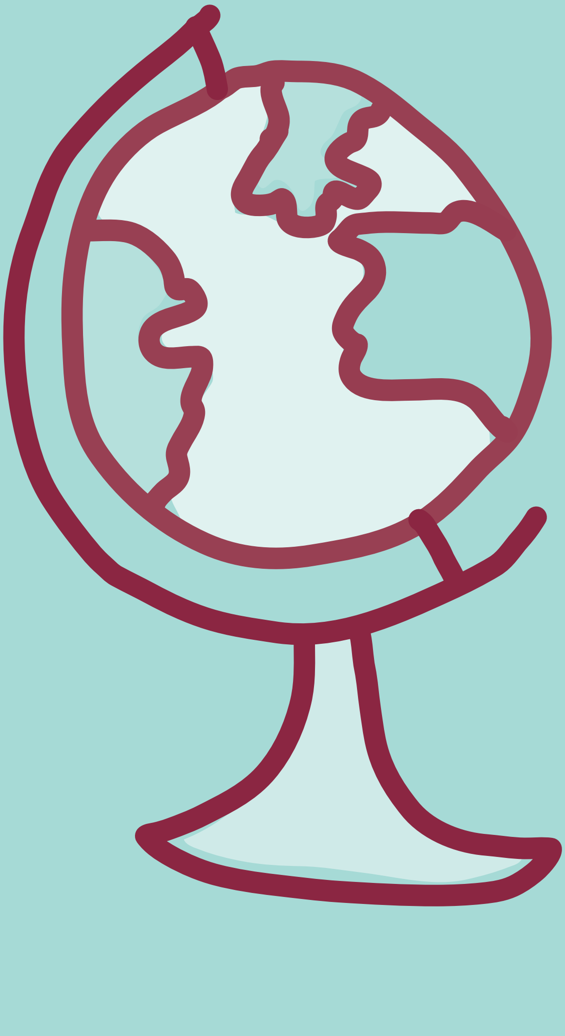
Latinwatch

Research Department

Third quarter 2005



Latin America: only a cyclical push?

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Under the microscope: bank lending in Latin America

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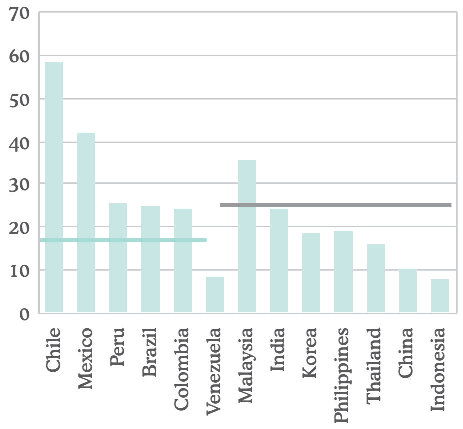
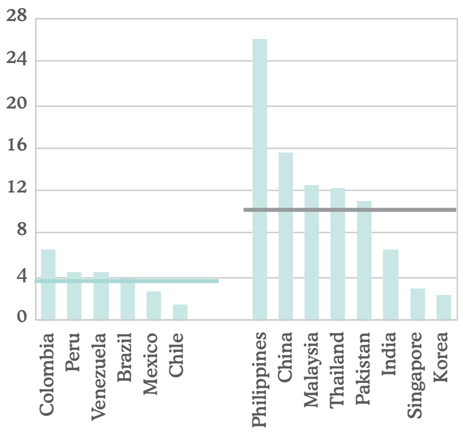
Moody's Indicator of Financial Strength, 2004



■ LATAM = 19,8
■ Asia ex-Japan = 28.4

Source: Moody's

Non-performing loan rate



■ LATAM* =3,6
■ Asia ex-Japan =10.1

Source: BBVA using IMF data

Editorial

What are the motors of economic growth? Factors such as the savings rate and income levels have been put forward as possible explanations for greater economic development. However, one area that has taken on greater importance in the world is the role of the banking system as a generator of wealth.

There are different ways whereby the development of intermediaries has a positive impact on economic growth. Banks provide liquidity, increase savings and channel it towards business projects. In addition, they reduce the costs of financing and increase productivity by choosing projects with the highest returns. Although this is not an exhaustive description of the benefits of a more developed banking system, we can say that in theory a positive relationship is to be expected between the development of financial intermediaries and economic growth. In this sense, different authors[1] have shown that this positive relationship exists and that the causality direction runs from the banks to the creation of wealth.

Finally, if progress in the financial system promotes economic growth, we have to ask ourselves: What can Latin America do to develop its banking system?

In the first place, financial intermediaries need macroeconomic stability. To the extent that agents can see that their expectations regarding nominal variables such as inflation and interest rates are confirmed, a large part of the uncertainty surrounding lending disappears. What is more, as is put forward in one of the following articles (see Hernansanz and Sánchez), the recurrence of banking crises has been fundamental in explaining the failure of intermediaries in the past 20 years to provide adequate funding. In both of these areas the region has made significant advances: macroeconomic stability now stands at historic levels and the process of restoring financial systems to health has produced solid intermediaries in the region compared with other emerging countries (see attached graphs). What is more, the coincidence of greater stability and good long-term prospects has allowed the establishment of a thriving mortgage market in countries such as Chile and Mexico (see the article by Riestra and San Martín).

Secondly, one should highlight the role the legal framework in which banks operate and the degree to which laws are enforced have on the allocation of credit. There is a large body of economic literature that has shown that countries which assign few rights to investors are precisely those with the least developed financial systems. It is of vital importance, therefore, that both banks and governments work together in drawing up laws and in the creation of institutions. Part of this process has already been seen in Mexico, where the creation of a credit bureau, the formulation of new laws and innovation by private banks in the creation of financial instruments have brought about a credit boom (see the article by Morales).

Likewise, a number of authors have shown that the enforcement of the law is just as important as the legal framework for the development of banks. This point is crucial, and constitutes the main challenge in the future for the economies in the region. As long as investors in general do not have guarantees about the level of support they can expect from the authorities in enforcing contracts, the certainty required for the development of financial markets will be lacking.

[1] See Levine, Ross, 1997, Financial Development and Economic Growth: Views and Agenda, Journal of Economic Literature, Jun. 1997.

I. International environment

Prospects for Latin America

Latin America is going through an unusual moment in its economic history: for the first time in 40 years the countries in the region have simultaneously posted growth for two years in a row. All of the seven major economies showed historically high growth rates last year and will continue to do so in 2005. There are a number of different factors that explain this phenomenon (see Latinwatch, Second Quarter 2005). Among these, we can mention short-term factors such as the favourable international environment and the positive evolution of commodities. But the structural changes in the region have also been important, particularly those that have brought about a more stable macroeconomic environment.

In this fashion, the region has benefited from the favourable inertia that it showed in 2004 in the first half of this year, and continues to show great dynamism. Concretely, Latin America grew at an annual rate of 4.1% in the first quarter of 2005. This rate of growth is below that of the average last year (6%), but still above the average for the past 15 years (3%).

In general, one can say that although growth in the majority of countries has started to moderate, it still remains relatively high. For example, if we exclude Brazil and Mexico, the increase in GDP in the region in the first quarter of 2005 was 6.5% (vs an average of 8.5% in 2004). However, in the case of Mexico the figures are particularly low due to a seasonal factor: there were five fewer working days in the first quarter of 2005 than in the same period of 2004. Thus, in seasonally-adjusted terms, growth in the quarter in Mexico was 3.8% (vs 4.8% in the fourth quarter of 2004). Lastly, although the export sector in Brazil is recording significant increases and constitutes the most dynamic factor in the domestic economy, both investment and domestic consumption showed surprising falls in the first quarter of the year (see Box on Brazil).

On the other hand, the favourable current external situation is expected to continue to benefit Latin America in 2005. For example, in the first five months of the year, the prices of oil, coffee and copper (65% of the exports of commodities of the region) remained at historically high levels in nominal terms. What is more, although the prices of these goods are expected to experience moderate falls in the second half of the year, price levels are expected to remain favourable for the economies in the region (see Boxes on Oil and Commodities).

Growth in the US will be close to its potential

Among the favourable external conditions that will support growth in Latin America during the rest of 2005 is the expectation that the US economy will continue to expand, albeit at a more moderate pace than in 2004. The dynamism of private consumption and the strong push given by investment will continue to be the main supports for growth in the United States.

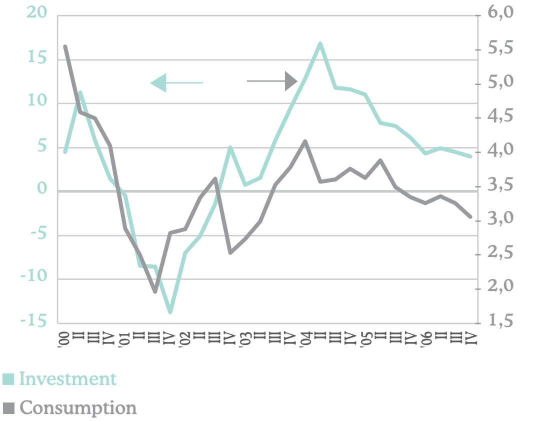
A number of factors will continue to underpin household spending in the United States. The first of these is the evolution of productivity, whose rate of advance dropped in the first quarter of the year to 2.5% (significantly below the rate of 5.5% posted in 2003), but which will continue to be relatively high. In addition, consumption will also be supported by the increase in house prices and the possibility of refinancing higher mortgages at low rates. On the other hand, the maintenance of low real rates of interest will continue to support growth in spending on durable goods.

