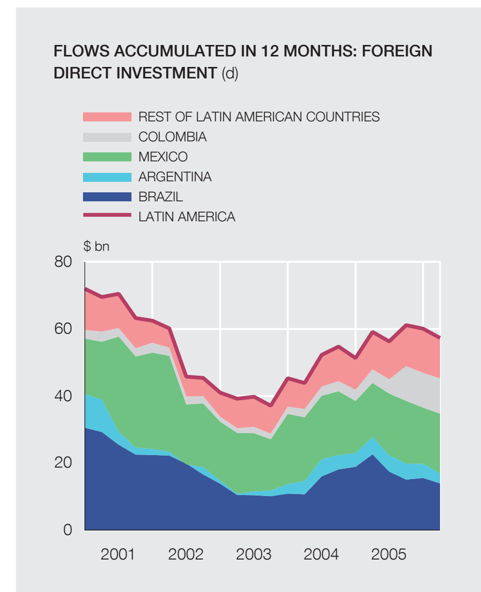
EXTERNAL CAPITAL FLOWS
USD bn

CHART 10









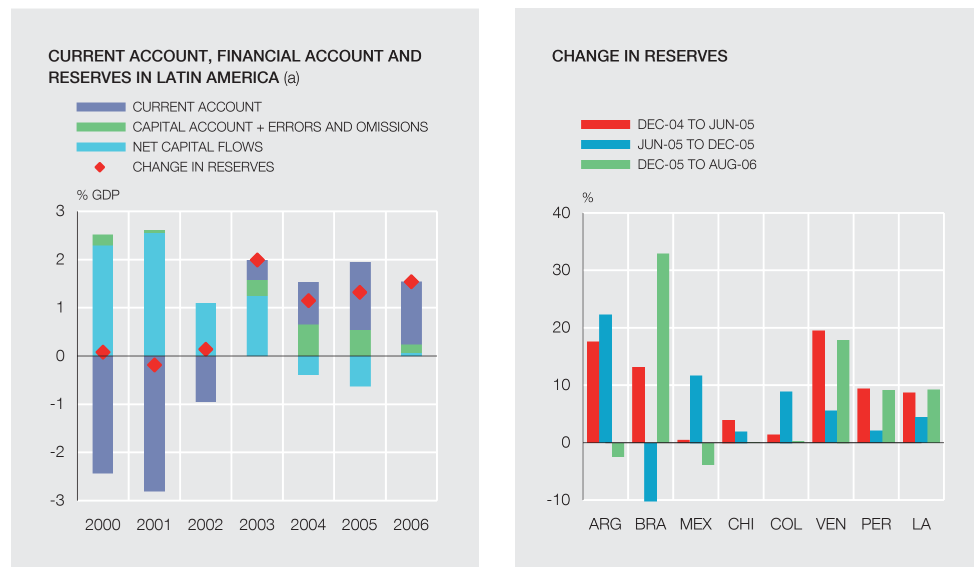
SOURCES: JP Morgan and IMF.

a. Quarterly average.
b. Data to August and estimation for September 2006.
c. 2006: estimation.
d. Q2 2006: estimation for Colombia.

The breakdown of private flows by category allows some striking conclusions to be drawn. Firstly, net flows of external loans and credits (under Other investment in Chart 10) have retained the negative sign of recent years, although the scale of the decline ($38 billion) is considerably less than that of the previous year. Secondly, a strong fall-off in portfolio flows is envisaged, from $25.4 billion in 2005 to a figure slightly over $4 billion. This decline is, above all, the result of a strong negative balance in fixed-income inflows, and not so much of a reduction in equity inflows, despite the recent volatility caused by the withdrawal of certain foreign funds. The Latin American countries are also reducing their exposure to external private debt through redemptions – such as the repurchase by Brazil of the remaining Brady bonds in April – and not so much due to a lesser rate of sovereign issues. After a very active first quarter, these issues practically ground to a halt in Q2 owing to the financial turbulence, and picked up again

EXTERNAL ACCOUNTS AND CHANGE IN RESERVES
Percentage of GDP and rate of change

CHART 11



SOURCE: National statistics.

notably in Q3 (see Chart 10) to the extent that, on average ($5 billion per quarter), they were only slightly down on 2005. Corporate issues showed similar dynamism, with a quarterly average of $4.3 billion (somewhat down on the previous year), although they were less affected in Q2. In countries such as Chile and Venezuela, these issues were the only ones to take place, and in Brazil they exceeded sovereign issues, totalling $4 billion in the first half of the year.

