HALF-YEARLY REPORT ON THE LATIN AMERICAN ECONOMY

Introduction

Over the past six months the Latin American economies continued to benefit from a clearly favourable external environment, both in terms of the growth of the world economy, and of financing and market-access conditions. Against the background of the ongoing firming of domestic demand and further improvements in the terms of trade, activity in the region quickened in 2006 to an annual average growth rate of 5.3%, compared with 4.5% in 2005. This was the third year running in which the expansion exceeded 4%.

During the second half of the year the pick-up in growth was more generalised than in the first six months. With the sole exceptions of Mexico and Chile, whose growth rates tended to ease, the region's economies accelerated appreciably, in contrast to the mild slowing trend of the world economy. In terms of components, there was a step-up in the trends observed in 2005: first, there was an additional boost from domestic demand, which contributed more than 7.5 pp to growth in 2006; and further, the negative contribution of external demand increased considerably to -2.2 pp. Notwithstanding, the current account balance was positive (1.9% of GDP), thanks to the fact that the terms of trade notably provided for a sizeable additional boost higher even than that recorded in the previous four years.

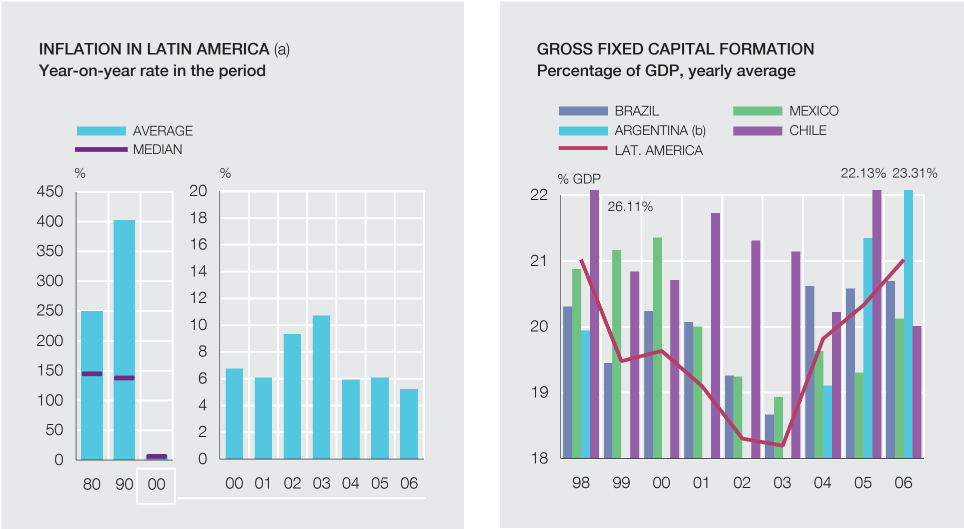
A key difference in relation to the first half of the year was the behaviour of investment, which underwent a relatively generalised recovery in the second half of the year, enabling the highest investment/GDP ratios for recent years to be attained, similar to those of the late 90s (see Chart 1). The recovery in investment, if it takes root, may prove pivotal for prolonging the current upturn in the economy and making it more sustainable. In this respect, it is worth highlighting the role that the improved terms of trade have played in recent years in respect of public-sector and corporate saving when explaining some of the most significant recoveries in investment in the region. Overall, the recent strengthening of domestic demand entrenches a "classical" economic cycle for the Latin American economies in which, following an initial impulse from the external sector in 2002-2003, there has been a pick-up in domestic demand. Taking a longer view, the mere existence of a prolonged cycle with few imbalances in most of the countries is a major achievement for a traditionally volatile region. Moreover, the ongoing expansion is unfolding against a backdrop of inflation that continued to ease in 2006, especially in the first half of the year, dipping to an annual average rate of 5.2%, the lowest posted in Latin America as a whole since reliable records first began (see Chart 1). In this setting, monetary policy developments followed diverging courses in the second half of the year, as in some countries the upward cycle of official rates continued while in others the downward cycle continued or resumed.

The behaviour of the financial markets was clearly favourable throughout the six-month period, this being interrupted only in the last month and a half by the emergence of fresh turbulence on international markets. Perhaps the key financial development in Latin America has been its ability to uncouple itself from some of the traditional determinants of its sovereign risk premia. These include, for example, expectations about the course of official interest rates in the United States (which fluctuated considerably during this period) or about long-term interest rates on the dollar. But mention should also be made of the scant impact not only of external turbulence but also of certain events originating in the region, such as the uncertainty arising from the possibility of debt restructuring in Ecuador, or the start of a process of re-nationalisation of strategic industries in Venezuela. These favourable developments translated into a narrowing of sovereign spreads, which reached minimums, strong stock market gains and currency ap-

INFLATION AND GROSS FIXED CAPITAL FORMATION

CHART 1

Year-on-year rate and percentage of GDP



SOURCE: National statistics.

a. Aggregate of the eight largest economies.
b. Below 18% from 2000 to 2003 (18% in 1999), with an average of 14.32%.

preciations (practically across the board but with varying intensity from country to country) until late February. The appreciating trend was checked with relative success, giving rise to a significant build-up in reserves by some central banks, which poses growing economic policy dilemmas in certain countries.

In the last month there was a strong correction in risk-bearing financial asset prices. Nonetheless, the resilience shown by emerging financial markets subsequently proved notable, despite the relative intensity of the episode and its global nature, against a background of sound macroeconomic fundamentals. In this respect, from the standpoint of market discipline the strong decline in sovereign spreads in Argentina is striking. Indeed, Argentina has been able to finance itself in dollars only four years after its debt default (although issues are admittedly being confined to the domestic market), paying a spread of less than 200 bp over risk-free assets.

Against this backdrop, the outlook remains favourable for maintaining relatively dynamic growth rates in the region as a whole, even if the negative contribution of external demand continues, as seems likely, to intensify. However, the gradual slowdown in world demand and the persistence of very high growth rates in some countries in recent years may herald some easing in the pace of growth in the area over the next two years. And a factor of uncertainty compounding this is the recent increase in volatility on financial markets. Indeed, taking a medium-term view, it should be questioned to what extent growth rates in the region such as those at present would be sustainable if the external environment were different and, also, were there to be no move away from the traditional dependence on the US business cycle towards that of other large-scale commodity-consuming economies such as China and India, exposing the region to other types of vulnerabilities. Further, the high external exposure to inherently volatile commodities prices, in a setting in which the increase in volume exports has been scant, may, as so often in the past, prove a factor of vulnerability for public finances, the external balance and, indirectly, the growth of some of these economies in the future.

Economic and financial developments

EXTERNAL ENVIRONMENT

The international economic environment continues to underpin clearly favourable developments in the emerging economies as a whole and, in particular, in Latin America (see Chart 2). In the United States, once the fears of a significant slowdown in the economy owing to the effect of an adjustment in the real estate sector abated in the final months of the period under study, most indicators tended to signal the continuing and notable robustness of the other sectors. This contributed decisively to firming expectations about a gradual and orderly easing in growth in 2007. Inflation tended to decline, largely as a result of the strong fall in oil prices. Economic activity rose in Japan in Q4 following a slump in Q3 as a result of the sluggishness of private consumption, while in the euro area economy the signs of dynamism tended to take root. In China, the high growth rate seen in recent quarters continued, as did the risk of the economy overheating, with no clear signs of it cooling despite the economic policy measures adopted in this connection in recent months.

Against this background, the Federal Reserve held its official interest rate unchanged at 5.25% from June. The Bank of Japan raised its benchmark rate by 25 bp to 0.50% in February, while the European Central Bank also raised its key interest rate on three occasions from October, taking it to 3.75% in March. Despite the stability of US official interest rates, long-term interest rates oscillated in a relatively wide range by recent standards between 4.3% in December and 5% in February. A possible influence here was the greater difficulty in forming expectations about growth and inflation, at the juncture of a change in cycle, and the consequently greater uncertainty when anticipating the monetary policy reaction. All told, the yield curve, measured as the difference between the ten-year and three-month interest rates, remained throughout the period in negative territory, which suggests that the market anticipates a scenario of moderating growth in the medium term for the US economy.

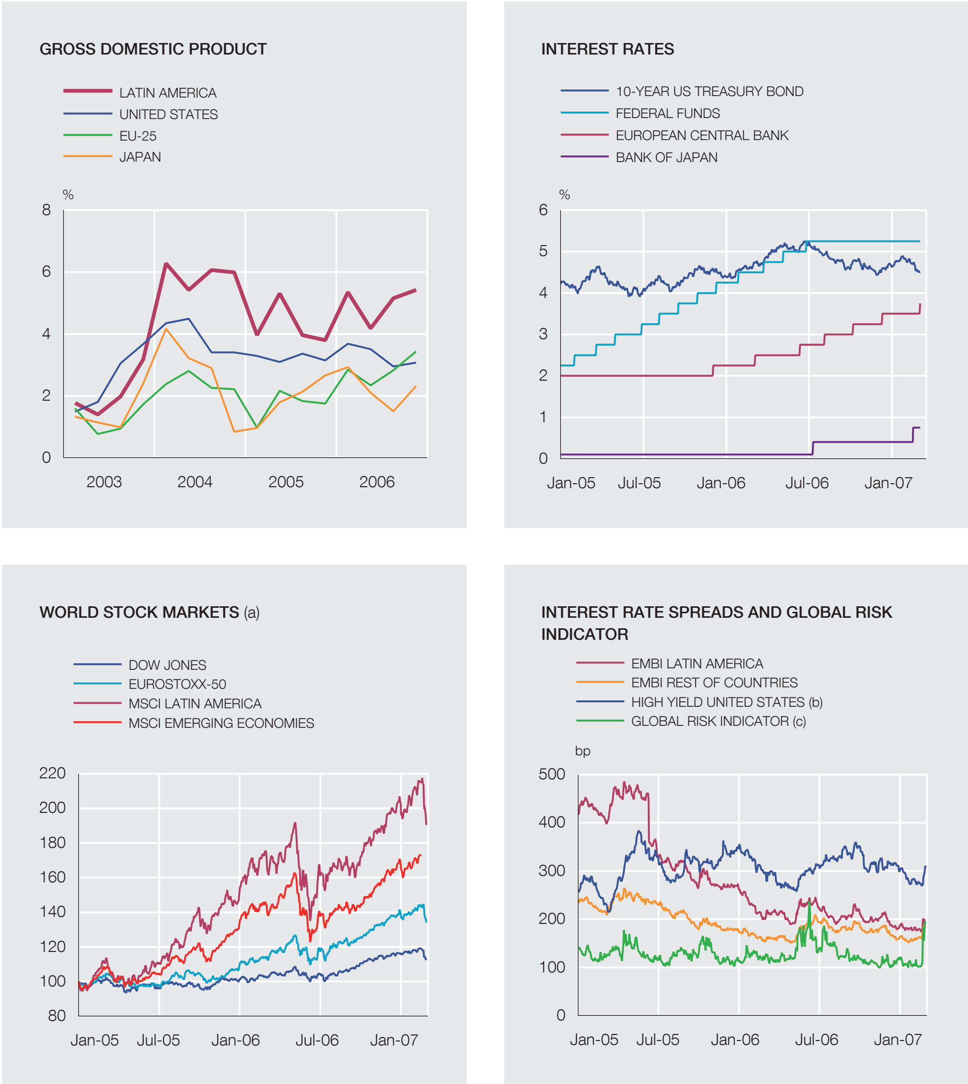
Between late February and early March there was a sudden change in market expectations towards greater risk aversion, triggered mainly by the sharp correction on the Chinese stock exchange and heightened uncertainty over the scale of the slowdown in the United States, linked to the deterioration in certain mortgage market segments. Investor disquiet particularly affected higher-risk assets, with stock market losses across the board, a marked increase in implied volatility and a significant widening of the lowest-grade corporate bond spreads. Sovereign debt spreads also widened and the main currencies depreciated, while instruments traditionally considered to be a safe haven - such as the industrialised countries' treasury bonds and also the yen - benefited.

On the foreign exchange markets, the dollar depreciated by around 3% against the euro in relation to September. Of most interest when interpreting some of the recent trends on emerging markets was the depreciating course of the yen against the dollar and the euro. This depreciation intensified in the closing months of the year and early 2007, with a loss of around 5% against the dollar since September. The lower level of interest rates in Japan and the continuing environment of low volatility on financial markets may have borne on the proliferation of the so-called carry trade (borrowing in yen and on-lending in high-yielding currencies), especially against the background of the widespread improvement in the emerging economies' fundamentals. Here the sudden appreciation of the yen by almost 5% between February and March, associated with financial turbulence, and the simultaneous widening of emerging-economy sovereign spreads are a sign of the high interrelatedness of markets and also of the degree of sensitivity of current valuations to potential future increases in volatility.