Latin America: GDP growth
(% oya)

	2004				2005
	I	II	III	IV	I
ARGENTINA	11.3	7.1	8.7	9.1	8.0
BRAZIL	4.0	5.1	5.9	4.7	2.9
CHILE	4.6	5.3	7.0	7.3	5.7
COLOMBIA	4.0	4.9	3.0	4.1	4.1
MEXICO	3.9	4.1	4.6	4.9	2.4
PERU	5.1	3.5	5.0	6.8	5.4
VENEZUELA	34.0	14.0	14.1	11.2	8.7
LATAM *	6.9	5.6	6.2	5.9	4.1

* Weighted average of 7 countries
Source: National Accounts

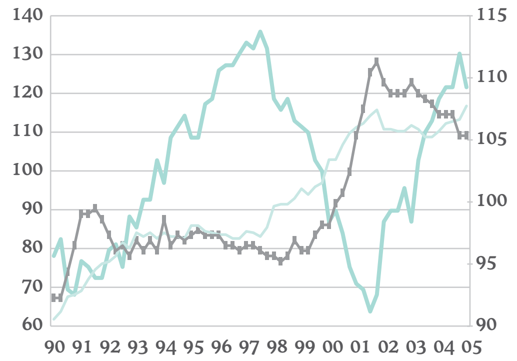
USA: consumer spending and gross private investment
(real % change oya)



Source: Bureau of Economic Analysis

USA: costs and earnings per unit of added value of non-financial companies

(value/average value Q190-Q105)



Earnings
Non-labour costs
Labour costs

Source: Bureau of Economic Analysis

USA: real and nominal 10-year rates

Nominal
Real

Source: Bloomberg

Investment, which accelerated notably last year after the strong fall experienced following the recession of 2001, will continue to drive economic growth. The solid financial situation of companies, the low cost of capital, growth in demand – with a moderate expansion in private consumption – and, mainly the noteworthy development in corporate earnings (see attached graph), will continue to allow high rates of growth in investment, albeit at a more moderate pace than that seen in 2004.

Long-term interest rates: the unknown factor remains in place

The context of low interest rates at the international level has been basic in explaining the greater flows of capital towards emerging countries, and towards Latin America in particular. In this sense, since the Fed began a gradual tightening last year of its benchmark rates, it was feared that the narrowing in the differential in yields with emerging countries would bring about a fall in investment flows to the region. However, the impact on the risk premiums of the Latin American countries has been limited. What is more, after the pick-up seen in March, long-term interest rates in the United States have fallen back again to levels of 4% (below those seen when the Fed started to increase rates in June 2004), which has increased the appetite of investors for emerging country financial instruments. This fall in rates has a number of possible explanations.

Firstly, one should highlight the change in expectations surrounding monetary policy both in the United States and in Europe. On the one hand, expectations for increases in interest rates by the Fed (factored into the futures market) have moderated significantly. In this sense, the main factors behind these expectations are, first, the stability of underlying inflation, and secondly, the uncertainty surrounding the evolution of US economic activity. On the other hand, inflation in the euro zone is under control, while confidence and activity figures have been disappointing, which has delayed expected increases in interest rates until the second half of 2006. Therefore, it is more feasible that there will continue to be downward pressure on interest rates in Europe. These pressures could intensify within a context of institutional uncertainty, and of greater probability of the structural reforms needed in the continent being frozen. This situation has been brought about by the rejection of the European Constitution in the French and Dutch referendums.

Secondly, capital flow movements have also contributed to keeping yields low at the long-end of the debt yield curve. The possibility of Asian central banks (particularly Japan) increasing their activity at the start of the second quarter of the year, and the fact that for regulatory reasons some agents (insurance companies) have been obliged to seek long-term public-debt assets have contributed to keeping yields lows.

Finally, it is possible that greater globalization is also favouring a fall in real interest rates. International savings is increasing as a result of the Asian countries, which are more than offsetting the drop in savings in developed countries.

As a result, these factors will allow long-term interest rates to increase in only a limited fashion in the coming months, a situation that will benefit the Latin America countries. Particularly, long-term rates in the United States are expected to stand at 4.5% at the end of 2005 and at 5.2% at the end of 2006. In the EMU, 10-year rates will foreseeably not move above 3.5% in 2005 and will increase to 4% the following year. This scenario assumes an improvement in the activity figures in Europe that allows the ECB to increase interest rates by half a percentage point in the second half of 2006. It also supposes a reduction in institutional uncertainty and a recovery in the confidence of economic agents.

Only a cyclical push?

The evolution of the foreign-exchange market has been characterised over the past year by the general appreciation of Latin American currencies, mainly against the dollar (see attached graph). The Colombian peso and the Brazilian real are among the currencies that have seen some of the biggest appreciations. The exception, however, is Venezuela, as a result of the devaluation last March. The appreciation of the currencies in the region against the dollar is not an isolated phenomenon in the currency market. However, the movement has been more intense compared with other emerging countries. In this sense, one's attention is drawn to the differences with what has taken place in Southeast Asia, where intervention by central banks to prevent the appreciation of local currencies has been frequent.

The favourable cycle in Latin America is finding support in a series of factors, which are significantly inter-related. Growth in the world economy, driven mainly by the United States and China, has constituted a positive shock for the region, which has doubly benefited. On the one hand, the volume of exports has increased, and on the other, demand pressure has pushed up commodity prices. In a parallel manner, the high level of liquidity and reduced levels of aversion to risk on an international scale have had a positive impact on financial conditions in the region.

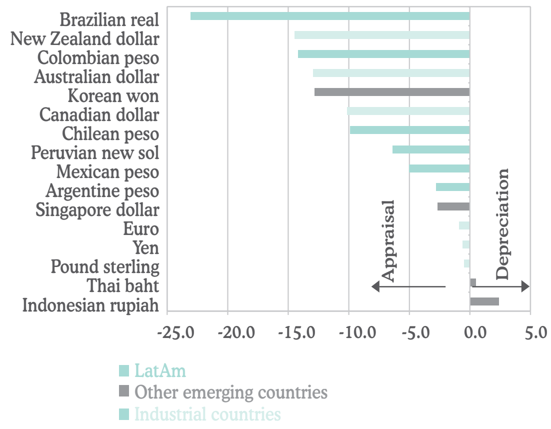
However, the favourable economic picture presented by Latin America at present cannot be explained solely by external and short-term factors. Clear proof of this is the situation regarding the current account balance, which despite historically being negative (an average deficit of 2% of GDP over the past 25 years), is currently in surplus (see attached graph). Although this situation could be linked to low levels of productivity in Latin America, and, therefore to a lack of investment in the region, there have also been significant structural improvements in recent years, which give rise to a more positive reading of the surplus. Proof of this is the greater degree of openness to trade, which has made the export sector more competitive, while manufactured goods now represent 60% of total foreign shipments (compared with 50% a decade ago).

Likewise, a more responsible budget policy has led to a substantial fall in the public deficit. In scarcely five years, the figure has gone from being around 3% of GDP to two points below that. As a result of budget consolidation, the level of foreign debt taken on by the Latin American countries has fallen noticeably.

Greater fiscal orthodoxy has been happily accompanied by the implementation of responsible monetary policies. The combined result has been a drastic reduction in inflation. Since the end of the 1990s it has been common to see inflation at single-digit levels in aggregate terms, a situation far different from the hyperinflation of the previous decades (see attached table). The containment of growth in prices reduces the uncertainty of economic agents and favours the development of long-term financial instruments in local currencies. This greater stability has fed through to the banking system, which has seen a significant fall in non-performing loans to levels below those in Asia (see following article).

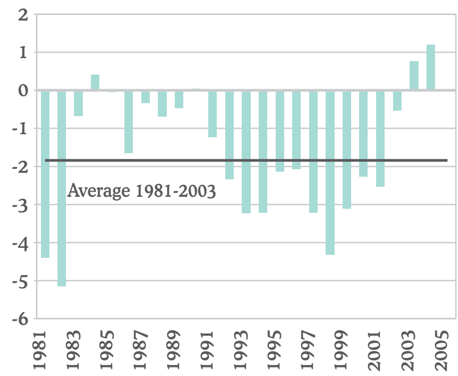
The markets are capitalising on the good performance of Latin America. Recently, and contrary to what has happened historically, the region has shown noteworthy strength in the face of the rise in interest rates in the United States. The pick-up in yields in the US curve has not be accompanied, as happened in the crisis of 1994-1995, by an increase in the risk premium of the region. The breaking of this correlation in the latter part of 2004 and the periods of independence from US high-yield instruments in 2005, demonstrates that international investors are assigning a greater degree credibility to the region.

Exchange rate variation versus dollar over past year
(in %)



Source: BBVA using Bloomberg data

Latin America: current account balance
(% of GDP)



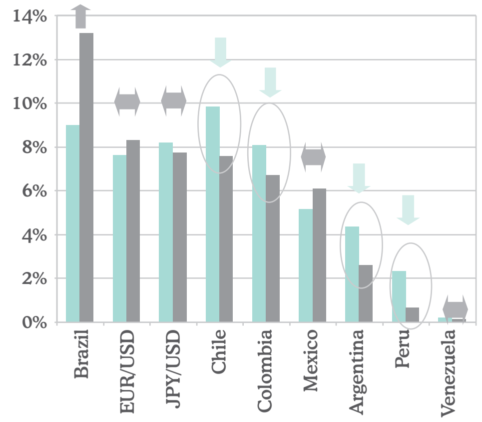
Source: BBVA

	Inflation target for 2005 (%)	Current inflation (%)	Short-term real interest rates (%)
Peru	2.5+/-1.0	1.8	1.8
Chile	3.0+/-1.0	2.7	0.4
Mexico	3.0+/-1.0	4.3	5.0
Colombia	5.5+/-0.5	5.0	1.3
Brazil	5.1+/-2.0	8.1	10.8
Argentina	5-8	8.6	-5.1
Venezuela	—-	17.4	-5.2