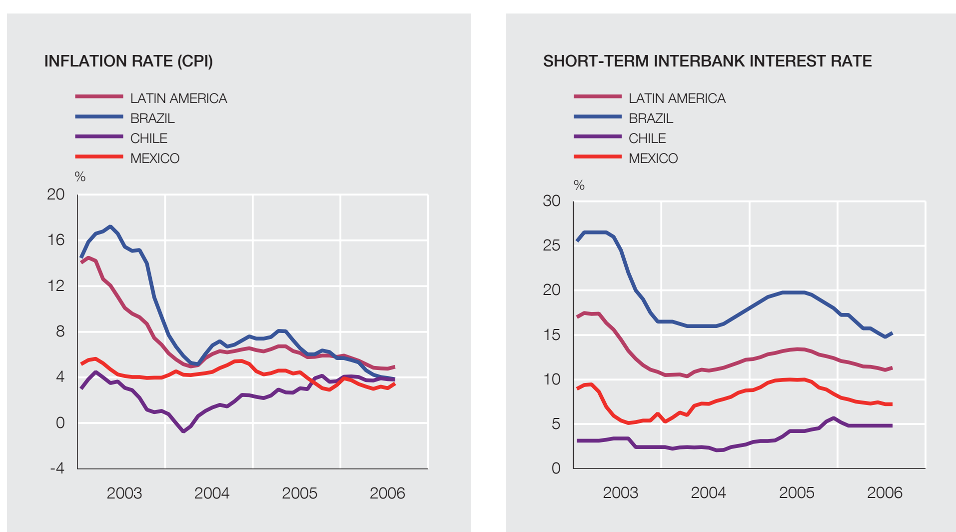
Against this background of zero or negative net inflows, foreign direct investment (FDI) flows remain strong. On present forecasts they would stand at $46 billion in 2006, a figure marginally down on the previous year, although with data to Q2, cumulative investment in Latin America points to a figure closer to $58 billion (see Chart 10). Country by country, there has been a notable decline in FDI in Brazil, prompted by a notable increase in FDI outflows ($4.5 billion, a 250% increase on the previous period), while Colombia showed the most notable increase in the region, consolidating the improvement in its attractiveness to investors in recent times.

The net balance of capital flows in the region in recent years is somewhat deceptive, since highly favourable external financing conditions have been in place during this period for these countries. These conditions, instead of being used to increase external debt, have been harnessed to reduce external exposure under favourable conditions, in order to alleviate financial vulnerability. This is one of the most characteristic – and in turn encouraging – features of this financial boom period.

As discussed, the external position remains comfortably in surplus in most of the countries, meaning that the area as a whole is a net capital exporter from a balance of payments perspective. From this standpoint, the combination of an extensive external surplus and balanced net financial flows entails (see Chart 11) the continuation of the ongoing build-up in reserves at a high rate (they are up 10% in the area as a whole in the six-month period). In this respect, the build-up in reserves does not only provide a line of defence against future financial turbulence, but goes hand in hand with the existence of a comfortable external position, which, as seen, has proven important in dampening the impact of turbulence. Nonetheless, the accumu-

INFLATION AND INTEREST RATES
Year-on-year rate and percentage

CHART 12



SOURCE: National statistics.

lation of reserves may ultimately entail sizeable and growing costs, especially in respect of monetary control in some countries, as analysed in Box 3.

PRICES AND MACROECONOMIC POLICIES

Inflation continued to perform most favourably in the area as a whole, with an additional reduction of almost 0.5 pp since the start of the year, taking the rate to 5.1% in August (see Chart 12). This performance is particularly notable against a background of rising oil prices and strong domestic demand pull, although administered prices have eased in many countries. In a less marked fashion, underlying inflation also continued to fall, dipping to 4.7% in July. Leading the reduction in inflation was Brazil, where the decline was by more than 1 pp in the last six months, while in Argentina the accelerating tendency of prices was interrupted and inflation, though still high, moved into a phase of stability from June. In Mexico, the inflation rate has stood in recent months at above the inflation target (3%), while in Chile the rising path of the past two years has been curtailed.

Despite these developments in prices, monetary policies tended to tighten. The notable exception is Brazil, whose central bank is one of the few globally to be still cutting interest rates. In any event, as Chart 7 showed, its real interest rates are also still among the highest in the region (and, practically, in the world). In Mexico, the cycle of interest rate cuts was interrupted in April, while in Colombia a new upward cycle began in May. In Peru, Chile (at a more moderate pace than in previous quarters) and Argentina, interest-rate increases continued. The rises in Argentina continue to be very muted in relation to the scale of the inflation problem faced, although real Argentine interest rates might cease to be negative in the coming quarters (see Chart 7 once more). Alternative price control policies have acquired a leading role and, in recent months, they appeared to achieve the desired effect, by means also of their dissuasive impact on other sectors not directly affected.

In the area as a whole, the budget deficit stabilised at around 0.5 pp in the last two years, although the primary surplus continues moving on a slightly rising trend at close to 4% of GDP (see Chart 13). Notable in recent quarters were the upward trend of the primary surplus in Mexico and Peru, which enabled them to build on a fiscal surplus position, and the drastic widening of the Chilean surplus.

THE BUILD-UP OF INTERNATIONAL RESERVES IN LATIN AMERICA: DETERMINANTS AND DOMESTIC CONSEQUENCES

BOX 3

One of the key features of the international economy in recent years has been the substantial increase in international reserves at the global level. The essential drivers – with the exception of Japan – have been the emerging economies, mainly in Asia, and more recently the oil exporting countries. Overall Asian international reserves at end-2005 thus account, after posting annual growth of 28% during the period 2002-2005, for 60% of total world reserves. The reserves of the oil exporting countries (OPEC and Russia), while accounting for a much smaller fraction of total world reserves (9% at end-2005), grew at an annual rate of 34% over the same period. Despite having received less attention, a large number of Latin American countries have likewise significantly built up their international reserves (see Chart 1), having posted annual growth of 20% in the period 2003-2005; even so, reserves in the area as a whole were equivalent at end-2005 to only 5% of world reserves. Of note were the holdings of Mexico ($66 billion) and Brazil ($71 billion).