The main international stock markets moved on a strong rising trend over the period as a whole, and this was even more significant in the case of the emerging markets, coinciding with the release of sound corporate earnings results (Chart 2). The US Dow Jones index, the Euro-

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

pean bourses and the Nikkei index increased by around 15% from September to February. However, the turbulence in the February-March period prompted corrections of close to 10%.

A crucial factor affecting financial markets in this period was the decline in oil prices by around 3%. Certain metal commodities followed suit, after having posted considerable rises in the previous months. Oil prices dropped to a level below $52 per barrel in mid-January, the lowest since June 2005, picking up once more in early February to a price of over $60.

Against this backdrop, the emerging markets continued to perform very favourably, exhibiting notable resilience to certain bouts of turbulence. The Asian and Eastern European MCSI indices climbed by around 20% to February, with an even higher figure for the Latin American index, although it was subsequently corrected significantly. Sovereign spreads also behaved soundly, narrowing in all regions to historical lows. In Asia, the EMBI Global spread narrowed

LATIN AMERICAN GDP
Year-on-year change, unless otherwise indicated

CHART 3

SOURCE: National statistics.

by around 50 bp from September 2006 to March 2007, while the related Eastern European and Latin American spreads did so to a lesser extent, and the US junk bond spread tended to be squeezed (Chart 2). With the correction in recent days, sovereign spreads have tended to resume their September levels, with the exception of those in Asia, which are still slightly lower.

ACTIVITY AND DEMAND

Latin American economic activity quickened notably during the second half of 2006. Over the year as a whole the annual average growth rate stood at around 5.3%, compared with 4.5% in 2005, making for the third consecutive year of growth of over 4% (see Chart 3 and Table 1). Activity would have accelerated significantly in year-on-year terms in the second half of the year, partly as a result of growth in Brazil, but also in Argentina and the main Andean economies (Venezuela, Colombia and Peru). Compared with the same period a year earlier, growth in Q4 was 5.8%. In quarter-on-quarter terms, growth was also more robust in Argentina and Brazil, but not in Chile and Mexico. In the region as a whole, quarterly growth rates were simi-

LATIN AMERICA: MAIN ECONOMIC INDICATORS

TABLE 1

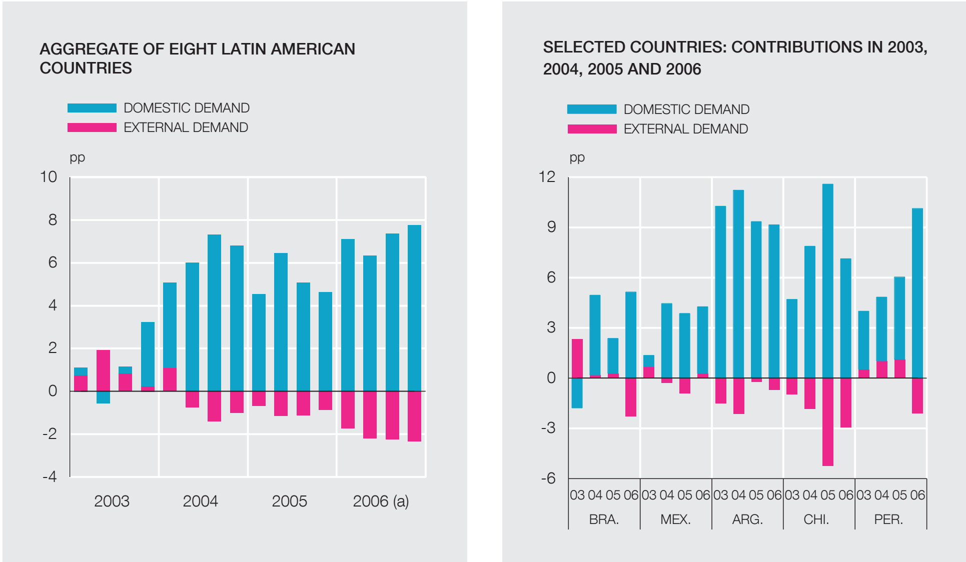
	2003	2004	2005	2006	2005				2006			
					Q1	Q2	Q3	Q4	Q2	Q2	Q3	Q4
GDP (y-on-y change) (b)												
Latin America (a)	2.3	6.3	4.5	5.3	4.2	5.0	4.7	4.2	5.6	4.3	5.7	5.8
Argentina	8.8	9.0	9.2	8.5	8.0	10.4	9.2	9.0	8.8	7.7	8.7	8.6
Brazil	0.5	5.7	2.9	3.7	2.8	2.8	3.1	3.1	4.1	1.5	4.5	4.8
Mexico	1.4	4.2	2.8	4.8	2.4	3.2	3.1	2.5	5.5	4.9	4.5	4.3
Chile	3.9	6.0	5.7	4.0	6.3	7.3	5.2	4.2	5.0	4.0	2.6	4.3
Colombia	4.0	4.9	4.7	6.8	5.0	6.9	5.9	1.5	5.5	6.5	7.6	6.8
Venezuela	-7.7	18.3	10.3	10.3	8.4	11.7	10.2	10.9	9.8	9.4	10.1	11.8
Peru	3.8	5.2	6.4	8.1	5.9	5.9	6.3	7.7	8.0	6.5	9.2	8.5
Uruguay	2.5	12.0	6.6	7.1	6.6	7.3	5.6	6.9	7.1	7.8	7.2	6.1
CPI (y-on-y change)												
Latin America (a)	10.9	6.0	6.3	5.2	6.5	6.7	6.0	6.0	5.8	5.1	5.1	4.9
Argentina	14.9	4.4	9.6	10.9	8.2	8.8	9.8	11.7	11.6	11.4	10.6	10.1
Brazil	14.8	6.6	6.9	4.2	7.4	7.8	6.2	6.1	5.5	4.3	3.8	3.1
Mexico	4.6	4.7	4.0	3.6	4.4	4.5	4.0	3.1	3.7	3.1	3.5	4.1
Chile	2.8	1.1	3.1	3.4	2.3	2.8	3.3	3.8	4.1	3.8	3.5	2.2
Colombia	7.1	5.9	5.1	4.3	5.2	5.0	4.9	5.1	4.2	4.0	4.6	4.3
Venezuela	31.4	21.7	16.0	13.7	17.0	16.3	15.4	15.2	12.6	11.2	14.6	16.1
Peru	2.3	3.7	1.6	2.0	2.2	1.8	1.2	1.3	2.4	2.3	1.8	1.5
Uruguay	19.4	9.2	4.7	6.4	5.6	4.5	3.9	4.8	6.4	6.4	6.6	6.2
PUBLIC-SECTOR BALANCE (% GDP)												
Latin America (a) (c)	-2.0	-0.8	-0.8	-0.7	-0.7	-0.5	-0.5	-0.8	-0.8	-0.7	-0.7	-0.7
Argentina	0.4	2.6	1.8	1.8	2.6	1.5	1.5	1.6	1.6	1.7	1.8	1.7
Brazil	-3.6	-2.5	-3.1	-3.2	-2.6	-2.8	-2.9	-3.3	-3.9	-3.4	-3.5	-3.4
Mexico	-0.7	-0.3	-0.1	0.1	-0.5	-0.5	0.0	-0.1	0.1	0.4	0.3	0.1
Chile	-1.4	2.4	4.7	8.0	3.2	4.0	4.4	4.7	6.3	6.6	7.9	8.0
Colombia (c)	-2.6	-0.6	-0.5	-0.9	-0.6	-0.7	-1.7	-0.5	-0.1	0.3	…	…
Venezuela (c)	-4.3	-2.7	2.6	-3.6	-0.1	3.2	5.2	2.0	0.3	-3.0	-1.6	…
Peru	-1.8	-1.3	-0.7	1.3	-2.2	-2.5	-2.6	-2.8	-2.8	-3.0	-3.1	-3.0
Uruguay	-4.6	-0.9	-0.5	-0.8	-0.8	-0.8	-1.0	-0.5	-0.2	-0.8	-0.7	-0.8
PUBLIC DEBT (% GDP)												
Latin America (a) (c)	54.4	49.6	42.1	41.1	50.6	42.4	42.7	42.1	42.5	40.3	40.7	41.1
Argentina	141.0	125.7	70.7	…	121.6	66.2	66.6	66.8	69.0	59.1	59.9	…
Brazil	57.2	51.7	51.5	50.0	51.3	51.4	51.5	51.5	51.6	50.4	49.8	50.0
Mexico	24.7	23.0	22.4	23.3	22.7	21.6	22.6	20.8	21.7	21.3	23.9	22.7
Chile	13.3	10.7	7.2	5.3	9.8	8.5	7.6	6.8	6.2	5.5	5.4	5.2
Colombia	50.9	46.4	46.5	…	49.7	45.2	42.4	42.7	49.0	46.4	41.3	…
Venezuela	56.9	53.3	48.2	…	47.1	48.7	50.1	48.2	36.1	38.2	43.1	…
Peru	47.7	44.3	37.7	32.7	42.0	35.0	38.0	36.9	36.0	30.4	31.2	30.4
Uruguay	108.3	100.7	83.8	…	78.9	81.2	82.5	83.8	73.6	75.4	76.1	…
CURRENT ACCOUNT BALANCE (% GDP)												
Latin America (a) (c)	0.8	1.4	1.8	1.9	1.4	1.4	1.5	1.8	1.9	1.9	1.9	…
Argentina	6.1	2.3	3.1	3.8	2.0	1.6	2.4	3.1	3.5	3.7	3.4	3.8
Brazil	0.8	1.7	1.6	1.3	2.0	1.8	1.8	1.8	1.5	1.2	1.3	1.3
Mexico	-1.5	-1.0	-0.6	-0.2	-1.1	-1.1	-0.9	-0.6	-0.2	-0.1	-0.2	-0.2
Chile	-1.5	2.2	1.1	3.6	1.9	1.5	0.9	1.1	1.7	2.8	3.9	3.6
Colombia (c)	-1.7	-0.9	-1.5	-1.7	-0.7	-0.7	-1.4	-1.5	-1.6	-1.9	-1.7	…
Venezuela	13.4	15.3	22.3	19.5	15.5	17.5	20.7	22.3	23.6	24.2	22.5	19.5
Peru	-1.7	0.0	1.4	2.6	0.3	0.7	0.9	1.4	0.9	1.2	2.2	2.6
Uruguay (c)	0.5	0.3	0.2	0.0	-0.2	0.0	0.0	0.2	0.2	-0.3	-1.1	…
EXTERNAL DEBT (% GDP)												
Latin America (a) (c)	46.7	39.9	27.5	24.2	40.3	31.6	29.9	27.5	26.0	23.6	23.6	24.2
Argentina	119.8	112.5	62.5	51.4	107.5	61.9	61.4	59.1	56.0	48.3	49.8	47.8
Brazil	40.1	28.9	19.2	…	32.0	28.1	24.8	21.3	18.9	16.5	15.8	…
Mexico	22.1	20.4	16.8	…	19.8	17.6	17.2	15.4	15.3	15.6	16.0	…
Chile	54.8	45.9	37.8	32.9	40.8	38.6	37.2	33.5	32.8	31.5	33.1	32.2
Colombia	44.9	40.2	31.3	…	36.2	31.2	28.8	28.3	30.6	29.4	28.1	…
Venezuela	48.3	43.1	39.8	31.7	35.8	38.9	38.6	39.3	31.3	28.9	29.2	29.6
Peru	48.3	44.8	36.1	30.4	42.6	35.4	36.4	35.3	34.4	28.9	29.3	28.3
Uruguay	98.0	87.6	68.6	…	67.1	67.4	67.3	68.6	59.0	59.7	59.5	…

SOURCE: National statistics.

a. Aggregate of the eight countries included in the table.
b. The GDP data for Chile and Brazil have been revised further to the methodological change in March 2007 in both countries. The public-sector balance, public debt and external debt ratios do not yet include the revision of the GDP series.