Source: BBVA

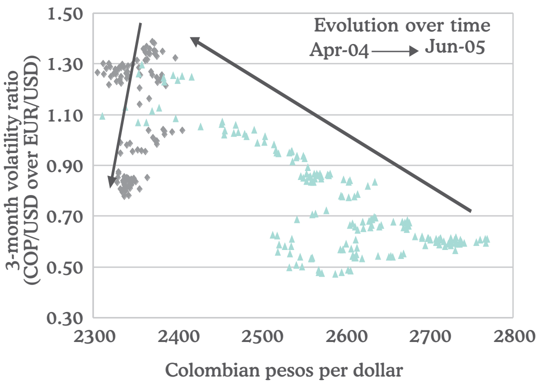
6-month exchange rate volatility versus USD

(annualised daily data)



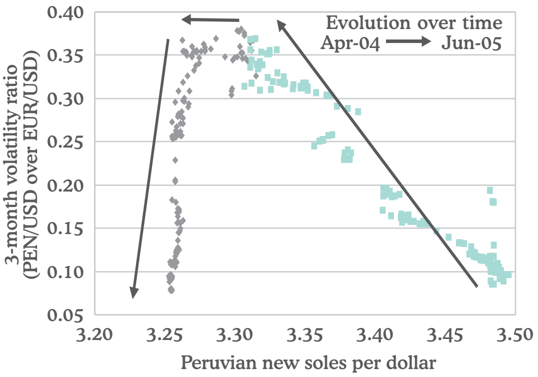
Source: BBVA using Bloomberg data

Colombia: foreign-exchange market intervention



Source: BBVA using Bloomberg data

Peru: foreign-exchange market intervention



Source: BBVA using Bloomberg data

Exchange-rate strategies: heterogeneity and fear of appreciation

The driving forces previously mentioned have been common to the Latin American countries as a whole. However, the response of the authorities to economic growth and currency appreciation has been different. The general trend in the structural phenomena is not incompatible with the fact that the current position with respect to the final aim is quite different according to the group of countries in question.

The first difference between the countries lies in the control of inflation. The experience in this sense is diverse, and stretches from countries such as Chile and Peru, where inflation is under control and stable at relatively low levels, to countries where the increase in prices has been above levels initially forecast by the government such as in Brazil, Argentina and Venezuela. The case of the latter two countries is particularly striking. Apart from having higher levels of inflation, they also have more expansionary monetary policies (in terms of real interest rates). Between these two types of experience, we find countries such as Colombia and Mexico. Both currently have relatively low levels of inflation but with opposite monetary policies: while in Mexico the tightening bias has strengthened notably, in Colombia the tendency has been towards easing. Therefore, in general we can say that there are easy financing conditions throughout the region (with the exception of Mexico and Brazil), but in completely different contexts of inflation and growth.

The inclination of the economic and monetary authorities regarding stimulating the economy or controlling inflation also shows itself in the exchange-rate policy applied. The accumulation of reserves in the past year has been intense in Argentina, Peru and Colombia, with increases of over 25%. This evolution is the result not only of the good performance on the current account front throughout the region, but also the product of interventions in the currency market to stem the appreciation of local currencies against the dollar.

Likewise, the exchange-rate volatility of these three countries in the past few months has declined considerably, while the rest of the Latin American currencies have performed more in line with international reference currencies (yen and euro). To the extent that the exchange rate of local currencies against the dollar has reached certain threshold levels, their volatility has dropped, probably showing fear of appreciation (see attached graphs). The reasoning on the part of the authorities is that an “excessive” appreciation could undermine the gains derived from the positive external shock on growth.

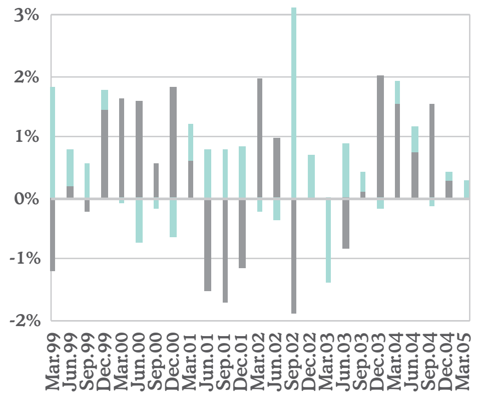
Definitively, Latin America is benefiting from a combination of a series of cyclical factors and the structural advances made in the past few years. These factors are putting upward pressure on growth and currency values, circumstances to which the countries involved are not responding in a uniform manner. This leads to a differing panorama in the region between those countries with a clear preference for stimulating economic activity through expansionary monetary policy and with a dirty float (Colombia), quasi-fixed (Argentina and Peru) or fixed (Venezuela) exchange-rate policy, and those oriented towards controlling inflation with a restrictive monetary policy and more flexible exchange rates (Brazil and Mexico).

Brazil: less growth

Slowdown in activity

The slowdown in the economy is evident (see graph), reflecting the production constraints which characterise an economy operating at the limits of its possibilities. The bottlenecks are many, and they cover all sectors. On the demand side, the weak performance of GDP growth in the first quarter of 2005 was reflected in consumption, which fell by 0.6% from the previous quarter, and investment, which shrank 3% in the quarter. Exports once again saved demand, with a quarterly rate of growth of 3.5%. Slower growth in imports (2.3%) than in exports led to an increase in the trade surplus.

Quarterly contributions to GDP growth



■ External sector
■ Domestic demand

Source: BBVA

It is difficult to identify the cause-effect relationship behind current production. Is it domestic demand – choked off by very high interest rates – that is putting a brake on production? Or is it productive supply – which has already reached the limit of its possibilities – that is simply looking for greater returns in higher international prices? The answer is a combination of both of these effects, which are conspiring to erode GDP growth. Although both factors exist, we believe that the main problem is the second one: Brazil's proximity to its potential growth is undermining its growth possibilities. This argument is borne out by the evolution of inflation, which, despite high interest rates and exchange rate appreciation, remains above the levels expected. In our initial projections we knew that Brazil would face the historical problem of the poor growth rate of its potential output, and that in 2005 there would be a slowdown in activity with respect to the previous year. However, the impact in the first quarter appears to be greater than expected, due mainly to the weakness of domestic demand. Under these new considerations, we are lowering our GDP growth forecast to 3% in 2005, and expect this figure to be repeated in 2006.

Cuts in rates in the second half

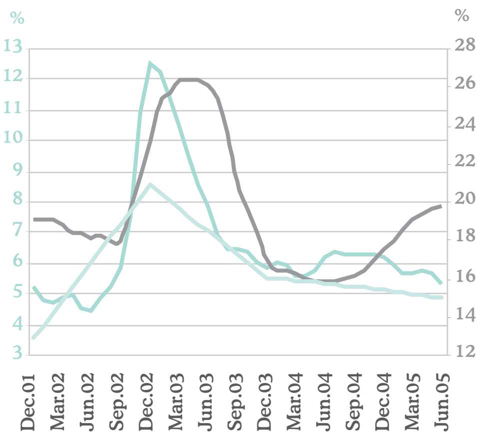
The evolution of the Brazilian currency and spread is not in keeping with the poor performance of the real economy. In the past few months, we have seen an appreciation of the real against the dollar. Behind this development, we find not only the excellent trade performance (a surplus of 15.6 billion dollars in the first five months of the year), but also renewed interest on the part of investors, who have been attracted by the combination of high interest rates and upward pressure on the exchange rate deriving from an increasing trade surplus. In this fashion, one has to add inflows of foreign capital (6.5 billion dollars in direct investment and a further 3.5 billion in portfolio investments) to the trade surplus. This situation cannot persist. On the one hand, currency appreciation will eventually lead to a reduction in the trade surplus. On the other hand, volatility in portfolio flows could bring about an abrupt correction in the exchange rate in the event of a shift in investor sentiment. We already saw in March that the foreign currency market is not very liquid and that turnabouts in demand can easily raise the currency to over 2.7Rs/$.

What does not appear to be particularly affecting the exchange rate nor the country risk premium is the political noise. Lula is currently facing the most complicated political scenario since he took office. Various accusations of corruption have been lodged against members of the coalition government, which has led to movements in the cabinet. The most important was the dismissal of the Presidential Chief of Staff, José Dirceu, who had been the executive's main interface with Congress. But this political noise ahead of the 2006 presidential elections has not been an obstacle to the appreciation of the real and the reduction in the spread.

The appreciation of the real has not only been nominal. There has also been persistent inflation. Despite extremely orthodox monetary policy efforts, neither actual inflation nor expectations of inflation have fallen at the rate that was expected. Only recently have expectations of inflation fallen to 5.1%. Actual inflation meanwhile should fall in the second half of the year to 6% to reflect the good performance of the real and the restrictive measures taken by Central Bank.

At its last meeting, the CB decided to maintain interest rates after having increased them on nine consecutive occasions. We believe the cycle of rises has now run its course, and expect a reversal in the second half of the year after inflation expectations have stabilised in order to stimulate domestic demand. The CB is expected to cut the SELIC rate to 18% by the end of the year from 19.75% at present.

SELIC, inflation expectations and CB target



■ Expectations (next 12 months) ■ SELIC (right)
■ CB target (next 12 months)

Source: BBVA using BCB data

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The paradoxes of the oil market

On analysing the oil market we come up against an important paradox; as supply improves and US inventories increase, the price of oil moves higher. Until 2002, there was a clear and strong negative correlation between the price of oil and the levels of reserves. From that year, if we analyse the impact of increased inventories on oil prices, we find that the correlation has become positive. That is to say, inventories rise and oil prices rise. Something similar occurs with OPEC output: when the cartel decides to increase production quotas, the market reacts by pushing oil prices higher.

In addition, an increase in oil prices of 10% traditionally accounted for a drop in demand for oil of between 0.3 and 0.5% in developed countries, depending on the phase of the cycle in which their economies found themselves.

Currently, one finds that increases in oil prices in the past few quarters have not brought about the expected correction in demand, causing a drop in price elasticity.

Another paradox is the scant inflationary reaction in developed economies in the face of the increases in oil prices. On the one hand, the existence of significant output gaps in most of the developed economies and productivity gains in the United States, along with a halving of the consumption rate for oil per unit of GDP with respect to the 1970s, explain a lower pick-up in inflation than that which the market had been factoring in.