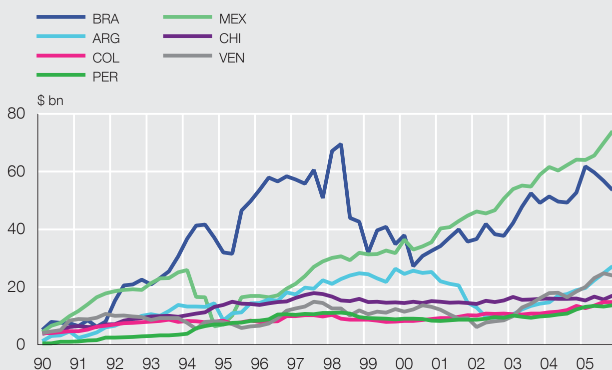
The persistence of sound financial conditions combined with ample external surpluses have generated strong upward pressure on local currencies. Although these appreciations have in part corrected a previous sharp movement in the opposite direction, most of the region's central banks have sought to offset them, to a greater or lesser extent, with sizeable purchases of dollar-denominated assets. In some countries, there have been other reasons, rather than an express desire to control the exchange rate, for the build-up. In Mexico, the strong increase in reserves has been fuelled by the sale of dollars by the state-owned oil company to the central bank, a mechanism whereby it is sought to prevent oil revenues being traded on foreign exchange markets, given the volatility that operations of this scale and irregularity might generate.

The increase in reserves has allowed financial vulnerability to be reduced. Following the crisis in the late 90s and early years of the current decade, as recently as in 2002, some countries had very small international reserves in relation to historical standards and to covering against vulnerabilities. The increase in reserves has also provided for the restructuring of sovereign debt through two channels. The first is direct, as the reserves are used, in specific instances (Brazil, Argentina and, more recently, Uruguay and Mexico), to repurchase debt on the market and to make early repayment of loans from international financial institutions. The second is indirect since, on countering upward pressures, expectations of an appreciation in the currency persist, thereby increasing the relative attractiveness of local-currency-denominated debt. Both factors have enabled external debt and foreign-currency-denominated debt, and by extension vulnerability, to be reduced. This improvement is manifest in the attendant indicators, such as the ratio of reserves to short-term foreign debt, which has risen in many cases (see panel 2) above unity (the appropriate level according to the Guidotti-Greenspan rule). Other more elaborate studies[1], in which the suitability of the level of reserves is set against a sudden reversal in capital flows, also support the improved resilience of these economies in recent years, without the accumulation having so far become excessive.

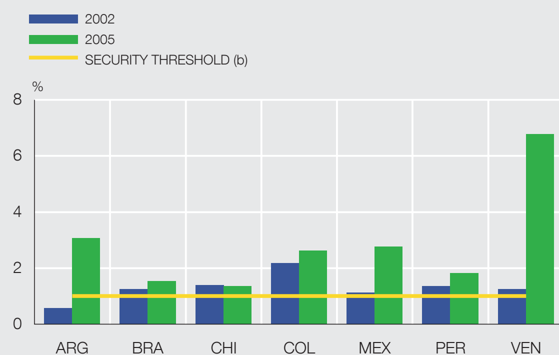
However, along with these positive aspects, the build-up in reserves gives rise to costs and problems that are also progressively affecting countries in the region. Firstly, increases in reserves are accompanied by expansions in liquidity which, if not sterilised, generate inflationary pressures. The case of Argentina is perhaps the most salient one. Despite the notable effort to sterilise increases in reserves (see Chart 17), a notable expansion in liquidity is taking place. This complicates excessively the management of monetary policy and the control of inflation which, despite price controls, is standing at an annual rate of around 10%. There is a similar problem in Venezuela, where inflation is around 15%, driven by the increases in the money supply stemming from incomplete sterilisation. Even if successful, sterilisation is not free from problems, such as the so-called fiscal costs. These

1. O. Jeanne and R. Ranciere, The Optimal Level of International Reserves for Emerging Economies: Formulas and Applications, IMF Research Department, forthcoming.

1 INTERNATIONAL RESERVES (a)



2 RESERVES AS A PERCENTAGE OF SHORT-TERM EXTERNAL DEBT
Percentage of external short-term debt



SOURCES: IMF (IFS) and External Debt Database (BIS-IMF-OECD-WB).

a. International reserves (gold excluded).
b. According to Guidotti-Greenspan Rule.

THE BUILD-UP OF INTERNATIONAL RESERVES IN LATIN AMERICA: DETERMINANTS AND DOMESTIC CONSEQUENCES (cont'd)

BOX 3

costs, defined as the spread between the return on reserve assets (US bonds in many cases) and on the bonds issued to sterilise the increases in the money supply, are proving to be of some size in Brazil and Mexico, as a result of the higher interest rates in both countries. Another problem is the distortions that central bank bond sales may cause to the financial system. A case in point is Colombia, where the bonds are largely being taken up by commercial banks. This situation biases portfolios excessively towards the public sector, and may even prompt a dilemma at the central bank by uncoupling monetary policy objectives from financial stability, in that a significant increase in interest rates (perhaps required to contain inflation in the event of a possible depreciation of the currency) would prompt a considerable deterioration in commercial bank assets, with the subsequent problems for financial stability.

In sum, in recent years, against a backdrop of sizeable trade surpluses, capital inflows and high oil prices, there has been a substantial increase in reserves in a large number of Latin American countries. This phenomenon is, along with the known positive effects in terms of the reduction in foreign exchange volatility and in financial vulnerability, giving rise to various problems. Admittedly, it is not possible to make a prediction concerning the continuity of the process in the area as a whole, as there are heterogeneous aspects to its determinants and domestic consequences. But it may be concluded that, in those countries where the build-up in reserves is essentially the outcome of foreign exchange intervention and where the process of accumulation continues at a brisk pace, the associated problems will increase and may have adverse consequences for monetary and financial stability, ultimately giving rise to the interruption of the process.