CONTRIBUTIONS TO GDP GROWTH
Percentage points

CHART 4



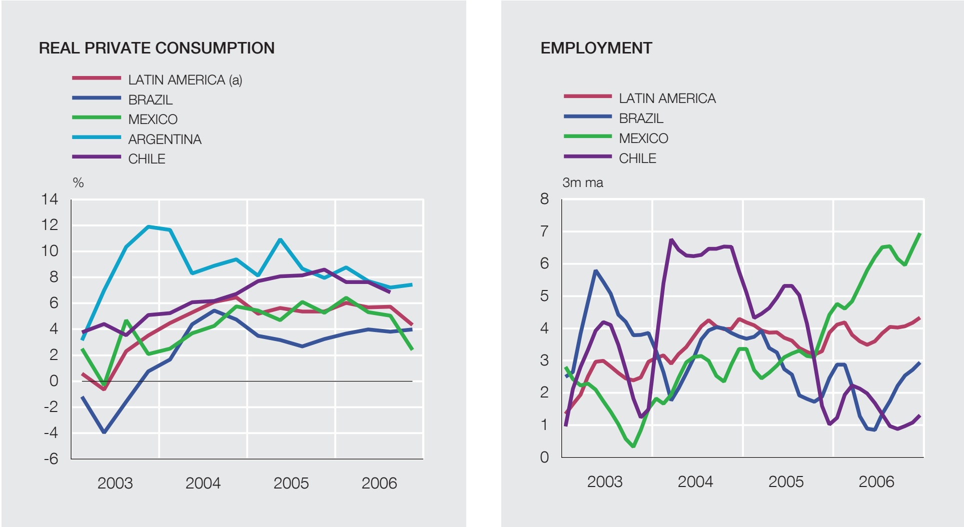
SOURCE: National statistics.

lar to those in the first half of the year. In terms of the contribution to the region's aggregate growth in 2006 as a whole, Brazil contributed 1.4 pp followed by Mexico (1.3 pp) and Argentina (1.1 pp).

The composition of growth tended to accentuate the trends observed in the first half of the year, namely the firming of domestic demand as the driving force of the expansion, with a contribution of 8.2 pp in the second half, and the accentuation of the negative contribution of external demand, both features being characteristic of a relatively mature phase of the cycle (see Chart 4). Private consumption maintained a growth rate of 6% on average, similar to the first half of the year (see Chart 5). This favourable trend in consumption is set against a generalised improvement in employment, the growth of which stood slightly above 4% on average in the area in 2006, similar to 2005, and a progressive rise in real wages, the average growth of which in 2006 was 5%. The unemployment rate dipped by 0.4 pp in relation to 2005, standing at around 8.5% of the labour force. Yet under this generally favourable labour market setting, the differences from one country to another were appreciable: there were strong increases in the growth rate of employment in countries such as Argentina and Mexico (where it quickened to 7%, albeit with a strong temporary-employment component), and more moderate growth in Brazil and Venezuela. The rise in real wages continued to be particularly significant in Argentina and Venezuela, running at around 8% and 20%, respectively. In Brazil and Mexico, real wages held stable and in Chile they rose very moderately. The rise in consumer confidence indices and the strong expansion of private-sector credit, which sustained growth rates of around 20% in the area as a whole, shaped a very favourable environment for a continuing and robust pace of private consumption growth.

Nonetheless, the main distinguishing feature of economic developments in the period was the firming of investment and, in particular, of investment in capital goods, the performance of which had, up to the first half of the year, been volatile and divergent across the region's countries. The favourable growth expectations for the area, the saving capacity generated by the persistent improvement in the terms of trade and low real interest rates – with the notable

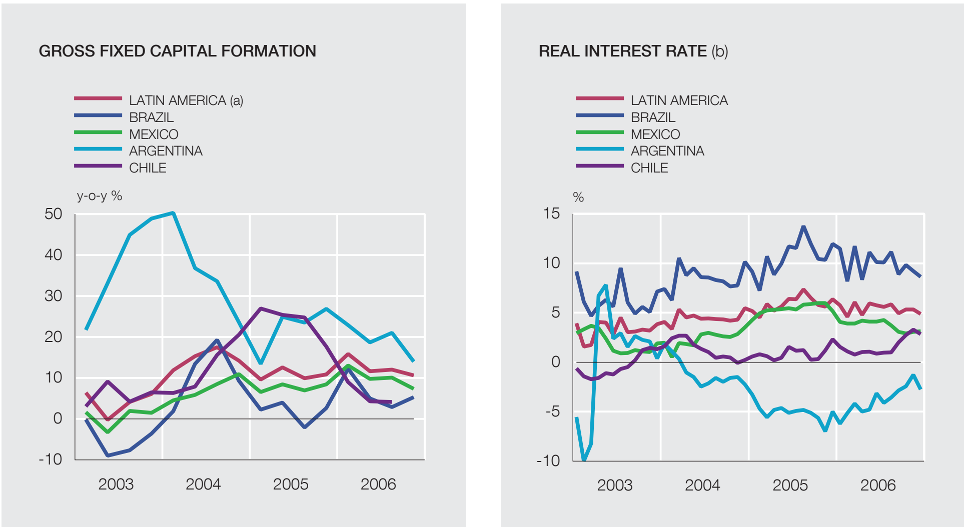
PRIVATE CONSUMPTION AND LABOUR MARKET CHART 5
Year-on-year change and 3-month moving average



SOURCE: National statistics.

a. 2006 Q4: estimated.

GROSS FIXED CAPITAL FORMATION AND REAL INTEREST RATE CHART 6
Year-on-year rate and annual percentage



SOURCE: National statistics and IMF.

a. Eight largest economies. 2006 Q4 estimated.
b. Short-term interest rate minus inflation rate.

exception of Brazil (see Box 1) – have ultimately boosted investment to levels higher as a percentage of GDP than those prior to the crisis in the late 90s. As a result, despite the advanced stage of the cycle, investment has held at a relatively high year-on-year rate of over 10%, one higher than in 2005 in the region as a whole (see Chart 6 and Chart 1). This trend was across the board, except in Chile, where investment tended to be sluggish throughout the second half of the year, against the background of a decelerating economy. The trend in investment, should it take root, would be particularly beneficial insofar as it would be conducive to a lengthening of the upturn beyond the five years it has already been in train.

Despite the favourable external environment, the significant reduction in financial vulnerability and clear macroeconomic discipline, Brazil's growth of 3.7% in 2006 was notably lower than that of the other Latin American economies (excluding Brazil, the estimated growth exceeded 6%) and of the other emerging economies (average growth in South-East Asia was around 9%). Against this background, it is of particular interest to analyse the possible structural constraints on the growth of the Brazilian economy. The most notable of these has traditionally been the high cost of financing, which significantly limits capital accumulation and economic activity. This box analyses the possible reasons for that high cost of funds and reviews some recent measures that may have played a part in the decreased cost noted in recent years.

The variable used to measure the cost of financing is the interest rate of credit extended at market prices. Credit continues to be the main source of financing and, although in recent years the cost of funds in the financial markets has decreased considerably, it still remains very high. Indeed, although some of the larger companies have been able to borrow in the domestic and external financial markets at progressively lower interest rates, and although a portion of bank credit in Brazil is administered and subsidised (see Chart 1) at below those rates, the market cost of credit is the basic benchmark for proxying the cost of financing in Brazil as in other countries.

The interest rate of credit depends, from a theoretical standpoint, both on the central bank's official interest rate and on the net interest margin (measured as the difference between the deposit rate and the lending rate).

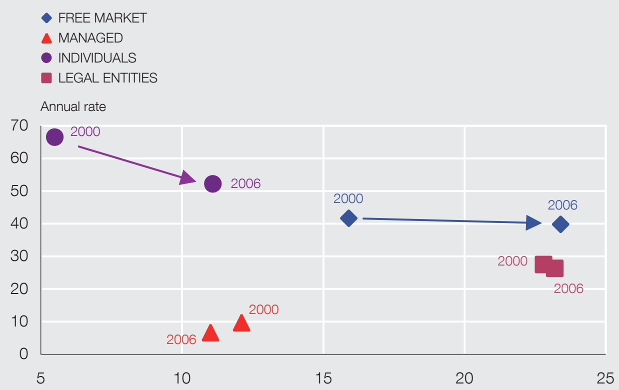
The traditionally high levels of the policy interest rate and their direct impact on short-term interest rates are one of the main factors explaining the high cost of funds[1]. Indeed, despite the fact that the cumulative decrease of 700 basis points in the current downturn has taken the policy interest rate to the lowest levels of the last 10 years, it continues to be high by international standards. The prospects for additional falls depend on the firming of the inflation expectations associated with the central bank's targets (this year, 4.5%, with a tolerance range of ± 2%) and the further reduction of risk premiums on the international financial markets.

However as shown in Chart 2, the net interest rate influences the interest rate of credit more than the policy interest rate does, and for this reason its determinants have been extensively and systematically analysed[2]. The high credit risk has been identified as the key factor in explaining the wide net interest margin. In turn, a series of institutional features have exacerbated this credit risk, including particularly the credit reporting systems and the legal and judicial systems. In this respect, it is considered that the deficiencies of the Brazilian default register system, given that it does not provide information on the credit record of the potential borrower and thus on the associated risk, may have contributed to generating high risk premiums. This may have caused problems of adverse selection, since the implicit quality of credit applicants is reduced. Along with these problems, the slowness of the legal system and its pro-debtor bias may have tended to prejudice creditors by reducing the chances of recovering the full value of the debt. All these circumstances may have contributed to laxer behaviour by debtors after the contract has been signed (moral hazard) and thus to higher risk premiums. These deficiencies have also helped to generate a captive market for each bank among its customers, which lessens competitive pressure and leads to wider net interest margins.

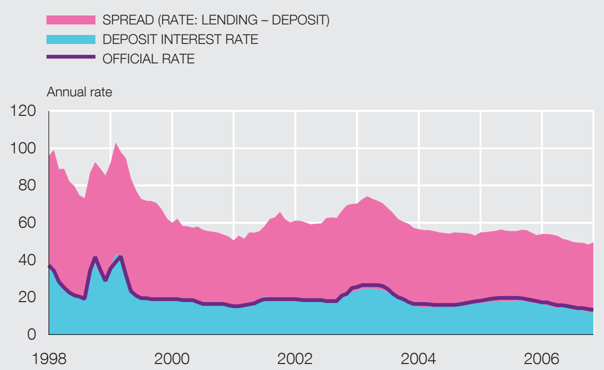
Other significant factors in explaining the wide net interest margins are the high reserve ratios, the distorting taxes on financial activity,

1. In Brazil the net interest margin is shared asymmetrically, since it falls almost solely on borrowers. This may be due to its asymmetrical origin (e.g. credit risk attributable to the borrower), either due to the absence of alternative financing opportunities for borrowers or to the existence of investment opportunities that are alternatives to deposits (perhaps derived from the high interest rates on public debt). **2**. The annual report issued since 1999 by the central bank of Brazil entitled *Economia Bancária e Crédito* (Banking Economics and Credit) contains detailed information on this topic.

1 CREDIT VOLUME AND INTEREST RATES



2 BANK NET INTEREST MARGIN



SOURCE: Central Bank of Brazil.

the requirement to allocate a certain portion of credit resources to certain sectors at below-market prices and the high administrative costs, which reflect a degree of inefficiency in the banking system.

Since 1999 the central bank of Brazil has been working on reforms to reduce credit risk. Noteworthy among these is the improvement in the central default register, the dissemination of the information in it and the creation of new financial instruments such as the payroll loan (in which the collateral is the borrower's future pay). The main purpose of disseminating credit records among banks is to encourage them to compete more intensely, which would diminish market power over solvent borrowers and reduce the premiums associated with adverse selection. Also, in 2003 a new bankruptcy law was enacted which ostensibly improves the creditor's position when a company goes bankrupt. In addition, efforts have been made to promote a legal culture that is less prejudicial for creditors, and various legal improvements have been made to expedite the formalities of litigation. Improvements in other areas (tax system, reserve ratios) have been limited and are constrained by monetary and fiscal policy or by the credit management policy in strategic segments.