The vision that prevails in the market now is of a fragile equilibrium between supply and demand, and in particular the fear that if an important producer were to drop out there would be insufficient capacity to offset this. The basis for this analysis rests in the additional production capacity of OPEC and declining production in OECD countries themselves. In 1985, excess capacity stood at 10 million barrels per day, equivalent to 17.2 percent of demand in that year, while in 2005 it stands at close to 2 million barrels, only 2.3% of the demand expected for this year. To the extent that an accumulation of inventories is in response to an increase in supply, this brings about a drop in the additional potential for production, which through expectations has an impact on prices not experienced before. This combination of factors, added to the accumulation of precautionary inventories that has brought about a structural change in the desired level of reserves, means that the accumulation is seen more as an increase in “strategic reserves” than for use in the short term. The market currently is factoring in a scenario in which demand will surpass supply by around 1% over the next three quarters. However, the market appears to believe that this is just the start of a prolonged phase of growing shortages.

On the supply side, while the scenarios for a significant interruption in supplies have a probability of occurrence of below 2%, recent political changes that have taken place in Iran have caused an over-reaction in a market that is more sensitive now than before to such events. At the same time, fears surrounding refining capacity mean that, despite the fact that inventories of gasoline are at their highest level in the United States in the past five years, the increase in precautionary demand for these has thrown up a different perception of the situation than that indicated by inventories as a whole. It would appear the market has failed to find answers to two questions. In the short term, can supply match demand that is less impacted by oil prices than in the past, and which also has a major player in the emerging markets? And in the medium and long term, given the characteristics of the OPEC countries, where 80% of oil reserves lie, will the investments necessary to transform these reserves into supplies be carried out in order to dispel the spectre of shortages. The responses being factored in by the market are scarcely comforting, a fact demonstrated by the incorporation of a structural risk premium in the second quarter of the year, which has displaced the price curve.

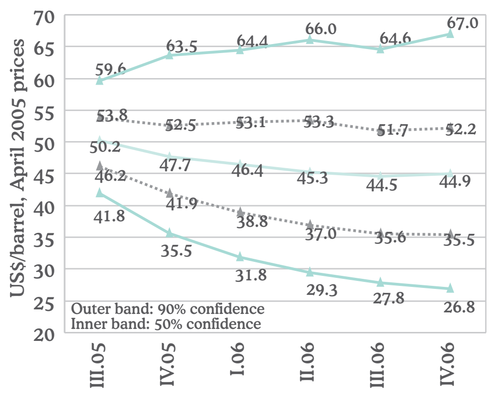
Updated price scenario

Faced with this paradoxical performance of the oil market, we have had to update our scenario for oil prices. The central element of this update consists of the incorporation of the highly persistent effect on prices of news and fears in the market with respect to the future balance between demand and supply of crude and crude distillates. Specifically, this translates into a rise in average benchmark crude prices for the next few quarters, as well as a possible increase in the frequency of future adjustments to the scenario.

Under our central scenario, we are forecasting an average price for Brent for 2005 of 49.7 dollars a barrel, and 45.3 dollars a barrel for 2006. On the other hand, the maximum and minimum prices that delimit the future uncertainty as regards prices suggest that fears of a possible run-up in the average quarterly price for Brent to above 70 dollars a barrel and even 100 dollars are exaggerated, events which, as we indicate in the attached graph, have a probability of occurring of below 5% even within a time horizon of one year.

Apart from the upward adjustment in our central forecast, we maintain the downward trend included in our previous scenario, which reflects the expected transitory nature of the expectation shocks that have caused the recent rally in oil prices.

Estimated Brent prices for 2005-2006



Source: BBVA Banco Provincial Research Department

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Commodities

Further rises in prices

Commodity developments continue to bring good news for Latin America. In particular, the prices of oil, copper and coffee (65% of the region's commodity exports) have risen to record highs over the past few months. In the case of oil, the $53 average price of a barrel of Brent observed in March represents the highest level registered in nominal terms in recent months (see Box on Oil).

In the case of copper, the price of the red metal on the London Metal Exchange reached a value of 167c/lb on June 17 of this year, just 1 cent below the all-time nominal high posted in 1988. As is the case with other types of inputs, the current situation is attributable to a shortage of stocks and the strong industrial activity data in China and the United States (40% of total demand for copper).

Likewise, the price of coffee is running at relatively high levels compared with those observed over the past 5 years. In particular, coffee prices currently stand more than 100% above the average price for 2002.

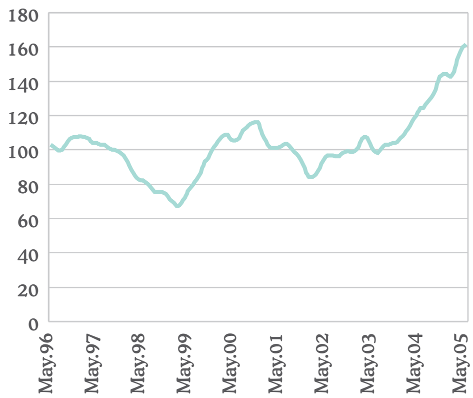
For these three commodities, we expect prices to moderate somewhat, although once again the end-year forecasts are for prices above those observed over the past 5 years.

The BBVA-MAP index[1] continues to move up

As regards the BBVA-MAP index, the increase in the price of oil has continued to play a crucial role in its trajectory over the past few months. In particular, between December and May of this year, the cost of a barrel of crude rose by 24%, while our index went up 13%. In addition to oil, agricultural products have also posted a strong performance over the past few months. The annual rate of growth of our agricultural index has been around 20% for the past 6 months, mainly as a result of increases in the prices of coffee and sugar.

BBVA-MAP

(3-month moving average - 1995=100)

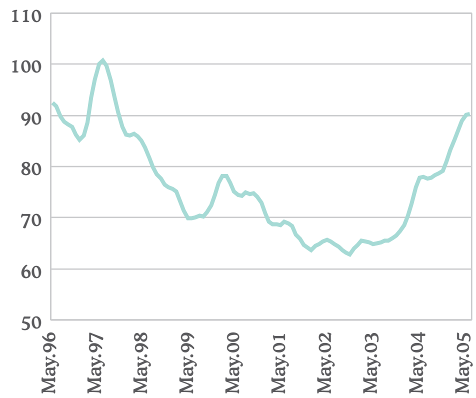


Source: BBVA

Moreover, if we look at the behaviour in different countries, we can see there is a clear difference between those that are producers of oil (Argentina, Colombia, Mexico and Venezuela) and those that are not (Brazil, Chile and Peru). In this sense, it should be stressed that the negative effect of oil prices has been mitigated in economies such as those of Chile and Peru because copper prices have also risen. The impact on these countries' terms of trade has therefore remained positive (see the year-on-year rate).

BBVA-MAP ex-oil

(3-month moving average - 1995=100)



Source: BBVA

Moderate downward adjustment in the second half of 2005

As we have noted in earlier issues of Latinwatch (see that of the second quarter of 2005), we expect the prices of commodities to ease back slightly towards the end of year. However, again it is important to stress that our forecasts for the end of the year envisage prices that are still above those observed in 2003. As a result, the favourable context that has been accompanying growth in Latin America is expected to persist.

BBVA-MAP commodity index

(% change as at May 2005)

	Since January 2003	Last 12 months	2005*
BBVA-MAP	54.12%	23.65%	13.39%
Ex-oil	37.02%	17.24%	4.42%
COMPONENTS			
Metals	64.14%	15.89%	-0.75%
Agriculturals	29.13%	19.12%	8.21%
Energy	65.45%	28.77%	22.31%
COUNTRIES			
Argentina	15.24%	-4.60%	7.75%
Brazil	4.52%	1.75%	-0.24%
Chile	46.54%	9.38%	-0.69%
Colombia	49.04%	31.44%	13.90%
Mexico	38.80%	24.49%	13.65%
Peru	30.79%	12.09%	-1.01%
Venezuela	64.02%	27.90%	19.68%

Commodity prices

	Annual average			End-year
	2003	2004	2005*	2005f
Coffee (USc / lb)	65,0	85,1	125,9	115,0
Copper (USc / ton)	81,0	126,0	147,5	110,0
Gold (US$/ounce)	363,9	409,6	426,9	440,2
Oil (US$/barrel)	29,6	38,6	49,0	47,7
Soya (US$ / ton.)	238,0	267,0	235,4	245,0

* Until May
f-forecast

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[1] The BBVA-MAP index is a weighted average of the prices of the main export raw materials and agricultural products of Latin America.