The stabilisation of the gap between the primary and total fiscal balances is explained by the scant scope available for further reductions in interest payments, which is linked to the downward interest-rate cycle and to the growing downward stickiness of public debt. Indeed, interest payments fell by more than 3 pp of GDP in recent years (see Chart 13), but have held almost flat at over 4% of GDP for almost two years, and in countries such as Brazil (8% of GDP) and Argentina (only 2%, following debt restructuring) they have recently risen. Meanwhile, public debt has also stabilised at over 40% in the area as a whole, and only in Peru and Chile has it held on a declining course.

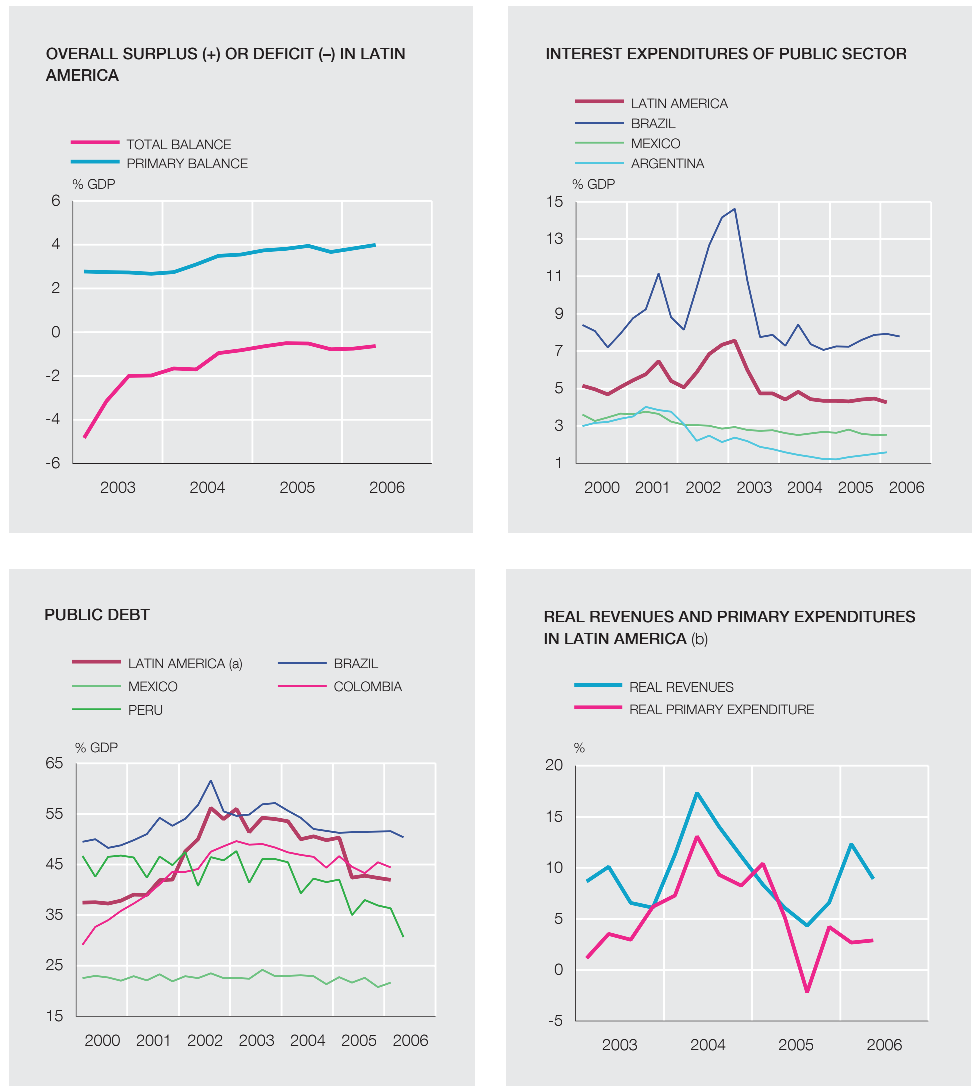
In any event, fiscal results continue to be positive, especially in a context of elections, which tend to generate pressures on expenditure. Primary expenditure in real terms turned down notably last year, from growth of over 10% to around 4% in year-on-year terms. Only in Argentina has there been a significant upturn in spending, extensive also to its provinces. In contrast, public revenue in the region continues to post high growth rates, of around 10%. The boom is a generalised one, although more marked in those tax systems that depend more on commodities revenue, such as Mexico, Venezuela and Chile. However, commitments to or uncertainty over greater future spending in some countries such as Brazil and Argentina might compromise the sound fiscal outlook.

TRADE INTEGRATION AND STRUCTURAL REFORMS

There were important movements in the trade area with a view to the reconfiguration of the Latin American regional blocs. On one hand, Venezuela's accession to MERCOSUR as a fully fledged member was formalised after it left the Andean Community. This departure was justified by the signing of the Free Trade Treaties by another two members, Peru and Colombia, with the United States. These treaties are pending discussion and approval in the US House, in the former case, and in the respective parliaments, in the latter. In both cases the timeline is significant, since the tariff benefits with the United States expire at the end of 2006. Conversely, Ecuador's ongoing negotiations with the United States reached an impasse following a conflict with a US oil company. After Venezuela's departure, Chile approached the Andean community and joined as an associate member in September, while it pursued its strategy of bilateral agreements (ratification of the agreement with China and negotiations with Japan, among others).

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

CHART 13



SOURCE: National statistics.