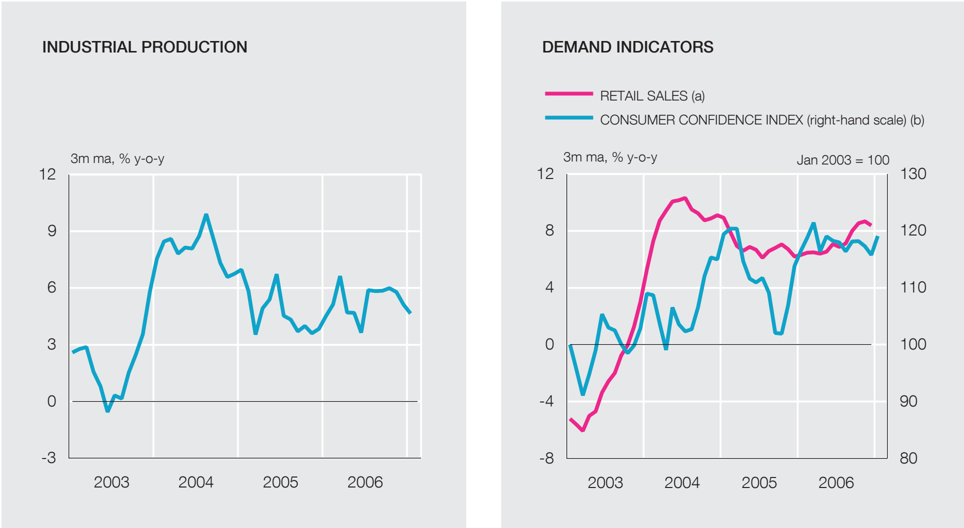
Despite these measures and the time elapsed, both the cost of financial intermediation and the net interest margin continue to be high, as illustrated by Chart 2, and constitute one of the main constraints on economic growth. However, credit has expanded strongly in recent years (23.6% and 27% in 2006 and 2005, respectively), and there are reasons for a certain optimism. Indeed, part of the apparent inefficiency of the measures taken to date might be attributed to the possibility of the frequent episodes of macroeconomic volatility in the period 1999-2004 having outweighed the beneficial effects of these reforms. Moreover, it seems plausible that certain measures (particularly the changes to the legal system, the introduction of new instruments and improved information) may have delayed effects that will be more perceptible in the medium term. In addition, the achievement of greater macroeconomic stability, the gradual reduction in the level of public debt and the improved composition of that debt seem to be allowing more leeway for reducing the policy interest rate. In short, despite some uncertainties, both the advances in macroeconomic stabilisation and the implementation of reforms with a possibly crucial role in reducing credit risk, make it reasonable to consider that an opportunity is at hand to overcome the obstacle that the extraordinarily high financing costs represent for the expansion of credit and long-term economic growth in Brazil.

Overall, the recent strengthening in domestic demand entrenches a classical economic cycle for the Latin American economies in which, following an initial impulse from the external sector in the years 2002-2003, there has been a pick-up in domestic demand characterised, moreover, by the relatively balanced composition of its main components. In this respect, the recently released higher frequency indicators would point to the continuity of the expansionary impulse, as can be seen in Chart 7. Industrial production has tended to stabilise in recent months at a growth rate of around 5% and the main demand indicators available, such as retail sales and confidence indices, are along these same lines.

The negative contribution of external demand to growth in the region as a whole stepped up from –2% in the first half of the year to –2.5% (see Chart 4). Not only did the growth rates of volume exports in most of the countries continue to ease during 2006 (see Chart 8), but imports were also more buoyant. These developments reflect, on one hand, the considerable strengthening of domestic demand; but in some countries, moreover, this trend may have been magnified by the appreciation of exchange rates. Set against this, the region's terms of trade trended particularly favourably in 2006, increasing on average by 8%, far up on the figures of 3.5% and 4.6% for 2005 and 2004, respectively, which were at the time considerable positive shocks. This sharp improvement is due to the rise in price of metal commodities (100%) and, to a lesser extent, of foodstuffs (20%) (see Chart 8). The changes in the terms of trade allowed for a further widening of the trade balance to 4.4% of GDP, up on the average for the past two years (4%), despite the relatively advanced stage of the cycle. As can be seen in Chart 9, the countries that most benefited from commodities price developments were Chile, Peru and Venezuela, whose trade surpluses stood at record levels of between 10% and 22% of GDP.

SUPPLY AND DEMAND
3-month moving average of year-on-year rate and levels

CHART 7



SOURCE: National statistics.

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

The current account surplus continued to increase, widening to close to 2% of GDP as a result of sound trade figures. Argentina and Brazil sustained high current account balances in 2006, similar to 2005, while Mexico managed virtually to eliminate its current account deficit during the year, although it underwent a marked deterioration in the second half of the year. In Chile, Peru and also Venezuela, the gap between the current account and trade surpluses widened forcefully, owing to the strongly adverse behaviour of their income balances. Remittance revenues rose to a very significant scale in some countries (2.8% of GDP in Mexico, 3.1% in Colombia and 2% in Peru). Finally, Colombia and Uruguay were the only countries to post a current account deficit.

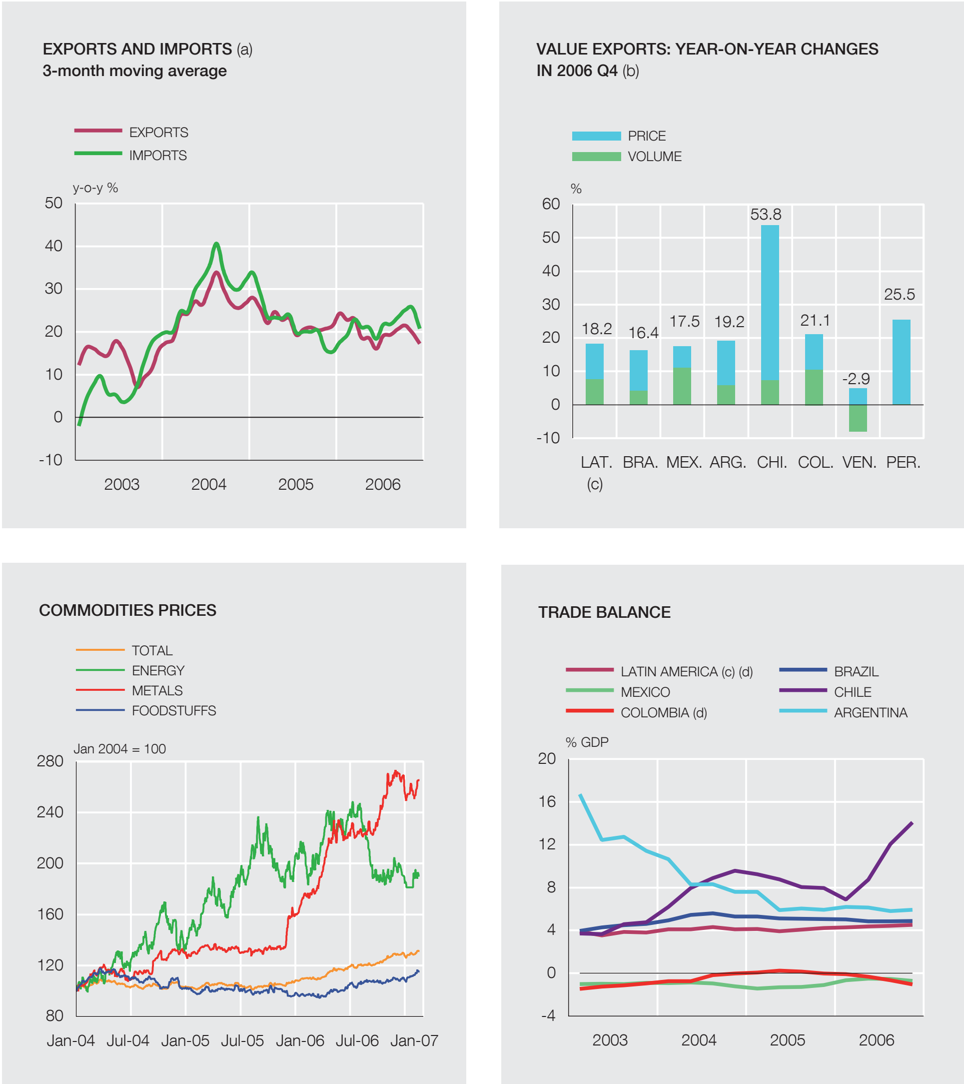
FINANCIAL MARKETS AND EXTERNAL FINANCING

The behaviour of Latin American financial markets was clearly favourable throughout the period and was only interrupted in late February by the turbulence on international markets originating in Asia and the United States. As in the April-May period in 2006, this bout of turbulence prompted an abrupt increase in volatility and a notable decline in financial asset prices (see Chart 10). This turbulence aside, the favourable market performance continued to be underpinned by the soundness of fundamentals, diminished vulnerability and the perception of ample global liquidity, against the background of widespread expectations of a soft landing for the US economy.

Stock markets rose across the board (see Chart 10). The regional MSCI index climbed by more than 25% between September and February, although the bout of instability in February resulted in losses of over 8%. The biggest stock market gains were in Chile, Mexico and Venezuela, which posted highs in mid-February between 30% and 50% above their September levels. The sovereign spread for the region, measured by the EMBI index, moved on a declining trend in a setting of very low volatility (lower even than that of the US Treasury bond; see Chart 11) which was interrupted only by the above-mentioned turbulence at the end of the period. The sovereign spread reached a historical low of around 170 bp, down from the 225 bp in September or the 280 bp in early 2006. The achievement of these lows may additionally have been due to some imbalance between the supply of and demand for these assets, as

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

CHART 8



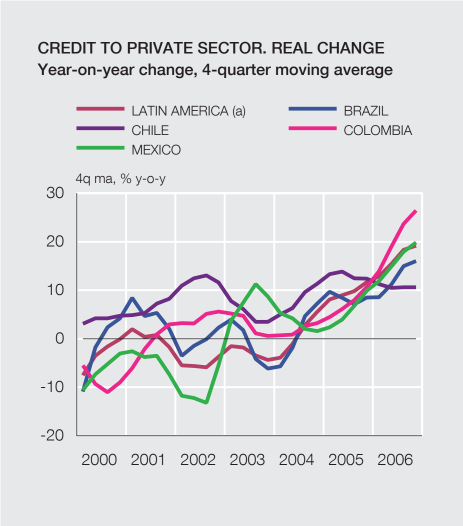
SOURCES: National statistics and Banco de España.

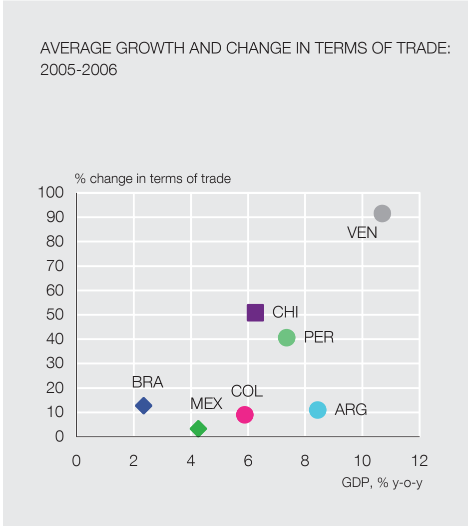
a. Customs data in US dollars.
b. National Accounts data in local currency. Argentina, Mexico, Chile and Colombia: 2006 Q3.
c. Aggregate of nine largest economies.
d. 2006 Q4 estimated.

countries pursued further the strategy of restructuring external debt and replacing it with domestic debt, and substantially reducing the volumes of sovereign debt issued in dollars. Sovereign spreads narrowed across the board in all Latin American countries (see Chart 10), with the exception of Ecuador, which practically doubled its level in September. There the spread widened to over 1000 bp at the start of the year as a result of the perception of an increase in external debt restructuring risk (although it subsequently narrowed to around 700 bp). This rise in risk prompted a downgrading of Ecuador's sovereign rating by the three main agencies. In the opposite direction, the decline in the Argentine sovereign spread proved particularly marked (from 300 bp in September to 185 bp). This was the biggest reduction among all the emerging countries, and the level was even below that of the Brazilian spread in late January, scarcely five years after Argentina's debt default. The Brazilian spread also narrowed by around 35 bp to 180 bp, assisted early in the year by the widespread expectations of an upgrade. However, further to the turbulence in February and March, the spread widened once more

CREDIT TO PRIVATE SECTOR, GROWTH AND TERMS OF TRADE

CHART 9





SOURCE: National statistics and IFS.

a. Average of the seven largest Latin American economies weighted by PPP.