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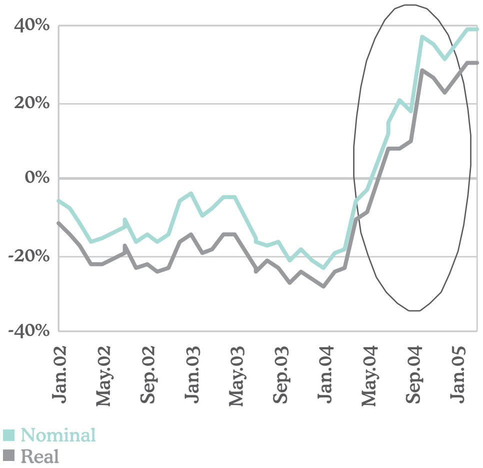
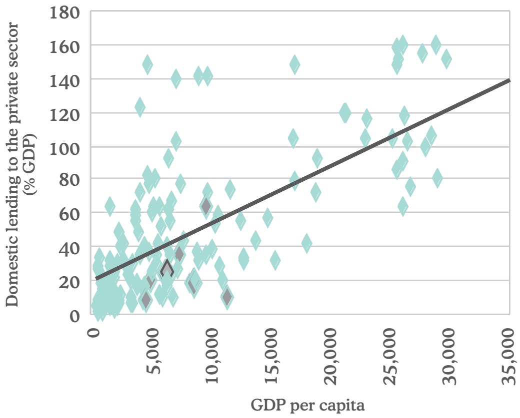
Graph 1. Real lending in Latin America

(% oya)



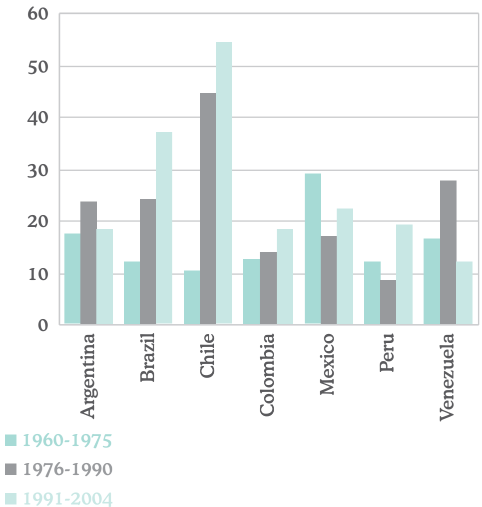
Source: BBVA using Central Bank and Superintendency data

Graph 2. Domestic lending to the private sector and GDP per capita



Source: BBVA using World Bank data

Graph 3. Ratio of lending to GDP



Source: BBVA using FMI data

III. Under the Microscope: Bank Lending in Latin America

Reflections on the recent growth in bank lending in Latin America

The potential for growth in lending is still there

After a long period of deceleration and stagnation, bank lending in Latin America picked up notably from the start of 2004 and strengthened further in 2005. Lending in March 2005 was up 39% in nominal terms and 30% corrected for inflation against a nominal 31% and a real 22% at the end of 2004.

This strong increase has been general to all countries, particularly Venezuela, where growth is running at a rate of 80%. Argentina, Brazil, Chile, Colombia and Mexico are also showing spectacular rates of growth, in most cases of over 20%. Peru, however, is the only country where lending has failed to take off.

Under these circumstances, it is worth asking whether the current situation is sustainable, and if there is room for growth in lending to the private sector in the region. Firstly, if we analyse bank lending from an historical point of view, we can see that the current levels reached are still below those seen in the 1960s. Chile and Brazil are the only countries where bank lending in real terms has consolidated at levels beyond those of the 1960s, while in Argentina and Peru they still remain well below those levels. The average level of lending granted to the private sector in the region stood at 29% of GDP in the 1990s, but is currently below 25% of GDP.

Secondly, the development of lending in Latin America remains below that in other emerging countries. In all of the countries in the region, with the exception of Chile, the size of the bank lending market is lower than it should be given the levels of GDP per capita. On this basis, the systems in Argentina and Venezuela are the most underdeveloped in terms of lending. If those two countries had lending levels that corresponded to their levels of per capita income, the volume of loans would be five and four times greater, respectively, than that seen at present. For the rest of the countries, lending has room to double.

Thus, while growth in lending in the past year and a half has been unprecedented, bank credit is still very much underdeveloped.

Banking crises have prevented consolidation in lending...

One of the reasons behind the lack of depth in the credit market has been the high number and recurrence of banking crises. Between 1974 and 2003, Latin America was the region where most recurring banking crises took place. According to IADB figures, 35% of the countries in the region suffered financial upheaval in the period under question, double that of the rest of the emerging areas.

Banking crises not only hold back the development of bank lending. The weakening of the asset bases of the financial entities that accompanies them also leads to periods of strong restrictions in lending, which in turn significantly slows the development of banking penetration. On the basis of a recent study by Barajas et al (2005), one can conclude that during the periods of slowing bank lending that took place in the main economies in the region in the past 10 years, the ratio of loans to GDP fell by an average of 10 percentage points.

Restrictions on the supply side, along with weak demand in the context of an economic recession, mean that lending is notably weak after a banking crisis. That is why for lending to return to the levels seen before the crisis it takes an extended period of time and requires the consolidation of orthodox macroeconomic policies, as well as for economic growth to take off.

This is evident in the case of Chile after it emerged from the crisis at the start of the 1980s. As can be seen in graph 5, the country took 10 to 12 years to reach the level of lending in real terms seen before the start of the crisis. If we carry out the same exercise in the recovery of Mexico (1994) and Colombia (1998) from their most recent crises, we can see a similar pattern. In fact, Mexico is only now entering a phase in which lending is taking off, while Colombia has barely reached the levels prior to the strong mortgage lending crisis it suffered at the end of the 1990s.

...but the economies in the region are less vulnerable

However, there are reasons to conclude that structural changes have taken place in the past decade that have reduced the weaknesses of the banking sector. In the first place, greater macroeconomic stability has been achieved. One of the areas in which this is evident is the noticeable fall in inflation over the past 10 years. Nominal stability is a healthy factor since it allows economic agents to anchor their expectations and take decisions with a greater degree of certainty. Lower levels of inflation have been accompanied by lower interest rates, which has had a positive impact on demand for loans. But besides that, the drop in financial volatility has brought about a situation in which fixed-rate loans are starting to be offered in some countries, a milestone for economies in which to take out long-term loans was either impossible or involved paying a high risk premium.

Secondly, progress has also been made in reducing levels of financial vulnerability such as dollarisation. After convertibility was abandoned in Argentina, the amount of dollar-denominated deposits in the five largest economies in the region stood at a modest 9% of total deposits, compared with the 21% seen three years prior to that[1].

Banks are better placed to lend

After the banking crises mentioned above, financial systems in the region carried out extensive restructuring of their bad loan portfolios, which allowed them to continually reduce non-performing loan ratios. If we exclude Argentina, which is still suffering the effects of its recent crisis, the average non-performing loan ratio in the six biggest economies in the region stood at 3.6% at the end of 2004. This evolution compares favourably with that seen in other emerging regions such as Asia, where, with the exception of South Korea, non-performing loan ratios are above 10%, and in some cases considerably so.

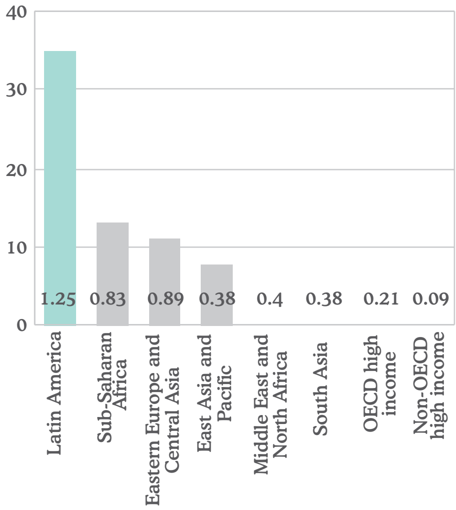
The improvement in risk management by banks has followed on in many cases from the introduction of enhanced regulatory frameworks. More than half of the Latin American countries that had adopted the Basel Accord in 2002 did so in the second half of the 1990s. In the same way, improvements in regulations protecting the rights of creditors, measures aimed at reducing the negative consequences of dollarised financial systems, and the creation of credit-rating information offices are examples of ways in which a number of countries have strengthened credit risk management.

Financial liberalisation, which brought with it the entry of foreign banks, should also be placed within this context. Foreign banks export technology and bank management capabilities to the countries in which they operate. There are many studies that show that foreign banks have increased competition in the banking systems in Latin America.

This increase in competition has brought down the traditionally high banking spreads in the region, which has improved access to financing for households and companies. Finally, the reduced dependence of foreign banks on local conditions has a positive impact on the supply of credit in the presence of negative shocks. This helps to mitigate the credit crunches that have done so much damage in the past.

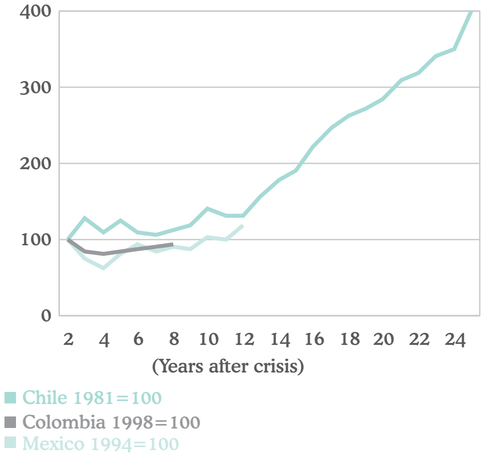
[1] Ecuador dollarised in 2000, but its weighting in the region is very low (1.2%).

Graph 4. Countries with recurrent crises 1974-2003
(in %)



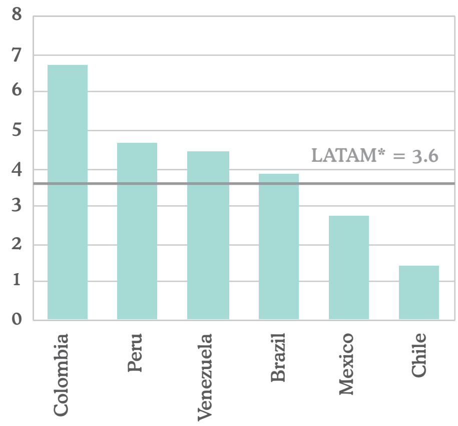
Source: IADB

Graph 5. Lending index in periods of crisis in real terms



Source: BBVA basado en datos del FMI

Graph 6. Non-performing loan ratio in 2004



* Ex Argentina.

Source: BBVA using FMI data . (Global Financial stability report. April 2004)

Finally, the expansion of the deposit base that is taking place means that banks in the region are well placed to lend. In fact, the ratio of private sector lending to deposits in the major countries has been falling for the past five years, and currently stands at near 0.8. In countries such as Argentina, Mexico and Venezuela this ratio is below 0.5. This stock of available funding is making a relatively high rate of lending growth possible without the generation of any significant tensions in financial balance sheets.