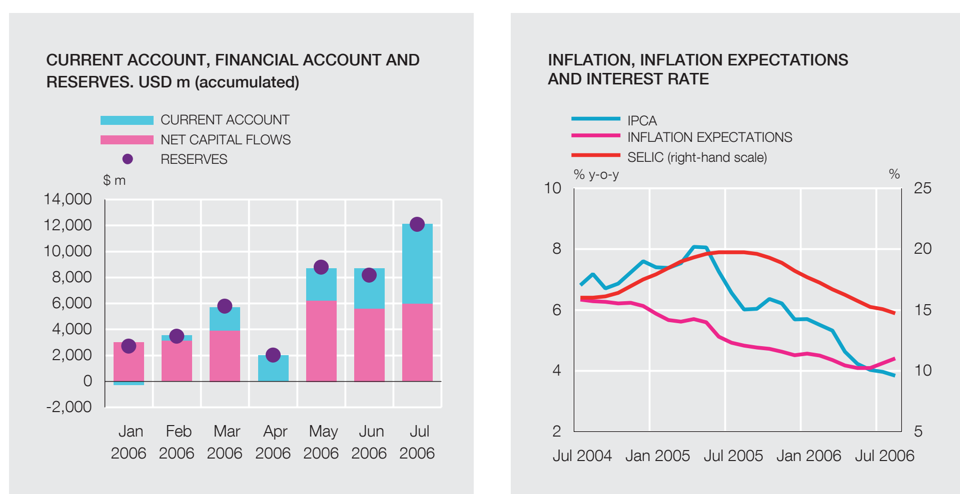
a. 2005 Q2: estimatlion excluding Argentina.
b. Deflated by CPI.

The new configuration of the regional blocs taking shape would reflect the two stances in the region in relation to trade integration. On one side is the Pacific bloc, which is more open and closer to the United States and, therefore, to the Free Trade Area of the Americas (FTAA). This bloc would include Mexico and, also, the Central American countries, whose free trade agreement with the United States (CAFTA) has not yet come fully into force. On the other side is the Atlantic bloc, represented by MERCOSUR, which is less in tune with US positions. Following Venezuela's accession and developments in recent years, MERCOSUR appears to be adopting an increasingly interventionist nature. In fact, the smallest countries in this bloc, Paraguay and Uruguay, asked to be able to enter into free trade agreements with other blocs or nations irrespective of the rest of the members, having disagreed with the course being followed.

Developments in the main countries

In *Brazil*, the year-on-year growth rate of GDP fell back to 1.2% in Q2 (the same rate as in the second half of 2005). The rise in 2006 Q1 (3.3%) proved fleeting, as a result of the fact that investment, after a notable pick-up in that quarter, resumed a year-on-year growth rate of

BRAZIL CHART 14

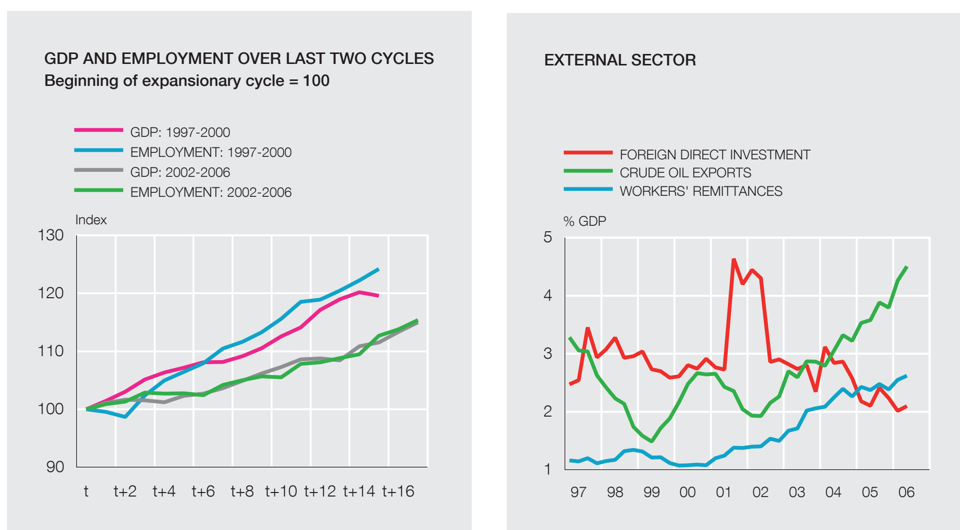


SOURCE: Central Bank of Brazil.

scarcely 2.9% in Q2, and that exports, which had been growing at a rate of close to 10% in the last year, once again posted a negative rate of change in National Accounts terms. Meanwhile, private consumption remained notably resilient and, indeed, quickened, underpinned by the strong growth of wage income and monetary easing, which are boosting credit. The growth of imports, at over 10%, led the negative contribution of the external sector to widen to 2.2 pp in Q2. In dollars, however, exports continued to grow, whereby the trade and current account surpluses stabilised at close to 6% and 2% of GDP respectively. The current account surplus and net capital inflows translated into an increase in reserves of more than $12 billion in the year to date (see Chart 14). This offset much of the decline in reserves associated with the refund of the IMF loan last year. As to fiscal results, in spite of the election campaign being waged and the replacement of the Minister of Finance, the primary surplus held above the figure of 4.25% of GDP set as a target. However, there has been a notable increase in committed public spending (increases in civil service wages and in pensions), which has restricted the government's room for manoeuvre and may affect fiscal stability in the future. Although high interest payments have allowed no more than a slight reduction in debt, measured in terms of GDP, debt management continued to pursue an improvement in its composition; specifically, debt indexed to the SELIC interest rate and external debt declined.