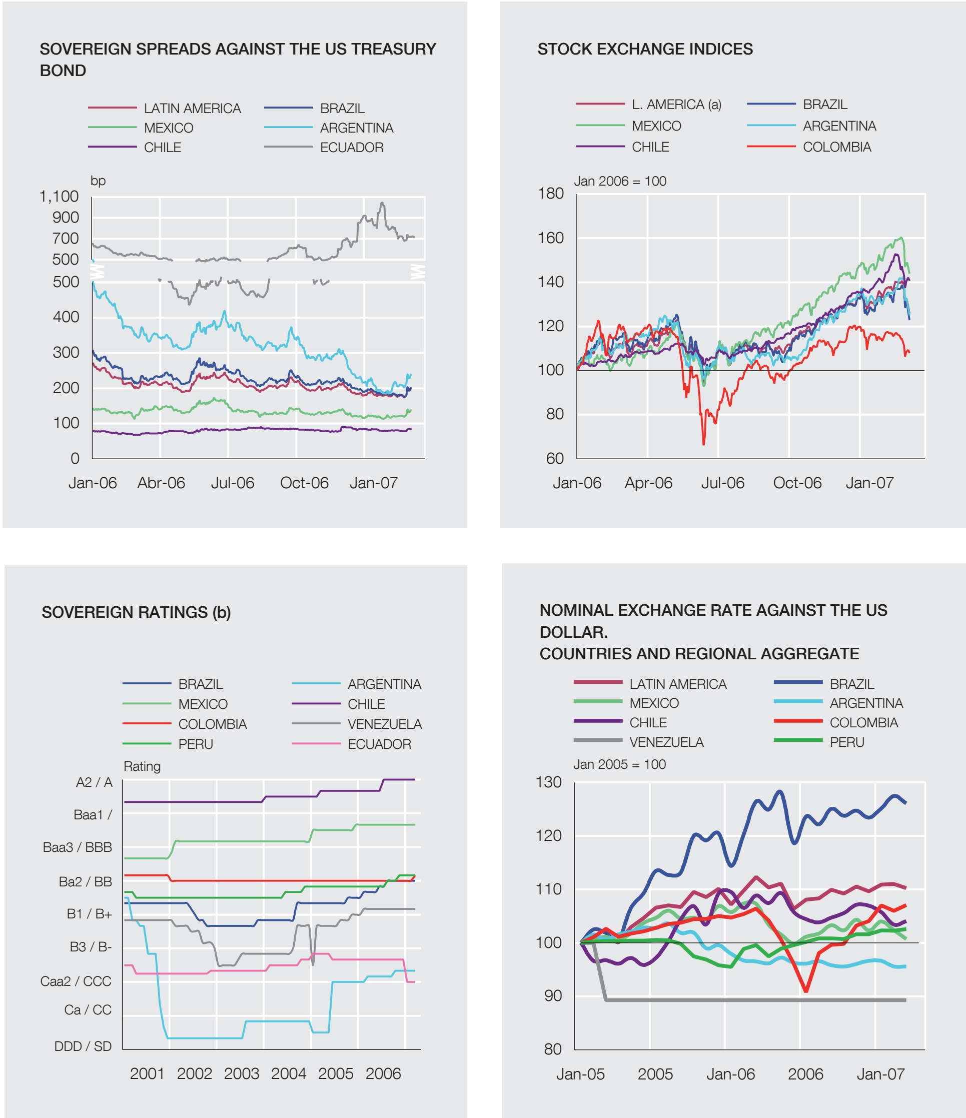
towards 200 bp, although Argentina and Ecuador were the countries most affected in this episode. Argentina, Uruguay and, more recently, Columbia saw their credit rating rise (see Chart 10), while Brazil and Peru witnessed an improvement in the outlook for their rating in the last six months.

On the foreign exchange markets, the Colombian peso and the Brazilian real were the currencies that most appreciated in the period, by 6% and 3% against the dollar, respectively, despite central bank intervention (see Chart 12). The Venezuelan bolivar depreciated by around 40% in the parallel market, especially from January further to the announcement of possible nationalisations, while the Argentine and Mexican peso held relatively stable over the past six months. It should be stressed that, in Argentina's case, the build-up in reserves by the monetary authorities was pivotal to such stability (see Chart 11). However, the turbulence in recent weeks has meant that the currencies which had been tending to rise against the dollar saw this appreciation corrected, resuming their September levels.

Total net capital flows in 2006 were virtually in balance (see Chart 12). Total net private flows stood at around $10 billion (a very small fraction of private flows to emerging economies, of below 5%, when a decade back the related figure was over 50%), a capital inflow that would have been offset by the decline in official flows. The evidence available indicates that, once again, direct investment was the main source of financing of flows, standing at around $30 billion, while the remaining components were negative. These developments reflect in part the growth of local financial markets and the reduction in dependence on external financing. During 2006 Brazil was a net exporter of foreign direct investment for the first time in its history, a noteworthy aspect and one which, along with the accumulation of reserves, illustrates the recent trend whereby certain emerging economies have become net creditors vis-à-vis the rest of the world. Finally, corporate issues on international markets remained buoyant, rising to almost $7 billion in the second half of 2006, a figure close to the total volume of sovereign issues, which remained relatively low in comparison with the past and with other geographical areas, to the extent that neither Chile nor Mexico (nor Argentina, for different reasons) made issues on international markets.

SOVEREIGN SPREADS, STOCK MARKETS, RATINGS AND NOMINAL EXCHANGE RATE AGAINST THE DOLLAR
Basis points and indices

CHART 10



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

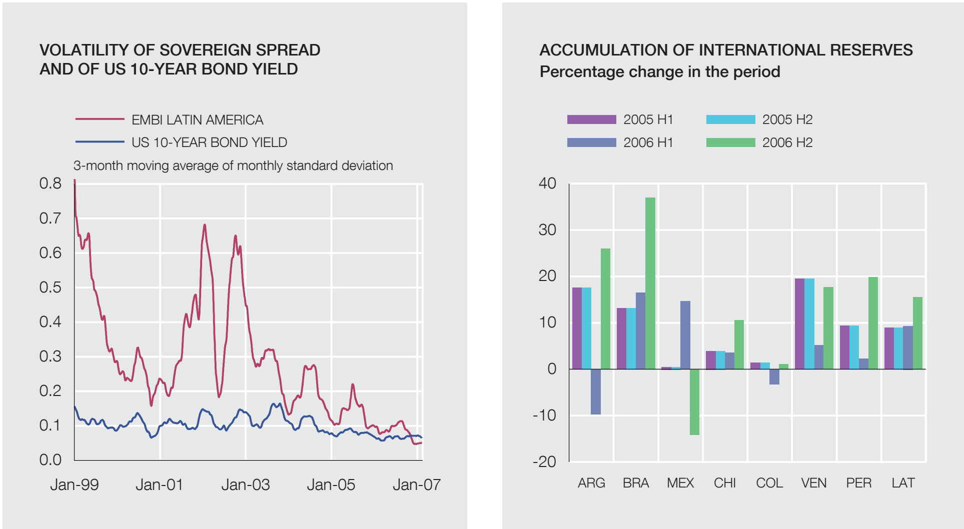
a. MSCI Latin America index in local currency.
b. Simple average of ratings from Moody's, Standard and Poor's and Fitch IBCA.

Bank lending to the private sector continued to quicken during the period, standing at a year-on-year growth rate of over 20% for the area as a whole (see Chart 9), albeit with notable differences from one country to another. This sustained growth is allowing the credit/GDP ratio to rise; however, the ratio remains very small relative to the area's level of per capita income. While improved fundamentals and the reduction in vulnerabilities account for the observed acceleration in credit, past experience advises caution, since previous episodes of uninhibited credit growth were a prelude, in many cases, to subsequent financial and banking crises[1].

1. For a detailed analysis, see the article (in Spanish) "La recuperación del crédito bancario en América Latina", by JC Berganza and E. Alberola, Boletín Económico, Banco de España, February 2007.

VOLATILITY AND ACCUMULATION OF RESERVES

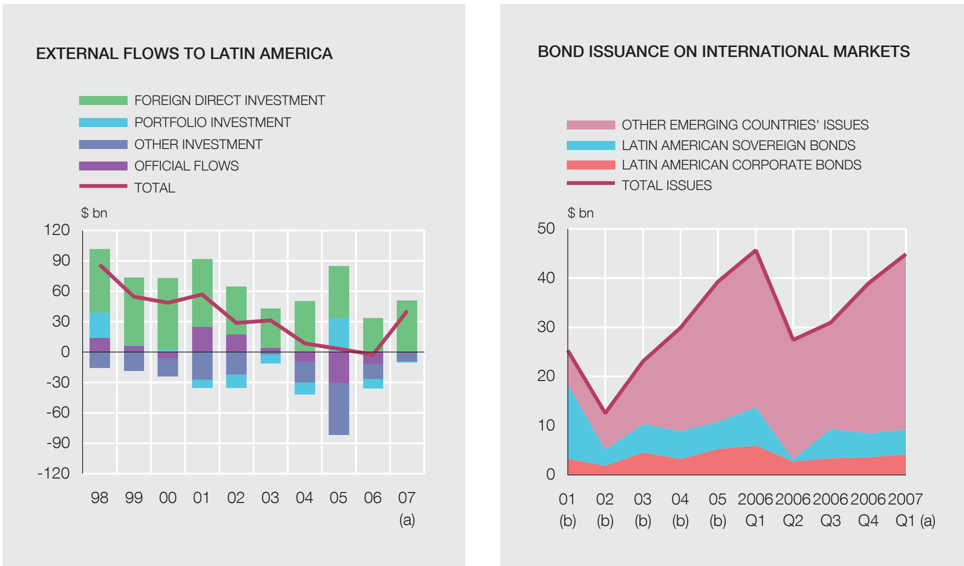
CHART 11



SOURCES: JP Morgan and Datastream.

EXTERNAL CAPITAL FLOWS
USD bn

CHART 12



SOURCES: JP Morgan, IMF and national statistics.

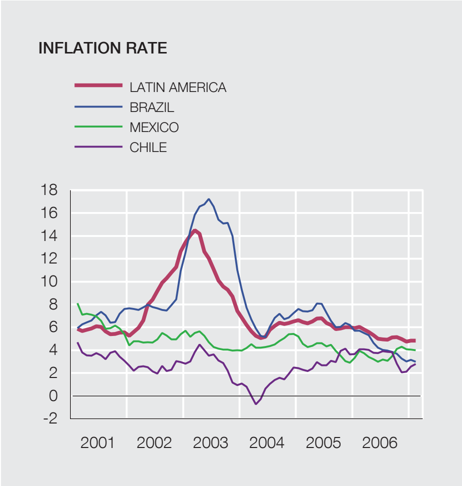
a. 2007: estimate.
b. Quarterly average.

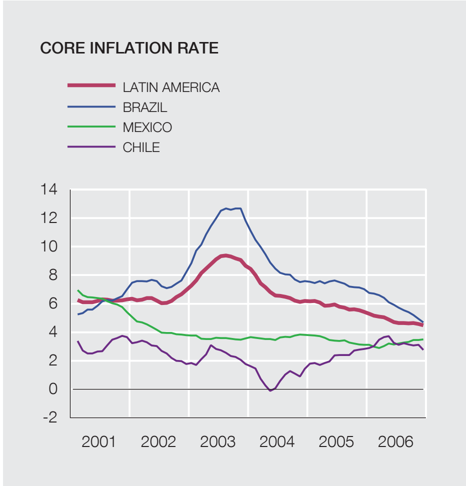
PRICES AND MACROECONOMIC POLICIES

During the year inflation eased significantly in the area as a whole, dipping to an annual average rate of 5.2%, compared with 6.2% in 2005 (see Chart 13). However, most of this containment in price growth was during the first half of the year, since in the second half inflation rates tended to stabilise, admittedly at very moderate levels by the region's standards. Inflation thus declined from a year-on-year rate of 5.1% in September to 4.8% in January 2007, after posting a low in November of 4.7%. In parallel, underlying inflation continued to moderate, falling to 4.6% year-on-year in January from 5.8% on average in 2005. Broadly speaking, the relative strength of exchange rates, prudent macroeconomic management and the moderation of oil

INFLATION
Year-on-year rate of change

CHART 13





Country	2005	2006			2007
	Fulfilment	Target	Fulfilment	December	Target
Brazil	Yes	4.5 ± 2.5	Yes	3.1%	4.5 ± 2.5
Mexico	Yes	3 ± 1	No	4.1%	3 ± 1
Chile	Yes	3 ± 1	Yes	2.6%	3 ± 1
Colombia	Yes	4.5 ± 0.5	Yes	4.5%	4 ± 0.5
Peru	Yes	2.5 ± 1	No (below)	1.1%	2 ± 1

SOURCE: National statistics.