Yet important challenges remain

However, a number of additional developments are required in order to strengthen bank lending. In the first place, the progress made in the area of fiscal consolidation needs to be taken further. Banks have traditionally been one of the main sources of public deficit funding in the Latin American countries, with a subsequent crowding out of private credit. The reduction in fiscal imbalances observed over recent years and the fall in public debt yields are incentives to search for alternative investments, and hence encourage an increase in the supply of credit.

Secondly, more efficient banking systems require a more precisely defined role for public banks. The existence of overlaps in the activities of both types of institution widens the social gap that exists between the population that has access to financial services and that which does not. In addition, the available evidence seems to suggest that public banks have higher margins than the private banks (BID 2004).

Thirdly, in some countries there has been a return to greater interventionism in the financial sector. This is very damaging to the development of the sector. The different types of taxes on financial transactions that exist in several countries may be included here. It has been documented that such taxes have a negative impact on the deposit base, which in turn has a detrimental effect on potential lending.

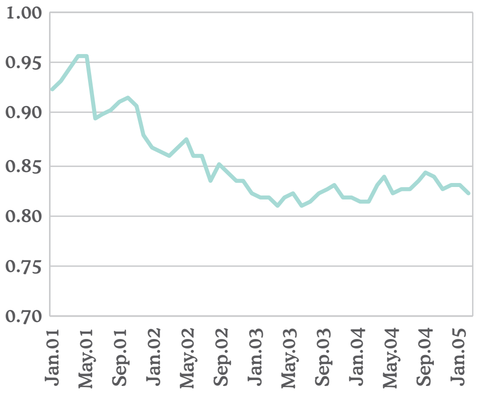
Interventionism is also apparent in the establishment of credit investment coefficients which require banks to direct bank lending towards certain sectors. Experience has shown that this generates notable inefficiencies in economic systems, in particular when limits are placed on the interest rates that can be charged on these loans. In the specific case of Brazil, it can be seen that the interest rate applied to free-market lending is higher than that on targeted lending, which means that debtors in the free segment subsidise those that can use forms of lending that are subject to intervention. In the case of Venezuela, the recent introduction of ceilings on all lending interest rates safeguards against this possibility. However, the requirement to comply with a certain credit coefficient, in the absence of freedom to set interest rates, is a potential risk for the quality of loan portfolios, since it makes it more difficult to establish appropriate risk premia in situations in which less solvent demand must obligatorily be met.

References

Barajas, A., R. Chami, Thomas Cosiano (2005), Did the Basel Accord cause a credit slowdown in Latin America? IMF Working Paper 05/38.

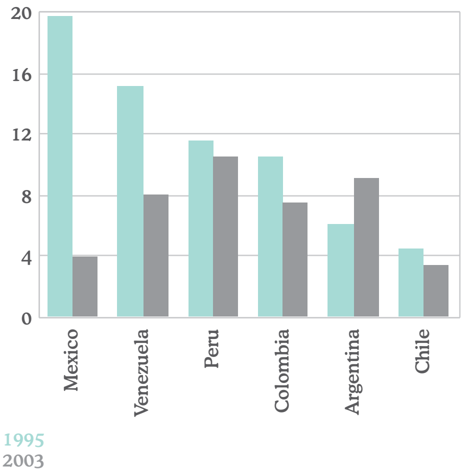
Inter-American Development Bank (2004): Unlocking Credit. Economic and Social Progress in Latin America, 2005 Report.

Graph 7. Ratio of lending to deposits in Latin America



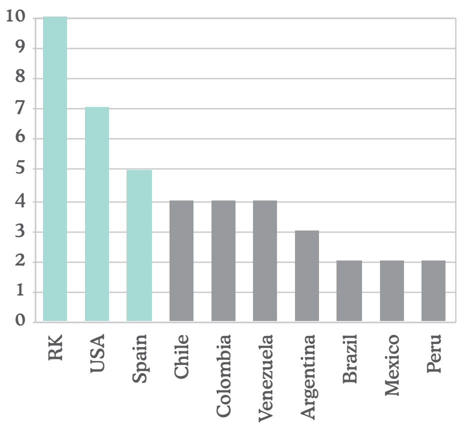
Source: BBVA using Central Bank and Superintendency data

Graph 8. Bank spreads in Latin America



Source: World Bank

Graph 9. Legal rights Index (0-10), Getting Credit*



*10 indicates that collateral and bankruptcy laws are better designed for access to credit

Source: Doing Business, World Bank 2004

The mortgage market in Latin America

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There are significant problems of access to housing

In the past 35 years, the population of the Latin American countries has doubled to almost 500 million at present. Although the population growth rate has fallen gradually, it is still above that for developed countries, which means that demographic growth is greater. Demographic projections for the region point to a total population of 1.1 billion inhabitants by the year 2050. Given the current age structure, the process of household formation far from having run its course will continue to grow. For this reason, the need for housing will grow in the coming years, creating severe tensions to the extent that the supply of housing does not adequately match potential demand.

In this sense, the scant development of the residential construction industry, along with the continuous ups and downs to which the property markets in the region are subject, constitutes an added difficult in increasing the supply of available housing. As a result, a significant part of Latin American households have not had their housing needs fully met. According to the information available from ECLAC, 60% of families find that their accommodation needs have not been resolved in a satisfactory manner. This percent includes the 32% of the inhabitants in the region (127 million people) who lived in slums in 2001.

This situation indicates the existence of a significant problem of access to housing for large sections of the population. On average, the price of a house for a Latin American family is equivalent to six years gross income, according to the latest figures from the IADB. Despite this high figure, only one out of four households turn to formal financing to acquire a home. In fact, the high level of informality in the construction sector considerably reduces the quality of the existing pool of housing, creating along the way a big shortfall in residential property in the region, both in terms of quality and quantity.

The demographic figures highlight that demand for housing for population reasons will increase in the medium and long term. However, part of this potential demand will not be reflected in actual demand, although the gap will tend to reduce itself as flows of financing towards housing increase. A real increase in household income, among other factors, would allow the possibility of potential demand becoming real demand. Therefore, the ability to create jobs, the salary levels reached and the growing evolution of both are the factors that will strengthen the residential property market. The performance of these variables throughout the present decade will determine the size of real demand. However, if the supply of property does not match demand, the improvements produced in the economic conditions in the region will be reflected in higher real-estate prices and not necessarily improved housing conditions.

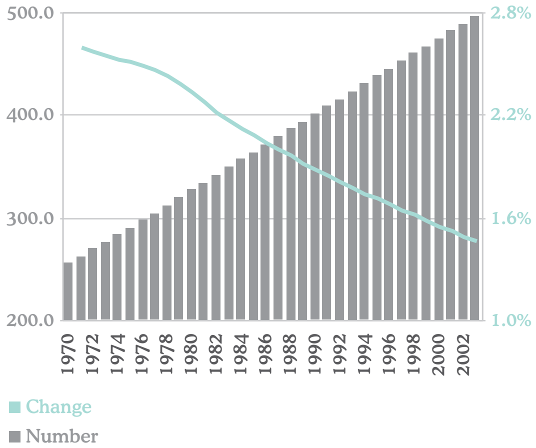
Financing for housing is still limited, although it is picking up in the region

The existence of a mature mortgage market improves access to housing for large sections of the population as is seen in the developed countries where the importance of mortgage financing for companies and households is significant and growing. Despite the multiple efforts made in the past few decades, Latin America has failed to develop a system that guarantees the provision of mortgage lending in favourable conditions for households as a whole, particularly those with lower income. Therefore, the importance of housing finance is almost symbolic, and constitutes a potential impediment to the development of the property market, although not the only one.

While in the United States and Europe, the value of housing finance is high in terms of GDP, the equivalent of 64% and 50% respectively at the end of 2004, in Latin America, the resources devoted to housing finance were below 6% of GDP, except in the case of Chile where they were slightly above 12%. High macroeconomic volatility and episodes

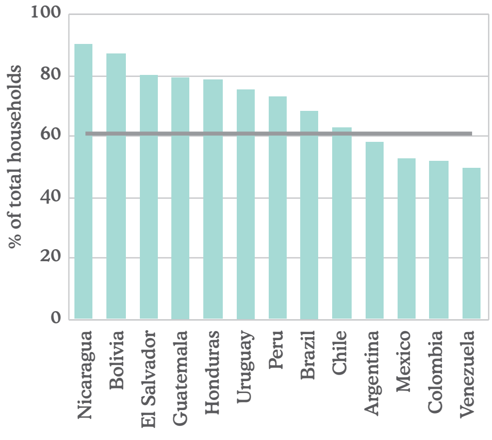
Graph 1. Population in Latin America

Millions of inhabitants and annual change



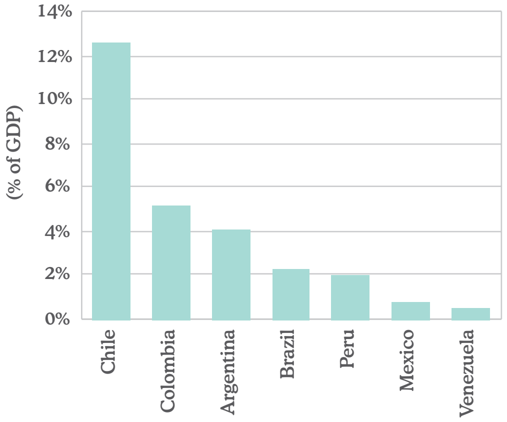
Source: National Censuses

Graph 2. Households with unsatisfied accommodation needs



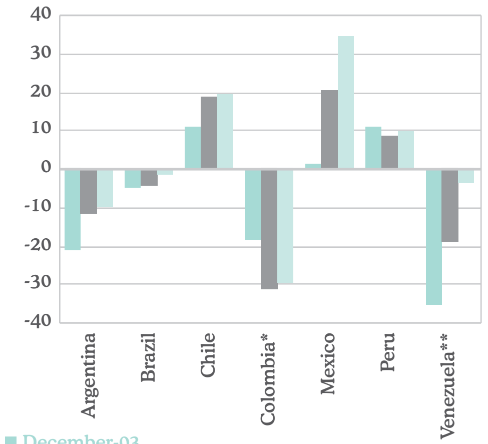
Source: ECLAC

Graph 3. Mortgage credit
(2000-2004)



Source: BBVA using central bank and superintendency data

Graph 4. Real mortgage credit growth



* Most of the mortgage portfolio has been securitised
** Data at March 2005

Source: BBVA using central bank and superintendency data

of high inflation have particularly had an impact on mortgage credit, which since it involves long-term operations, needs to evolve in a more stable macroeconomic environment.