The most favourable aspect of the Brazilian economy was inflation and inflation expectations (see Chart 14). The inflation rate fell from 5.7% at end-2005 to 3.8% in August, and the underlying rate declined on a similar scale. Among the factors behind this process are the appreciation of the real and the effects of the official interest rate rises made by the central bank to September this year. The favourable behaviour of prices allowed the central bank to continue easing monetary policy, cutting the official interest rate by 375 bp during 2006, to which the 175 bp reduction in the closing months of 2005 should be added. Accordingly, the SELIC rate (14.25%) stood at its lowest level since 1997, and the yield curve continues to show a negative slope. The exchange rate appreciated notably to mid-May. This rising trend, which is a source of concern to the authorities, was harnessed to reform Brazilian foreign exchange legislation in August and to thus reduce the upward pressure on the real. The episode of financial turbulence temporarily eased pressure on the exchange rate (it depreciated by around 15% in one month, but has since held on a rising path). Both the sovereign spread – which narrowed by almost 100 bp between January and May to historical lows – and stock markets posted similar behaviour, comprising a correction and subsequent recovery. In the case of the markets,

MEXICO CHART 15



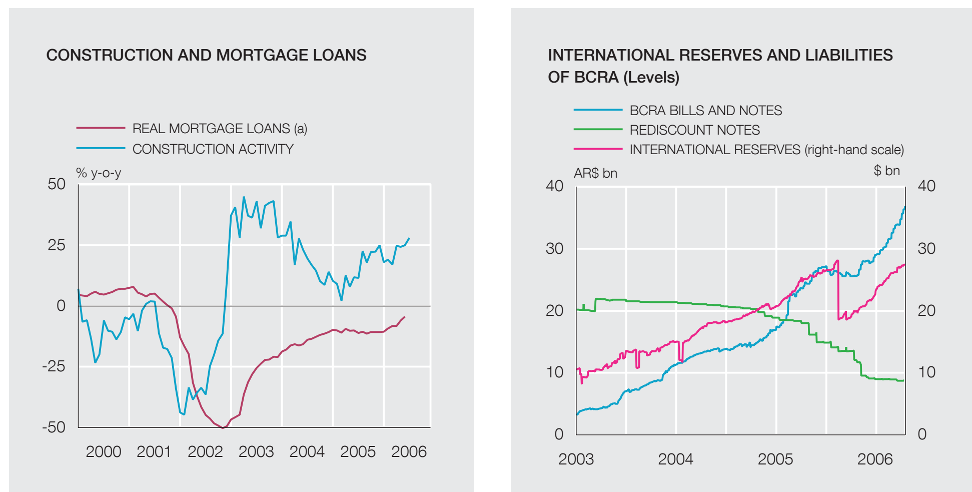
SOURCES: INEGI and Banxico.

the recovery did not provide for a resumption of the levels attained in May. Despite the strong capital inflows on the debt and stock markets in the preceding period and although the greater liquidity of the Brazilian market tends to make for greater volatility, the scale of the correction was approximately in line with the average for the region (see Chart 9). In terms of structural reforms, there has been no significant progress in recent quarters in the run-up to the October presidential election.

In *Mexico* economic activity quickened notably in the first half of the year to an annual growth rate of 5.1% (5.5% in Q1 and 4.7% in Q2), compared with growth of 3% in the second half of 2005. This is the biggest growth rate posted since the second half of 2000. Higher growth was driven by domestic demand, whose growth rose to 6% in Q2. There was a particularly notable acceleration in government consumption (related to the July elections) and in investment, while private consumption continued to grow at a rate of over 6%. Underpinning consumption was the acceleration in job creation, with a growth rate of over 6%, although many of the jobs generated are temporary and the rate of increase is still less sharp than in previous cycles (see Chart 15). The contribution of the external sector (–1.2 pp in both quarters) was slightly more negative than in previous periods. Despite this and chiefly as a consequence of the improved terms of trade associated with oil prices, the trade balance posted a surplus in 2006 Q1 (for the first time in the last nine years) and ran a small deficit in Q2. The current account balance was very close to equilibrium in the first half of the year, following five years of gradual correction. Contributing to this behaviour is the growing inflow of remittances, which have become one of the most dynamic components of the external accounts (behind crude oil exports), exceeding even inward foreign direct investment (see Chart 15). The fiscal balance moved into a surplus position (0.6% of GDP) in the first half of 2006, owing to the fact that the growth of public revenue – because of both oil-related resources and tax revenue – more than offset the rise in public spending, which was partly associated with the presidential and general elections held in July.

Inflation rose in the first two months of the year owing to seasonal factors, gradually declining thereafter and standing since at over 3% (at the centre of the central bank's target interval), while underlying inflation has been increasing very slowly (by 0.2 pp in terms of its 12-month growth during 2006 to 3.3% in August). Against this background, the central bank interrupted in April the process of monetary easing initiated in August 2005 and which had entailed a de-

ARGENTINA CHART 16



SOURCES: BCRA and INDEC.