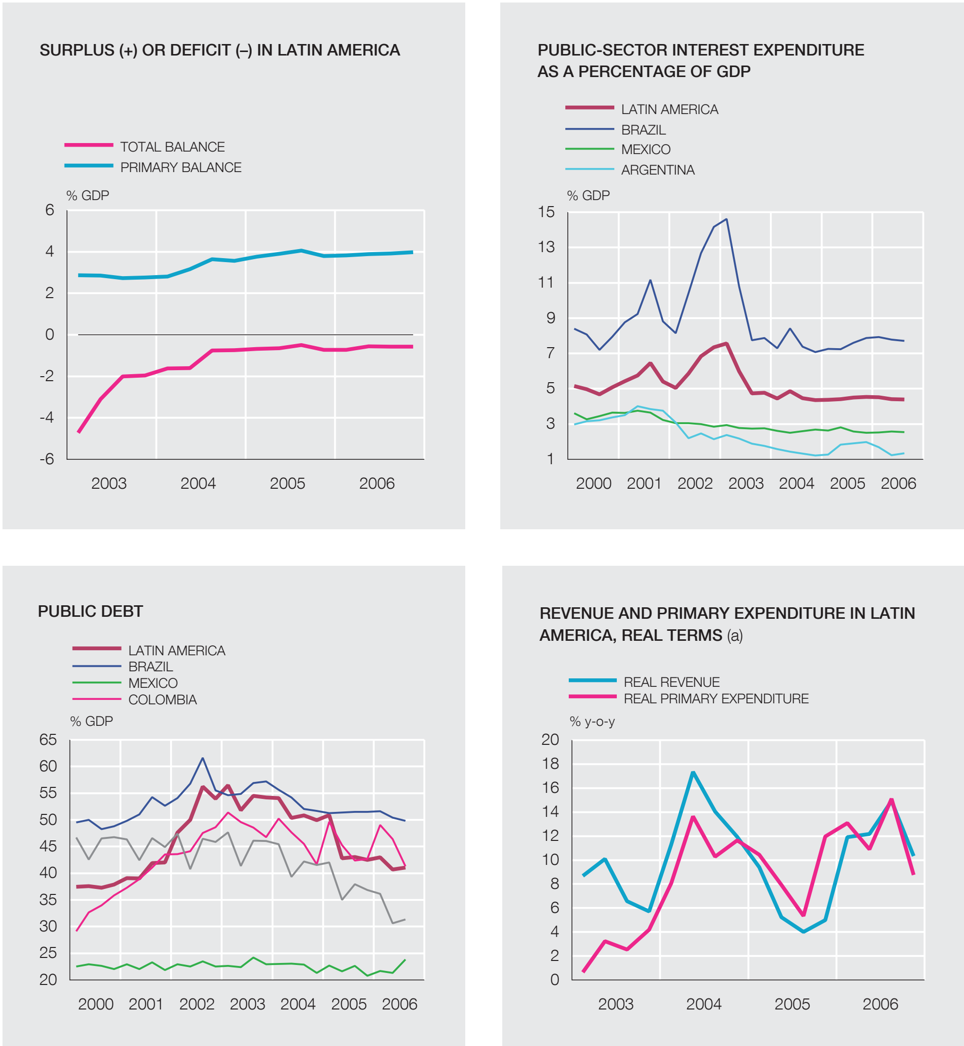
prices, against a background marked by the absence of adverse disturbances, all contributed decisively to the sound behaviour of inflation in the second half of the year.

In Brazil, the year-on-year growth rate of prices fell to 3%, down 0.5 pp since September, in parallel with a significant containment of underlying inflation. That allowed for comfortable compliance with the targets set by the Brazilian central bank (see the table in Chart 13). Generally, there was greater dispersion in respect of price developments than in the first half of the year. In Argentina, where prices had increased at double-digit rates in the first half of the year, there was some easing to a rate of below 10% at year-end, the result of the decline in underlying inflation. It should be clarified, however, that much of this containment was a result of the application of price controls and moral suasion, the effectiveness of which over the medium term is debatable. The trends witnessed in Venezuela in the first half of the year intensified, taking the year-on-year inflation rate in early 2007 to over 20%, far off the central bank's 10% target. And in Mexico, where inflation had eased substantially in the first half of the year, there was a rise of almost 1 pp to a rate of slightly over 4% in the second half, exceeding the central bank target. Finally, in Chile and the other Andean countries, a deflationary trend became more entrenched, with inflation rates in some countries that were lower than the related central bank targets (see Chart 13).

Against this background, the divergences in respect of monetary policy developments in the region tended to grow relative to the first half of the year. Thus, set against the upward cycle prevailing in the first half of the year (with the exception of Brazil), in the second half only Argentina and Colombia continued raising their benchmark rates, while Mexico and Peru held their interest rates unchanged. Chile raised its official interest rate by 25 bp to 5.25% in July,

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

CHART 14



SOURCE: National statistics.

a. Deflated by CPI.

but reversed this movement six months later, against the backdrop of sluggish activity and the lack of inflationary pressures. Finally, Brazil continued trimming its official interest rates, taking them to 12.75% in March. That entailed a slowing in the pace of reduction, from 50 bp to 25 bp in the last two movements, possibly as a sign of caution due to the potential lagged effect of the cumulative decline in interest rates in recent years (7 pp).

Turning to fiscal policies, the average budget deficit in the area as a whole held at around 0.7% of GDP, unchanged on the first half of the year, and the primary balance stabilised at around 4%, a similar figure to 2005 (see Chart 14). With the exception of Brazil, whose budget deficit remained at 3.5%, the other countries posted a surplus or were at least very close to a balanced budget. Even so, Brazil retained the marked fiscal discipline of recent years, achieving a primary surplus of 4.33% of GDP, higher than the target of 4.25%. Also of note was the trend of the surplus in Chile, which doubled that of 2005 and stood at almost 8% of GDP. This was the result of a more than 80% increase in copper prices, which came to account for over one-third of total public revenue. Interest payments generally held stable, while debt/GDP ratios stabilised or turned slightly downwards, except in Peru, where the reduction was more marked owing to strong out-put growth. In the area as a whole, the public debt/GDP ratio stood at close to 40% (2 pp less than in 2005), making for a sizeable reduction of 15 pp of GDP in the last four years.

Developments in public finances were therefore favourable, with some exceptions. However, it should be clarified that, given a favourable cyclical position and strong growth in revenue owing to the rise in commodities prices, fiscal policy might have been somewhat more countercyclical and ambitious, especially in certain countries, so as to contribute to stabilising growth and making further headway in reducing vulnerabilities. In any event, and in line with events in recent years, the course of spending was largely subordinate to the leeway allowed by revenue growth.

TRADE INTEGRATION AND STRUCTURAL POLICIES

During the closing months of 2006 there were no essential changes in trade integration processes in the region following Venezuela's formal accession to MERCOSUR, after abandoning the Andean Community, and Bolivia's official application to join. However, there was a series of initiatives which, taken together, reinforce the perception of a clear divide between the two trading blocs in the region. In December, the United States extended its preference arrangements with Colombia, Peru, Ecuador and Bolivia by six months, offering a further extension of another six months should progress be made in achieving and applying free trade treaties. In Peru, the free trade treaty was approved by Parliament, while in Colombia it will foreseeably be approved in the near future, meaning they will be pending ratification by the US Congress. Nonetheless, the change in the US Congress majority might hamper this ratification. In contrast, in Ecuador, the new government has been reluctant to sign a free trade treaty with the United States (a matter which, in any event, had been blocked for several months owing to the conflict with a US oil company). Chile and Peru signed their free trade treaty in August, while Chile's free trade agreement with China and its economic association agreement with other Asian countries came into force at the end of the year. Finally, the Free Trade Agreement between the United States, Central America and the Dominican Republic was pending ratification by Costa Rica.

In terms of structural reforms, results were relatively limited in the region as a whole, a fact to which the holding of various elections between 2005 and 2006 may have contributed. It is in any event notable that, despite the boom, due progress is not being made in outstanding structural reforms. However, further to the changes brought about by elections, there appears to be greater political readiness in some governments to undertake certain reforms. Such is the case of Mexico, where momentum is gathering behind the reform of pensions, the energy sector and also the tax system. In Chile and Colombia, too, there has been some headway on tax and capital markets matters. Finally, Brazil approved plans to accelerate growth, which are not strictly a structural reform but do show greater initiative on the part of the government in respect of stimulating growth in the economy.

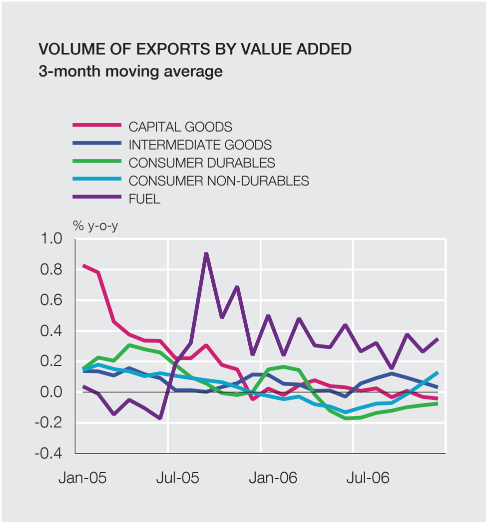
Admittedly, all these planned reforms are a step in the right direction and show that the initiative has been regained following several years in which a favourable economic situation had induced a degree of complacency. However, it is to be questioned whether the reforms under discussion are on a sufficient scale to succeed in increasing competitiveness and boosting long-term growth in these economies.

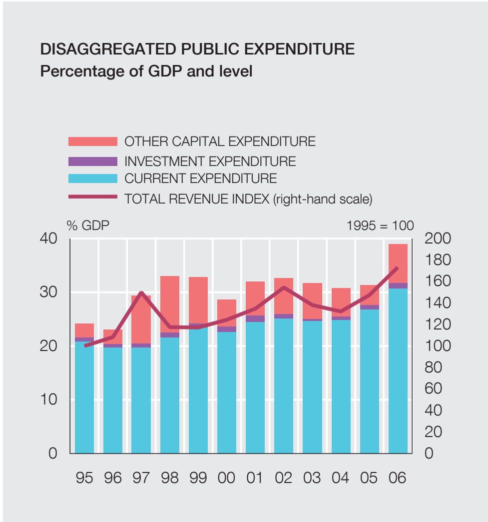
Developments in the main countries

In *Brazil* the year-on-year growth rate in the second half of the year picked up significantly to 4.5% in Q3 and 4.8% in Q4, following the notable slowdown in Q2 (1.5%). The resulting growth rate of 3.7% in 2006 was higher than that of 2.9% recorded in 2005[2]. Growth was

2. In Brazil a methodological change in the National Accounts series entailed a change in the base year and closer observance of the national accounting guidelines of the United Nations. This revision left the growth rates for 2000 and 2001 practically unchanged, but there was a significant upward revision for the period 2002-2006.

BRAZIL CHART 15



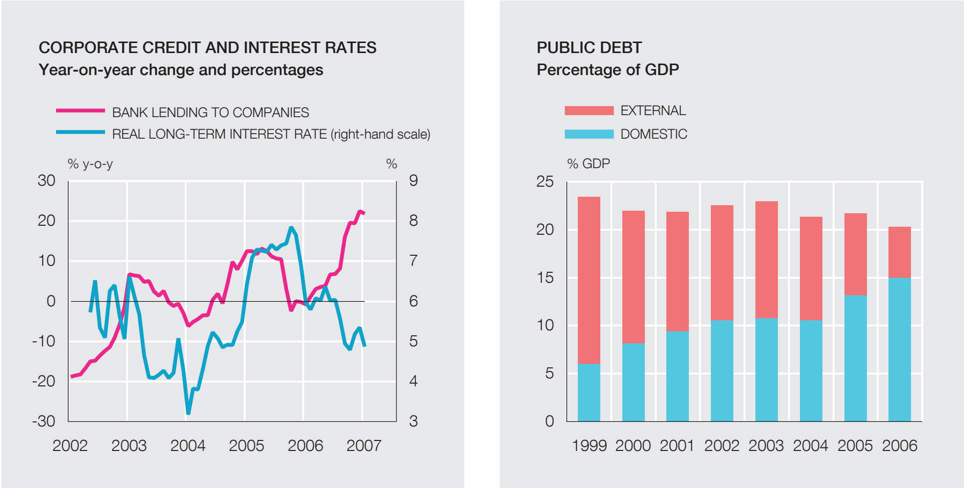


SOURCE: Central Bank of Brazil and Finance Ministry of Brazil.

driven by domestic demand, both by private consumption, which remained strong throughout 2006 (with a growth rate of 4.3%), and by investment (8.8%), which was the most buoyant component. The negative contribution of external demand, already recorded in the first half of the year, sharpened in the second half, reversing the positive contribution of previous years as a result of the scant growth of exports (4.6% during the year) compared with that of imports (17.9%). This slowdown of exports in value terms was due to the behaviour of sales with greater value added (capital goods and durable goods), in contrast to the strong growth of fuel exports (see Chart 15). In the year as a whole, the current surplus in GDP terms stood only at around 1.3%. The inflows of foreign direct investment in the second half amounted to $11,400 million, which took the total for the year to more than $18,700. Despite these strong inflows of foreign direct investment, in 2006 Brazil was a net exporter of foreign direct investment for the first time in its history. Its fiscal policy in the second half managed to achieve the objective of a primary surplus amounting to 4.25% of GDP. However, the interest burden generated a deficit of 3.4% of GDP and this prevented a greater reduction the net public debt as a percentage of GDP in the half, which held at nearly 50% of GDP.