The limitations in developing housing finance have been accentuated by the different banking crises that have taken place since the second half of the previous decade. Despite this, the process of restoring most of the banking systems in the region to health, along with greater macroeconomic and financial stability in the past few years, has brought about a strong increase in bank lending for the acquisition of housing in a number of countries in the region.

One should also point out the greater financial stability that has existed in the past few years, and the significant development that has taken place in the domestic capital markets in local currencies, which has allowed a notable increase in local-currency lending at fixed rates of interest, and with a significant lengthening in tenures. All of the above facilitates the access of households to housing finance, while at the same time increasing security in the face of adverse scenarios in the future.

In addition, modernisation of banking systems and a significant improvement in risk management have taken place over the past few years. As can be seen in the graph, credit bureaux and public information on the credit records of potential clients have significantly developed in the region compared with other emerging economies, approaching the level seen in developed economies. On the other hand, the sound foundations of the banking entities in the region place them in a good situation to increase their presence in the mortgage market.

In addition, parallel development in the secondary mortgage market is taking place. In this sense, the growing importance of institutional investment as a result of the privatization of pension funds and the growth of investment funds in most countries have strengthened these markets with high levels of demand for long-term assets. This allows the development of financing systems for mortgage portfolios through the issue of bonds and mortgage securitisation. This also has a positive externality, given that since we are dealing with issues launched in the market, these act as an incentive for the development of legal and regulatory frameworks. In this sense, in Chile more than half of the mortgage portfolio is in the hands of institutional investors and insurers through mortgage-backed securities and mortgage bonds. Likewise, in Colombia and Mexico securitised mortgage funds are starting to be used to gain access to liquidity in the secondary market.

Although the natural development of housing finance in Latin America takes place within the banking sector, the existence of a diversified mortgage credit base increases the stability of access to liquidity, allowing at the same time enhanced management of interest-rate risk.

More efficient housing policies would improve access to housing for a greater number of households

The State has generally played an important role in housing finance in all of Latin America. This intervention has mainly taken place through public financial entities, which has limited the development of private financing. Although their importance has decreased in most countries, public banks, whose management is more inefficient, and which have higher non-performing loan ratios, still maintain large shares of the market for housing finance, as is the case in Brazil.

To this should be added the fact that in some countries private sector lending is likewise subject to state intervention through various government policies. Housing market intervention mechanisms tend to produce unwelcome distortions and are difficult to offset, particularly those of a retroactive nature that generate a considerable lack of security for the healthy development of the market. This is particularly the case in housing finance, which, since it has a marked social component, is the first focus of action of these types of intervention. Another form of intervention is the compulsory allocation of a percentage of the lending portfolio of financial institutions towards housing, as occurs in Brazil and Venezuela. This affects the market supply of credit since it makes it impossible for banks to manage risk effectively in a cyclical business such as the property market.

Another of the common problems of housing finance is the extent of subsidies. Thus, in Brazil and Mexico, a part of housing finance comes from the compulsory savings funds that companies deduct from workers' pay. Given the difficulties of a significant part of the population in qualifying for this type of finance, these resources end up becoming regressive subsidies that benefit middle or upper-income households.

In this sense, it is important to note the distortions caused by planning legislation and intense state intervention in the regulation of construction. In the case of urban planning, a lack of clear, well-defined property rights, the limited resources of local administrations, the slow pace of urban development and endless administrative red tape impede the generation of urban land in sufficient amounts and in appropriate conditions at a price affordable to households.

As regards the regulation of construction, the existence of high or very exacting standards with regard to quality and minimum house size can displace a significant portion of demand to the informal segment. Thus, in Brazil and Mexico, to be eligible for a subsidy, houses have to meet certain requirements (such as a surface area over 90m^2), which makes them inaccessible for a large percentage of the population. In Chile, in contrast, the average free market house has a surface area of 127m^2, whereas the average size of subsidised housing is 42m^2. This facilitates access to housing for households in lower income brackets. Once households gain access to the formal housing market, the capacity for moving up the social ladder rises.

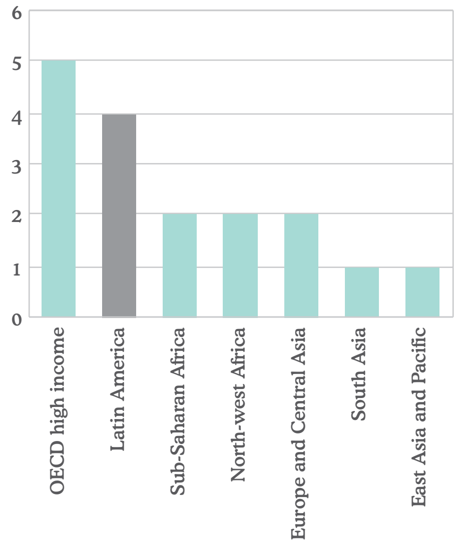
Public sector housing policies need to focus more on resolving the basic problems of housing finance. That is to say, the problems of property rights and the reinforcement of the rights of creditors. The development of an efficient and effective system for registering property is the basis for the expansion of the mortgage market, since this allows one to define the guarantee on which lending rests. Access to information regarding title deeds and the charges that exist on these guarantees and facilitates the process of credit allocation. Another very positive development would be the existence of an independent and transparent evaluation system that would allow entities to assign with the greatest possible precision the value of guarantees with a view to safeguarding the financial institutions' policy with regard to risk. Finally, it is essential to speed up and enhance guarantee recovery systems, since it is on this possibility that growth in the mortgage markets is contingent. An example of the latter can be found in the long guarantee recovery processes that exist in Peru, where between 18 and 36 months are needed for guarantee recovery, according to the results of a study undertaken by the Superintendency of Banks.

Progress with these structural reforms is crucial to ensure the sustained growth of mortgage lending as well as to reduce the cost of such lending. Currently, this includes in many countries the risk derived from a lack of regulatory development. In this sense, it is worth highlighting the progress made in Mexico during the last 5 years.

Time for reform

Three fundamental factors have constrained the development of the Latin American property market over the past two decades: macroeconomic and financial instability; an inadequate regulatory framework in relation to property rights and the rights of creditors; and inefficient intervention by the State. The important strides made by most countries in economic stabilization over the past few years make it crucially important to adopt measures aimed at enhancing the regulatory environment and to redefine housing goals and policies in the region. This is particularly true at present when the banking systems of most of the economies are in a position that is much more conducive to the development of such products.

Graph 5. Index of access to credit information



*The index measures the scope, access and quality of credit information on the basis of 6 indicators (existence of positive and negative information, for companies and individuals, sources of information, keeping of historical information, information on loans and access to information)

Source: World Bank

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Mexico: Recovery and expansion of bank lending

In 1995, Mexico's GDP shrank by 6.2% and inflation went from 7% to 52%, while unemployment increased to 6.2%. The deterioration in the economy caused sudden increases in interest rates and severely affected the ability of debtors to service their loan payments, as well as being the detonator for an intense banking crisis. This translated into an increase in the portfolio of overdue loans, financial weakness in banks, and the subsequent restructuring and recapitalisation efforts on the part of institutions.

The end effect was a significant contraction in lending to the private sector for a period of over seven years. The balance of the outstanding loan portfolio[1] as a percentage of GDP went from 36.5% in 1994 to only 6.5% en 2001. From 2002, credit in relation to GDP began to grow again but remains far from the levels seen before the crisis.

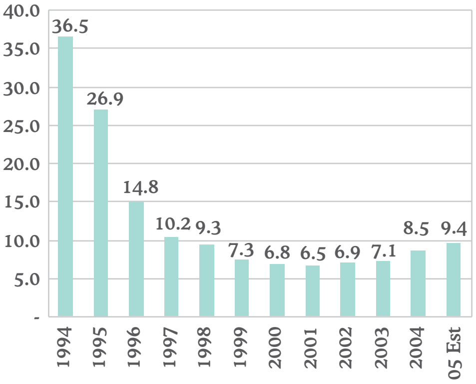
Causes of the contraction in lending

The banking crisis of 1995 was the product not only of the deterioration in the macroeconomic framework, but was also due to the weakness of institutional, legal and prevention factors, as well as the limited availability of accurate financial information, which form the basis for the healthy functioning of lending activity. This was the case as regards the legal framework, which did not protect creditor rights; the absence of elements that reduce credit risk or allow it to be adequately evaluated; the use of accounting norms that did not reflect the real financial situation of the banks, and the granting of credit at variable rates of interest in a context in which macroeconomic instability exposed debtors to high interest-rate volatility. The presence of these factors increased the effects of the banks' problems when the crisis broke in 1995. Lending started to flow again only after these factors were addressed

Driving and recovery factors

As has been mentioned above, reduced demand for credit linked to the economic crisis and supply restrictions prevented a rapid recovery. Lending only started to pick up again when a number of different favourable conditions were in place both on the macroeconomic level and within the sector itself that reduced the risk of granting credit. On the macroeconomic level, what stands out is the reduction in inflation and the confidence that economic policies were directed at keeping it stable. This allowed agents to take long-term debt decisions. As regards the regulatory environment, laws and regulations governing banking activity were modified to make them more rigorous (accounting criteria). Institutional and methodological measures were also introduced to improve the measurement of credit risk (the credit bureau and new regulations for classifying loan portfolios). In addition, the banking system opened up completely to foreign investment, which allowed the introduction of better lending practices and facilitated the capitalisation of institutions. Protection for lenders was also improved by modifying a number of laws governing lending activity. All of the above brought about the necessary conditions for agents to seek long-term loans.