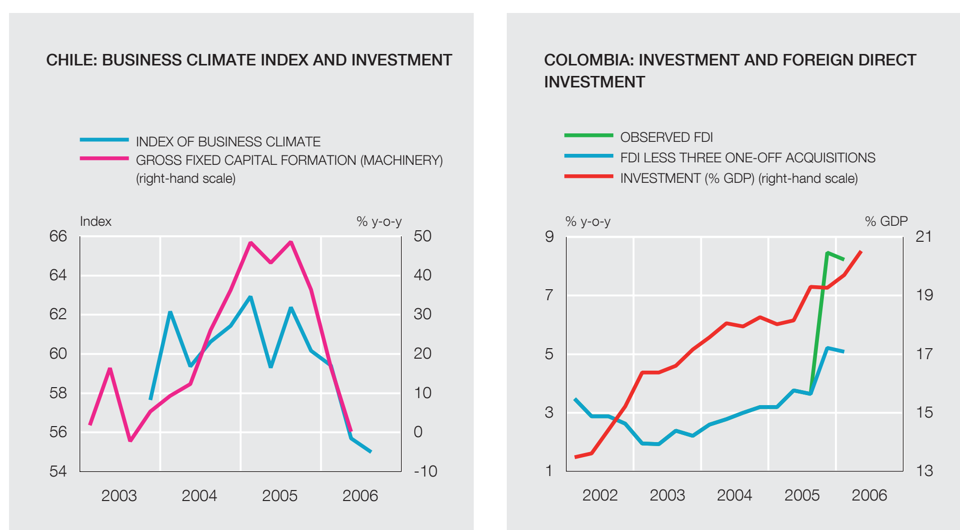
a. Total real mortgage loans in national and foreign currency.

cline of 275 bp in the bank funding rate to 7% and, since the last interest rate cut, the yield curve has maintained a slightly positive slope. The exchange rate of the peso against the dollar began to move on a depreciating course in February, which steepened with the financial turbulence. From June, however, it began to appreciate moderately, without regaining its levels at the start of the year. As discussed in Box 3, high oil revenue continued to boost international reserves, up to levels never previously recorded, which has led to an increase in daily foreign exchange intervention selling dollars in accordance with a regulated mechanism. Stock market indices peaked in early May, at which point a 25% decline ensued until the end of June. The rises seen during July and August enabled levels close to the annual high to be regained. The presidential elections resulted in an extremely tight winning margin for the continuity candidate, whose party also attained a relative majority in Parliament. The opposition candidate did not accept the electoral result, giving rise to the complicated institutional situation which, however, has hardly been reflected to date in the financial indicators.

In *Argentina*, economic activity slowed slightly in the first half of the year, standing at a year-on-year growth rate of 7.9% in Q2. This slowdown in output is due to the lower growth of domestic demand, especially investment in equipment. In contrast, investment in construction continued at a year-on-year growth rate of over 22% and, moreover, mortgage loans have shown the first signs of recovery (see Chart 16). Private consumption held at a similar growth rate to that of output in both quarters, driven by increases in employment of over 5% year-on-year. In the first half of the year, the excellent performance of the trade balance continued and the surplus on the current account balance widened due to the improvement in the incomes balance, associated with lower interest payments. The primary fiscal surplus run by the central government stood above the target set in the 2006 budget, but below that recorded in 2005. However, the data released on the provincial fiscal situation, the legal rulings that oblige the government to increase certain pensions and the amendment of the Financial Management Law – which grants greater budgetary powers to the government – pose some uncertainty about the future course of public finances.

The uptrend in inflation recorded in the second half of 2005 was interrupted, assisted by the price agreements on some products and the regulation of certain charges. The 12-month

CHILE AND COLOMBIA CHART 17



SOURCES: Central Bank of Chile, ICARE, Central Bank of Colombia and National Statisitics Department of Colombia.

inflation rate dipped from 12.3% in December to 10.7% in August and, moreover, inflation expectations lessened. However, price developments continue to be the main factor of concern, since inflationary pressures might be renewed following the approval of the increases in gas and electricity charges (which have not yet gone up in practice). The central bank continued very gradually to tighten monetary policy, but monetary conditions remain lax, as testified by the still-negative real interest rates. The pace of money issuance linked to high intervention on the foreign exchange market was maintained (allowing the reserves in the prepayment operation to the IMF at the beginning of the year to be restored in their virtual entirety and the exchange rate of the peso against the dollar to hold stable), despite the attempts at sterilisation through the net placement of bills and the cancellation of rediscounts granted during the crisis (see Chart 16). The financial turbulence was also felt on the Argentine markets, with corrections in stock market indices and the widening of sovereign spreads, along with the interruption of dollar purchases by the central bank. Subsequently, these movements reversed, in their entirety for the sovereign spread and only partially for the stock market indices.

Economic activity in *Chile* continued to slow in the first half of 2006. There was a dip in growth from 5.8% in the last two quarters of 2005 to 5.3% and 4.5%, respectively, in the first two quarters of 2006. The main explanatory factor behind this was the collapse in investment, especially in machinery and equipment, which declined from a year-on-year growth rate of over 40% in the second half of 2005 to a rate of 0.2% in Q2 this year (see Chart 17, which also shows the decline in the business confidence index). Consumption continued to grow at a high rate, given strong job creation and the buoyancy of bank credit. The negative contribution of the external sector (–3.5 pp) fell in relation to the previous quarters, owing to the slowdown in imports. The improvement in the terms of trade, chiefly as a result of the high price of copper, led to a sharp improvement in the surplus on the trade balance, which exceeded in the first half of 2006 the annual total for the whole of 2005 which, in turn, had been an all-time high. However, as has recently been the case, this exceptional trade surplus was largely offset by the increase in the deficit on the incomes balance, due to the higher repatriation of profits generated by foreign direct investment. Also, the high price of copper, along with the buoyancy of domestic demand and the limits on spending prompted by the structural surplus rule,

allowed the budget surplus to reach an historical high in the first two quarters of the year. Given this exceptional position in public finances, there was industrial action in various industries demanding, among other things, increases in public spending. Inflation held at close to 4% (the upper limit of the central bank's target interval), owing to fuel prices, since underlying inflation dipped to 3% (at the centre of the target interval). Against this background, the central bank continued the process of interest rate rises, but at a lesser pace than in 2005, as it implemented a sole rise of 25 bp per quarter, taking the official interest rate to 5.25%. Notably, unlike in other countries in the region, the sovereign spread held stable after having risen during the financial turbulence. This was due above all to the negative trend of the debt spread of state-owned companies, which are also included in the calculation of the EMBI. As regards reforms, the government unveiled structural measures aimed at boosting growth and competitiveness in the economy.