Inflation continued to fall and stood at 3% in January, practically 4 pp below the average growth rate in 2005, as a result of factors such as the abundant agricultural production, the effect of exchange rate appreciation, the absence of significant increases in administered prices and the favourable behaviour of energy prices. The fall in inflation came against a background of cuts in official interest rates (50 bp in each of the September and November meetings, and 25 bp in each of the two subsequent meetings), and left the official interest rate at 12.75%. Notable in regard to the exchange rate was the continuing significant upward pressure on the real (after weathering the financial volatility of May-June 2006) because of the persistent large trade surplus and the inflow of short-term capital against a background of low exchange rate volatility and comparatively high interest rates in Brazil. The central bank's intervention to partially counteract this upward pressure was relatively successful in the half, although unable to prevent an appreciation of 10% in 2006 and of 25% since 2005. This intervention resulted in a substantial accumulation of international reserves (over $23 billion in the second half of the year and about $14.8 billion more in January and February 2007), which raised the reserve level above $105 billion. As in the last few years, once again in 2006 external debt as a proportion of GDP tended to decrease relative to domestic debt. In view of the relatively disappointing growth of the Brazilian economy in recent years, the government made

MEXICO CHART 16



SOURCES: INEGI and Banco de México.

it a priority in its second mandate to address a problem which, along with the high cost of capital, is one of the main constraints on Brazil's growth: infrastructure deficiencies. To this end, it developed the Growth Acceleration Plan 2007-2010, basically aimed at raising growth to rates of 4.5-5% through higher spending on infrastructure and a selective policy of tax incentives. This plan will step up the low level of spending on infrastructure in the last decade despite the increase in total public expenditure and revenue in this period (see Chart 15). Central government will only partially finance this expenditure, which will also be financed by local government and diverse joint public-private initiatives. Overall, the public investment will effectively reduce the primary surplus by 0.5% of GDP to 3.75% GDP.

In *Mexico* activity slowed in the second half of the year to a year-on-year growth rate of 4.3% in Q4, against 5.2% in the first half. Nevertheless, growth amounted to 4.8% in 2006, up 1.8 pp on 2005 and the highest figure since 2000. Domestic demand tended to slow, its growth being down somewhat on the figure of 4% year-on-year recorded in Q4. Private consumption slowed to a rate of 3% in Q4 from 5% in previous quarters, while investment eased. Even so, investment growth remained relatively buoyant in Q4 with growth exceeding 7%. This was partly explained by the highly favourable financing conditions: the growth of bank credit to companies picked up and real interest rates decreased further in the second half of the year, as shown by Chart 16. The negative contribution of external demand expanded in Q3 but turned positive in Q4. However, the trade balance deteriorated notably in the second half of the year after a surplus in the first half. This deterioration, which was sharper in Q4, left the trade deficit at 0.7% of GDP for the year as a whole (1% in 2005). Both oil and non-oil exports slowed, the latter linked to the lesser buoyancy of the US economy, despite the fact that a part of the share of Mexican manufactures in this market was recouped. Imports also slowed, although to a lesser extent. The current account balance showed a deficit in the second half after a surplus in the first half. Nevertheless, for 2006 as a whole the current account deficit was small (–0.2% of GDP), thanks to the surplus on the oil trade balance (2.4% GDP) and the funds received in the form of household remittances (2.8% of GDP), although both these items tapered off during the year. Foreign direct investment flows amounted to nearly $19 billion, down 3% on 2005. In the fiscal realm, a budget surplus of 0.2% of GDP (–0.1% 2005) was achieved, an unheard-of situation during the last 10 years, although developments turned more unfavourable in the second half of the year, under the affect of the expenditure derived from the organisation of the presidential and parliamentary elections in July. Revenue progressed very favourably, and, in particular, the relative weight of that from oil increased to 38% of total revenue in 2006. In addition, the government made various early repayments of external debt and replaced external debt with domestic debt, thereby reducing net external public debt to 5.3% of GDP at end-2006, 2.5 pp less than 2005, as shown in Chart 15. Furthermore, the first tender of peso-denominated 30-year domestic debt took place in October.

Inflation rose from 3.1% in mid-2006 to 4.1% in December, thus slightly exceeding the upper limit of the central bank's target range. In the first three months of 2007 it has remained around 4.1%. This price behaviour was initially attributed to seasonal factors (mainly food). However, the rise in underlying inflation to 4% in February and a certain increase in short-term inflation expectations led to fears that this inflation rate might become entrenched, prompting harsher language from the central bank, which has not yet been reflected in official interest rate movements. This worsening also fed through to the yield curve, the slope of which has steepened in recent weeks. The exchange rate of the peso against the dollar, following an appreciation once the financial volatility of May-June had passed, held steady in the range 10.8-11.1 pesos per dollar, although it depreciated during the turbulence of the last few weeks. The stock market rose by 35% from September and then lost some ground in the recent turbulence, which has also caused sovereign spreads to increase to around 100 bp, slightly above the historical low. The risk of social and political confrontation which followed the investiture of the new president dissipated during the second half of 2006, and the prospects for undertaking certain reforms can be regarded, with the due cautions, as more promising than in the last few years. In this respect, Parliament may begin to debate in April a reform of public-sector pensions aimed at completing the transition from the current pay-as-you-go pension system for public-sector workers to a funded, defined-contribution pension system, similar to that established a decade ago for private-sector workers. The main objective of this reform will be to reduce the pressure on public finances.

Following three years in which economic activity in *Argentina* grew at an average rate of 9%, this buoyancy was seen again in 2006, with a growth rate of 8.5% year-on-year. Indeed, the second half of the year saw a slight pick-up in activity to growth of 8.7%. Consumption remained buoyant, although somewhat more subdued than in the previous year, driven by the rise in real wages (8% in real terms), pensions, employment and lending (28% in real terms) and by the high confidence of households. The growth rate of investment was twice that of the economy despite a certain slowdown – particularly in construction – in Q4. The contribution of investment in capital goods had the effect that, despite the ongoing buoyancy of industrial production, capacity utilisation rose by scarcely one percentage point (see Chart 16). This dissipated some extent possible fears of bottlenecks in the coming quarters. The unemployment rate ended the year below 10% (specifically, 8.7%) for the first time in the last 13 years. The negative contribution of external demand expanded in 2006 as a whole (to 0.7 pp from 0.2 pp in 2005), since real exports slowed somewhat more than imports. In 2006 the trade surplus was down slightly in terms of GDP (5.8%) with respect to 2005, but the current account surplus widened to 3.8%, given the decrease in the income issued in the form of interest. The public finances continue to trend favourably, and in 2006 ran a primary surplus of 3.5% of GDP, similar to that of the previous two years. This performance reflected the strong increase in tax revenue, particularly in the second half of the year, against a background of slightly slower growth in primary expenditure than in tax revenue. By contrast, the deterioration of the fiscal results of the provinces seen in previous years continued.

Inflation underwent a sustained fall during the year to stand at 9.8% in December, i.e. within the range stipulated in the 2006 Monetary Program (8-11%), and then further decreased to 9.6% by February 2007. The slowdown in inflation is basically due to the underlying component (see Chart 16), which in December stood at 10.2% year-on-year, after having ended 2005 at 14.2%, al-

THE ARGENTINE SUPREME COURT RULING ON THE PESIFICATION OF DEPOSITS: THE LAST STEP IN THE RESOLUTION OF THE BANKING CRISIS

BOX 2

On 27 December 2006 the Argentine Supreme Court ruled that the bank deposit pesification carried out at the beginning of 2002 was not unconstitutional. The legal grounds for this decision were that the pesification of savings did not constitute an impairment of the property rights of the depositors (constitutionally protected), but rather the exercise of monetary sovereignty, since in the final instance the depositors had the power to recover their assets, notwithstanding the unavailability during a period of time or the elapsed term. Generally speaking, the ruling will allow depositors with appeals for relief pending to recover the value in pesos of their original dollar-denominated deposits at the current exchange rate. This ruling is particularly significant because, although it imposes certain hard-to-quantify costs on banks and certain issues have yet to be clarified, it ends a five-year period of uncertainty for the Argentine financial system and definitively rules out the possibility of a decision favourable to the redollarisation of the economy. This box sets the Supreme Court ruling within the general framework of the strategy adopted to resolve the Argentine financial crisis and assesses its main implications and uncertainties.

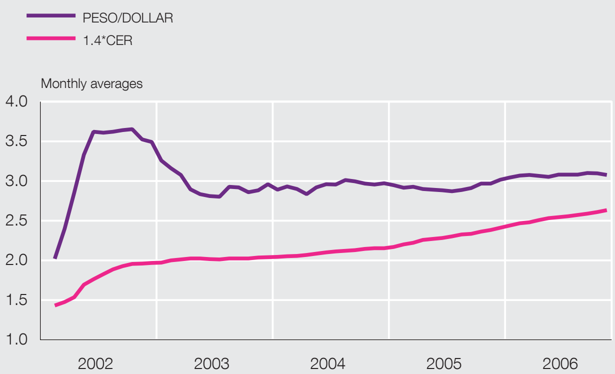
Since mid-2001 the Argentine economy was caught up in a financial crisis which had a profound impact on the country. In December of that year, to contain the outflow of deposits, the government decreed withdrawal restrictions (except for very small amounts) on current accounts, savings accounts and time deposits (*corralito*). Subsequently, in January 2002 the withdrawal restrictions on time deposits were ratified and a timetable was set for returning those deposits (*corralón*). Also in January 2002, the government revoked convertibility, and in February it decreed the asymmetrical pesification of deposits (at 1.40 pesos/dollar) and loans (at a 1:1 rate), which further prejudiced banks. The government decreed that deposits in frozen (unwithdrawable) pesified dollars would be revalued using an inflation-linked index (CER) and that depositors would receive an annual interest rate (set at 2% by the central bank) until the scheduled refund date.

These measures pushed bank balance sheets into a bankruptcy situation and collapsed the financial system. The situation was aggravated because, following the freezing of deposits, certain depositors began to file appeals alleging unconstitutionality in order to recover their funds in full, either in dollars or the equivalent amount in pesos at the market exchange rate. These allegations were upheld by some courts, which set as a precautionary measure the payment on account of part or all of the deposit since, under their interpretation, the pesification and the imposition of restrictions (*corralito* and *corralón*) were unconstitutional. The accompanying table lists the "amount of appeals for relief" from 2002 to 2006 and the amounts that banks were obliged to pay in each of those years.

To cope with the bank liquidity problems caused by these circumstances, the central bank made a series of advances to the financial system and, as the liquidity problems became less pressing, gradually lifted the *corralito* withdrawal restrictions. The balance of the deposits trapped in the *corralón* withdrawal restrictions was able to be reduced more rapidly than initially expected. Some depositors, however, did not take up the successive exchange offers made by the government or agree to the payment of their rescheduled deposits, partly because the Supreme Court had not established case law as to the constitutionality of the pesification of dollar-denominated deposits and of the withdrawal restrictions imposed. This made for considerable legal uncertainty and even, at certain times, expectations of the redollarisation of the economy.

The Supreme Court finally ruled on 27 December 2006 that the pesification at the beginning of 2002 was not unconstitutional. As courts throughout the country fall into line with this ruling, the depositors with

1 PESO/DOLLAR EXCHANGE RATE AND RATE APPLICABLE TO PESIFIED DEPOSITS



2 RELIEF PAID

Period	Number of cases	Total paid (a)
2002	174,119	13,615
2003	87,413	5,032
2004	42,429	2,626
2005	19,525	1,177
2006	13,691	773
TOTAL	337,177	23,224

SOURCE: BCRA and INDEC.

a. In millions of pesos.

relief appeals pending will receive the equivalent in pesos of the value of their dollar-denominated deposits at the peso/dollar exchange rate prevailing at that date of the court decision[5]. However, the Supreme Court expressly indicates that if this rule differs from the dollar exchange rate on the execution date, the amount payable in pesos shall be the minimum between the peso/dollar exchange rate and the result of applying the rule set in the court decision. Additionally, the ruling stipulates that the funds paid by financial institutions under the precautionary measures shall be considered as payment on account.

The ruling does not affect those who accepted exchange options for their rescheduled deposits and all those who failed to take court action before the deposit refund deadline expired. This accounts for the significance of legal decision adopted on 27 December, since a ruling in favour of the unconstitutionality of pesification could have entailed the refund of the dollar-denominated deposits for which relief appeals were not filed, i.e. those released through the scheme for refunding the rescheduled deposits or any of the voluntary options established in these years, which would have had a very high cost for banks. In short, the ruling marks the end of the uncertainty for the financial system associated with the appeals for relief.