Growth in *Colombia* quickened notably in relation to 2005 Q4, placing the year-on-year growth rate at 5.9% in 2006 Q2, thereby resuming a growth rate similar to that recorded in the previous quarters of 2005. The contribution of domestic demand to growth stood at 9.5 pp in the six-month period, with the growing contribution of investment particularly to the fore, assisted in turn by the sharp rise in foreign direct investment, which is notable even when certain recent exceptional transactions are stripped out (see Chart 17). The contribution of the external sector remained strongly negative (4 pp), in view of the sharp slowdown in exports, which translated into an increase in the trade deficit. The deterioration in the trade balance, along with higher interest payments and a reduction in inflows in the form of remittances, prompted an increase in the current account deficit. From the fiscal standpoint, the data for the first half of the year show progress in public finances to have firmed. Inflation held at a rate of below 4% in the first half of the year, but it has risen in recent months, drawing close to the upper limit of the central bank's target interval (4%-5%). Against this backdrop, there were three consecutive rises in interest rates (by 25 bp on each occasion) between May and August, taking them up to 6.75%. The financial indicators were the most affected in the region during the turbulence in May, owing to limited market liquidity and to the more marked improvement in the previous quarters, although the recovery has also been notable in recent months. The government obtained an absolute majority in the presidential and general elections, which have given it ample room for manoeuvre to tackle anew the reforms outstanding in the fiscal and other areas.

In *Peru*, the dynamism of the economy remained high, though diminishing (year-on-year growth of 6% in Q2). Domestic demand was mainly underpinned by investment, which quickened notably. The negative contribution of the external sector (amounting to almost 2 pp on average in the half-year period) is the main new development in respect of the growth pattern. This change can be explained by the strong slowdown in exports which, after posting double-digit growth in the previous quarters, dropped to growth of scarcely more than 1% in the first half of the year. Despite this, the surplus on the trade balance widened to 9% in Q2, and the current account balance was once again in surplus, given the high price of exported commodities, which also explains why public finances posted the most favourable figures in recent years. After rising to March, inflation dipped again in the following months to below 2%. Notwithstanding, the central bank raised its official interest rate six times (25 bp each month) from December 2005 to May 2006, among other reasons to counter expectations of a currency depreciation, linked to uncertainty over the results of the presidential elections, against a background of high financial dollarisation. The sovereign spread and the stock market indices did not behave so adversely in May as in other neighbouring countries, since the fears associated with the electoral outcome, which generated some volatility at the start of the year, abated once the first-round results were known.

In *Venezuela*, economic activity remained strongly dynamic in the first half of 2006, with growth of 9.2% in Q2, stemming almost in its entirety from the non-oil sector. Domestic demand quickened, especially in Q2, when it posted a year-on-year growth rate of 17.1%, despite the slowdown in private consumption. The negative contribution of the external sector continued to increase during the half-year period, rising to almost 9 pp, owing to the decline in exports and the acceleration in imports. Despite this, the trade surplus widened owing to high oil prices, which led to the current account surplus reaching a record high during Q2. In contrast, direct investment flows into the country were negative during the first half of the year, owing to the sale of foreign-held shares to resident investors, and to the cancellation of private-sector oil corporations' bonds to their parent companies. Fiscal policy continues to be notably expansionary. Inflation slowed to May (without dipping below the 10% ceiling), but rebounded to almost 15% in August. These pressures on prices reveal excessive liquidity that harbours inflationary risks for the future. Finally, mention should be made of the elimination of the tax on bank debits, the creation of a new tax on hydrocarbons exports and several operations relating to public debt management, aimed at lengthening the maturity of public debt and reducing the proportion of external debt.

In *Uruguay*, growth in Q2 rose to 9.1% year-on-year. Driven by the notable pace of growth, the trade deficit worsened during the six-month period. At slightly below 7%, year-on-year inflation gradually increased from the start of the year. In the fiscal realm, the primary surplus progressively increased to 3.6% of GDP in July, in line with the government forecast for 2006. Mention should also be made of the early cancellation of a portion of the debt with the IMF in March and July 2006. This initiative by Uruguayan institutions is part of a more efficient debt management programme, although the debt replaced continues to be issued in dollars, whereby potential balance sheet problems persist. In *Ecuador*, growth quickened in Q1 (a growth rate of 5.6% year-on-year), thanks to the fact that the greater buoyancy of domestic demand more than offset the negative contribution of the external sector. Inflation, meanwhile, after undergoing increases in Q1, moved back to a year-on-year rate of 3%, the same as the end-2005 figure. In *Bolivia*, the new government ordered the nationalisation of energy resources in May, royalties were raised from 50% to 82% for certain operations, the price of gas for export to Argentina increased and a process of renegotiation of contracts with foreign companies was initiated. The impact of these measures, besides seriously damaging the country's attractiveness to investors, is already translating into difficulties in the operation and management of gas resources.

29.9.2006.