The wide range of grounds alleged in the appeals for relief makes it complicated to calculate the economic impact on banks deriving from the Supreme Court measure. The main reason is that in most of the appeals for relief there was part or full payment on account of the value of the deposit at different exchange rates ranging from 2 to 3.80 pesos per dollar (see accompanying Chart). However, since most of the relief was paid between 2002 and 2003 at a lower exchange rate than that currently prevailing, it is reasonable to think that the effect of the ruling will not be very unfavourable for banks. Moreover, the central bank allowed the banking system to amortise in 60 equal and consecutive monthly charges any loss arising from compliance with the legal measures relating to the refund of deposits.

In conclusion, the good general situation of the Argentine financial system, the consideration that the ruling will not entail a significant additional cost for banks and the fact that the central bank has allowed banks to provision over five years any possible losses, suggest that the ruling will not, in principle, pose a serious concern for banks. At the same time, the ruling clears up a significant uncertainty as to the possibility of a decision favourable to the redollarisation of the financial system. However, certain matters have yet to be clarified which will determine the final cost for banks of winding up this process. Particularly notable among these is the payment of the legal costs of the proceedings which will probably have to be met by banks in the majority of cases, the possibility that the banks may make claims on the depositors that received amounts on account exceeding those specified under the precautionary measures and the possibility that depositors may file suit for damages arising from loss of profit due to delay in the refund of money.

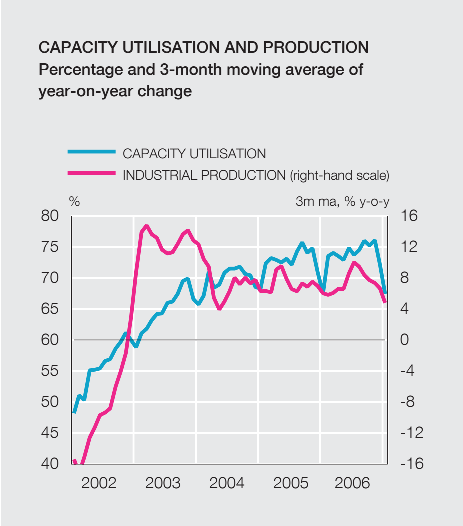
5. Specifically, the ruling upheld the refund to a depositor whose dollar-denominated deposit was trapped in the corralón, at a rate of 1.40 pesos/dollar adjusted by the CER plus annual interest of 4% (uncompounded) until the refund date, for each dollar deposited.

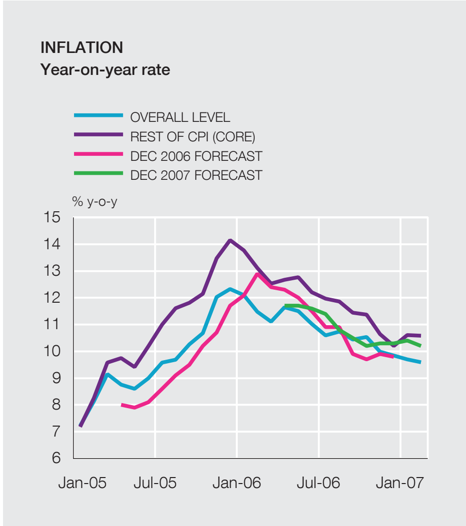
though in 2007 it rose again. This downward path of inflation was reflected in the progressive reduction of inflation expectations, which, however, have not broken through the floor of 10%. The central bank continued to gradually raise its official interest rates (a total of 150 bp between September and March), although real interest rates continue to be negative. At the same time, the central bank continued its policy of holding the exchange rate steady at around 3.05-3.10 pesos per dollar, for which it had to accumulate significant international reserves. Total reserves amounted to $35 billion. This accumulation enabled the country to regain and exceed the levels that existed before total payment of the debt to the IMF at the beginning of 2006. In January the Argentine and Spanish governments reached agreement for payment of the Argentine government's debt of $982.5 million, and also Argentina made the initial contacts with the Paris Club to renegotiate past-due debt. The purchase of foreign currency was sterilised with the envisaged early settlement of rediscounts granted during the 2001-2002 crisis, the issuance of central bank bills and notes and the raising of bank reserve requirements. Notable in the institutional sphere was the Supreme Court ruling which declared the "pesification" of deposits during the 2001-02 financial crisis (see Box 2) not to be unconstitutional and approved a pension system reform enabling contributors to the funded system to switch to the pay-as-you-go system and set limits on pension fund fees.

Economic activity in *Chile* slowed notably in Q3 to year-on-year growth of 2.6%, down from 4.5% in the first half of the year. There was, however, a certain recovery in Q4, since year-on-

ARGENTINA

CHART 17





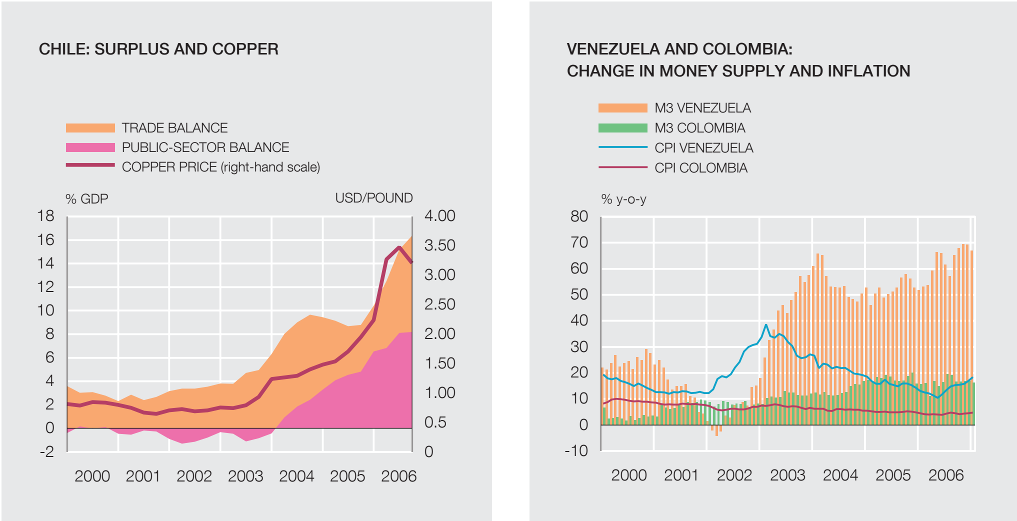
SOURCE: National statistics.

year growth was 4.3%. Thus growth in 2006 stood at 4% (5.7% in 2005, after downward revision of this growth with the change of methodology and the new base year). The slowdown in Q3 was caused by lower growth in domestic demand, since the negative contribution of external demand was smaller than in previous quarters. The subsequent recovery in Q4 was linked to the pick-up in investment in construction, since investment in capital goods remained weak. Private consumption remained strong throughout the year, partly because the labour market showed sustained growth of dependent employment and the unemployment rate held on its downward trend of the last two years, aided by the zero increase in the working population. Headline and core inflation decreased, particularly in Q4, due to the fall in oil prices and the moderation of economic activity, a trend broken in January. The central bank made the first interest rate cut (to 5%) in January, six months after the first rise, given the weakness of activity and the downward revision of inflation forecasts. The high price of copper and the structural surplus rule were reflected in another spectacular fiscal surplus in 2006, amounting to 7.9% of GDP (4.7% 2005). As seen in Chart 17, the price of copper, which increased by 83% on average in 2006, is also the main factor explaining why the 2006 trade surplus exceeded 16% of GDP, a sharp increase with respect to 2005, already a record high, and also why the current account showed a surplus of 3.6% of GDP despite the significant growth in net outflows of investment income in the copper mining sector. With regard to the structural reforms, it should be noted that, within the framework of the *Plan Chile Compite* (Chilean competitiveness plan) announced in July, the government promulgated a fiscal responsibility law (to complete and institutionalise the country's fiscal policy rules and enhance transparency in the management of countercyclical funds) and a law to foster investment by small and medium-sized enterprises. Also, Parliament is currently debating reforms to modernise the functioning of the capital markets and the social welfare system.

Economic activity in *Colombia* continued to pick up in the second half of the year. The year-on-year growth rate during this period was 7.9%, taking the average growth rate for the year as a whole to 6.8%. The main factor behind the higher growth in the second half was the smaller negative contribution of external demand, which was associated with the pick-up in exports, since domestic demand slowed slightly due to the investment component. Private consumption remained strong, and even quickened further under the influence of the sharp increase in lending and the higher real wages. The current account deficit widened slightly,

CHILE, VENEZUELA AND COLOMBIA

CHART 18



SOURCE: National statistics.

moving in parallel with the trade balance, due to the sharp increase in imports in the last few months of the year. From the fiscal standpoint, the central government deficit continued to decrease, but the total balance of public sector deteriorated, ending the year with a deficit of 0.9% of GDP, against –0.5% in 2005. Inflation in the second half of 2006 remained around 4.5% (within the central bank's target range), although it accelerated in the first two months of the year. Against this background, the central bank raised its official rate to 8% in February. Additionally, the strong inflow of capital, partly linked to privatisation transactions, led the central bank to intervene in the foreign-exchange market to slow the appreciation of the currency and pursue a strategy of sterilisation to control the growth of the money supply, as shown in Chart 17. On the fiscal side, a limited reform was approved that fell short of the government's original proposal. One of the principal agencies raised the credit rating of Colombia's sovereign debt.

In *Peru*, economic activity picked up in the second half of the year, and the average annual rate reached 8.1% in 2006 (6.4% in 2005), the highest in the last 11 years. The buoyancy derives from the strength of domestic demand, especially in Q4, when it grew by 12.5%. In the second half, consumption grew at a rate of 7% and investment was up by 30%, the growth of the construction sector being particularly significant. In this respect, despite the fact that external demand in Q4 trimmed four percentage points from growth, the trade balance showed a surplus of 9.4% in 2006, since exports grew by 37% and imports by 23.6% as a result of the sharp increase in metal commodities. The current account showed a surplus of 2.6%, despite the fact that factor income, which is associated with foreign investment, showed a deficit of 8% of GDP. The fiscal accounts improved significantly in the year and, overall, they showed a surplus for the first time in the last eight years. The strong growth rates were not reflected in inflationary pressures, since inflation held below the central bank's target range (1.5-3.5%) and expectations remained firmly anchored. Against this backdrop, the central bank held its official interest rate at 4.5% despite the high buoyancy of domestic demand. The economic programme agreement with the IMF was renewed.

In *Venezuela*, economic activity picked up in the second half and the average annual growth rate for 2006 stood at 10.3%, the same as in 2005. The high growth resulted from the pick-up in domestic demand, the growth rate of which was as high as 25.1% in Q4, due to the acceleration of both consumption (to a rate of 20%) and investment (to a rate of 40%). By contrast, the negative contribution of the external sector became increasingly marked and stood at more than 12 pp in Q4, with growth in real imports of 43% and a fall in real exports of 7%, the latter associated with the oil industry. Nevertheless, oil exports, which in dollar terms increased by 21.6% year-on-year in 2006 thanks to oil prices, accounted for 89.6% of total goods exports in the year and were the sole cause of the growth of the current account surplus in 2006 (by 6.4% with respect to 2005). Fiscal policy continued to be expansionary. Inflation continued to gather pace to rates of 20.4% year-on-year in February. In response to this, new price controls were put in place, the VAT rate was cut from 14% to 11% and the last three digits of the national currency were removed. However, these measures did not address the main cause of the quickening inflation, namely the growth of the money supply, as can be seen in Chart 17, and the vigorous expansion of spending. After the presidential elections in December, the government seems more inclined to intervene in the economy, as shown, inter alia, by the announcement of nationalisation of a number of companies in what are considered to be key sectors of the economy.

In *Uruguay*, GDP growth in the year as a whole stood at 7.1%, after slowing slightly in Q4. Inflation tended to abate up to October and subsequently rose to 6.8%, slightly above the target range (4.5-6.5%). The government paid early the amount ($1,079 million) of its stand-by programme with the IMF. In *Ecuador*, with growth of 4.6% in Q3 and positive external and fiscal balances, the most notable development was the marked widening of the sovereign spread in the face of a possible restructuring of external debt by the new government, and the downgrading of the country's credit rating by the major agencies. In *Bolivia*, new oil exploitation contracts were signed in late October between the government and the oil multinationals operating in the country. These contracts represent a further step towards the nationalisation decreed in May, although a number of vicissitudes have so far prevented them from entering into force.

21.3.2007