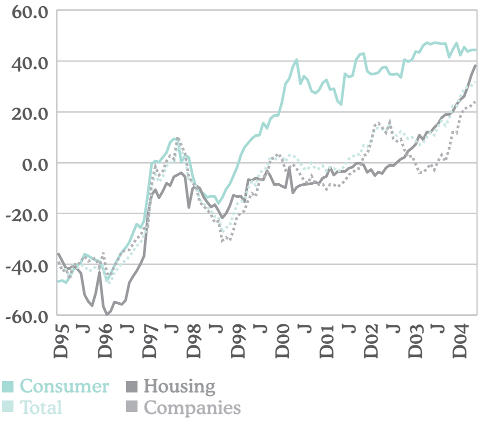
Commercial bank outstanding loans to the private sector
(% of GDP)



* Excludes the overdue loan portfolio, restructured loans in UDIS and finance granted to companies through debt instruments issued

Source: BBVA Bancomer using INEGI and Bank of Mexico data

Commercial bank outstanding loan portfolio
(balances and % real annual change)



Source: BBVA Bancomer using Bank of Mexico data

Commercial bank sector before and after the 1995 crisis
Weaknesses before the crisis and changes made

Some weaknesses before the crisis
Inadequate legal protection of creditor rights Limited tools for measuring credit risk Inadequate and lax accounting and prudential rules Deficient levels of capitalisation and precautionary provisioning
Some changes made
Modification of accounting rules Tighter rating rules for loan portfolios Introduction of improved practices and methodologies for measuring credit risk Creation of a credit bureau, with obligatory consultation before granting new finance More rigorous capitalisation rules Instrumentation of an early warning system Complete opening up of the banking system to foreign investment
Source: BBVA Bancomer

1 The portfolio of outstanding loans excludes: overdue loans; financing granted to companies through debt instruments they issued; and loans that were the product of special programmes that emerged due to the crisis of 1995. The latter included loan restructurings in UDIS (investment units) and the portfolio ceded to FOBAPROA (Banking Fund for the Protection of Savings), which was the product of the Capitalisation and Debt Purchase Programme.

Consumer and Housing loans

The recovery in different types of lending took place in different ways as a result of the factors behind the recovery occurring at different times. The experience of Mexico in this sense indicates that it is the sum and permanence of favourable factors that brings about recovery and expansion in lending, while the lack of one of these elements can present an obstacle to this taking place.

Recovery in consumer lending

Consumer credit finance began to recover in January 2000 and has continued to do so without interruption for 64 months. During the period, the real average growth rate was 33%, which meant that the outstanding balance of consumer loans rose by five times in the period December 1999 to April 2005.

The main reason behind the expansion in consumer credit was the strong reduction in inflation during this period (from 20% to rates below 5%). This allowed loans to be granted under improved conditions. For example, banks introduced promotional campaigns to encourage the use of credit cards through agreements with companies that allowed deferred payment free of interest charges for purchases using cards. In addition, banks substituted credit schemes based on variable rates of interest for fixed-interest ones. This provided certainty regarding the total cost of the loan taken on, while increases in interest rates did not affect the ability of clients to pay. These benefits implied lower credit risk.

The Credit Bureau has been a very important institution in the recovery and growth in consumer finance. The obligation on the part of banks to consult it before granting finance has made it a very useful tool in reducing risks.

Recovery in housing loans

Since the significant fall in the size of the housing loan portfolio as a result of the crisis in 1995, the outstanding balance contracted constantly in real terms until 2003. Since the middle of that year until now it has grown at high rates for 22 months. However, the level recorded in April 2005 was only 21.9% of that at the end of 1994.

The crisis of 1995 left it clear that the legislation at the time governing the recovery of overdue loans was very inadequate. A series of reforms to a number of different laws aimed at the faster recovery of overdue loans was approved in 2000. These reforms were called Miscellaneous Guarantees (MG), and they were expected to help bring a rapid recovery in mortgage lending. This was not the case. The MG of 2000 contained barriers to the swift recovery of guarantees on overdue loans, which meant that credit risk remained high. A further reform of the MG was carried out in April 2003. This improved procedures and removed legal obstacles, thereby reducing credit risk and allowing a recovery in mortgage lending.

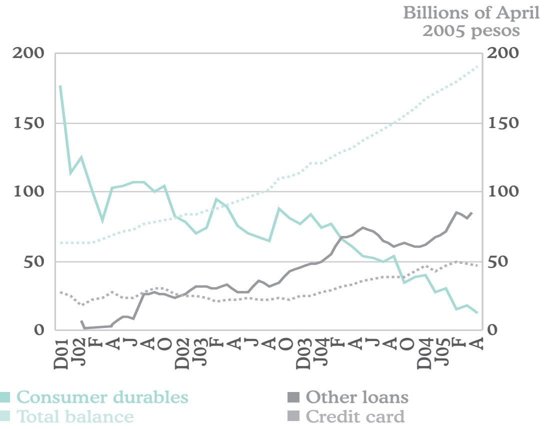
Interest rates also have had an impact in the recovery in mortgage credit. This type of lending started to recover when the use of fixed interest rates in credit schemes became generalised; particularly from April of 2004 when the fixed interest rates charged by banks dropped below 15% due to greater competition among institutions.

Consumer lending
Recovery and driving factors

Macroeconomic environment
Reduction of inflation and interest rates
Improved risk measurement tools
Consultation of credit bureau Modelling to measure credit risk
Use of fixed interest rates
In loans for car purchases Special credit lines linked to credit cards with fixed repayments over 12 months Payroll loans granted to employees whose salaries are deposited in a bank account
Promotions and new and more flexible products
Credit card purchases with deferred interest-free payment for 3, 6, and 12 month loan periods Products linked to fixed-interest rates Loans based on the capacity to pay

Source: BBVA Bancomer

Consumer lending
(balances and % real annual change)



Source: BBVA Bancomer using Bank of Mexico data

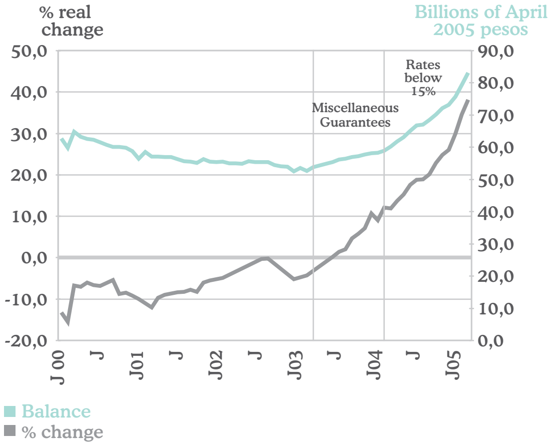
Mortgage finance
Recovery and driving factors

Recovery factors
Improved legal framework for recovering overdue loans The MG of 2000 laid the foundations and the changes to it in 2003 kick-started the recovery **Reduction of inflation and interest rates** Permitted first the granting of loans from UDIS to variable interest rates and then at fixed rates. **Enhanced credit risk measurement** Lower credit risk and improved portfolio quality
Driving factors
Financing schemes at fixed interest rates Reduce uncertainty and provide certainty regarding the total cost of the loan **Market factors** Competition brought down interest rates, thereby reducing costs and making credit conditions more flexible **Demographic factor** The country's large young population means there is a growing demand for mortgage loans **Wider target market** The purchase of Sofoles mortgage banks by the banks increases the possibilities for granting loans to other population groups

Source: BBVA Bancomer

Outstanding mortgage loan portfolio

(balances and % real annual change)



Source: BBVA Bancomer using Bank of Mexico data

Bank lending to companies

Risk reduction and impediments to activity

Reduction of risks
Commercial insolvency law of 2000 2000 and 2003 Miscellaneous Guarantees Lower levels and lower volatility of interest rates
Impediments to a sustained recovery in lending
Weak economic performance with no sustained growth at high rates Use of variable interest rates (TIIE + surcharge) and high levels Available substitutes for companies with high credit ratings Debt issues; wide range of non-bank financial intermediaries; external financing Rigidities, risks and a variety of obstacles High regional and sectoral risks; poor credit records; inadequate guarantees; the economy's limited competitiveness (lack of structural reforms)

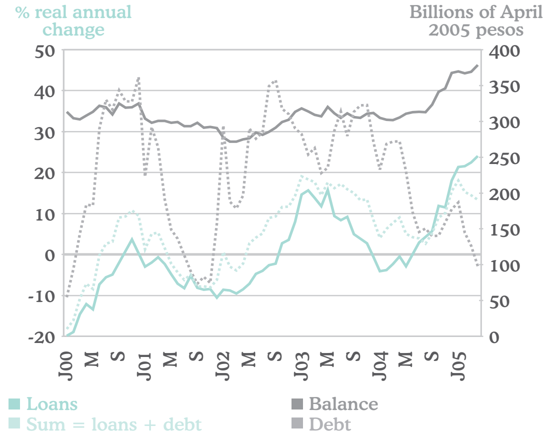
Corporate debt issuance and placement

Driving and limiting factors

Driving factors
Successful instruments: securities certificates Strong demand from Siefores (pension funds)
Limiting factors
Instruments available only to companies with high credit ratings Weak economic performance with no sustained growth at high rates Volatility of benchmark interest rates (TIIE)
Source BBVA Bancomer

Lending to companies: bank lending and corporate debt

(balances and % real annual change)



Source: BBVA Bancomer using Bank of Mexico data

Lending to companies and prospects

Recovery of lending to companies and corporations

Unlike the evolution seen in consumer and housing lending granted by banks, the outstanding portfolio of loans disbursed to companies has not undergone sustained growth to date despite the regulatory conditions being in place for an expected sustained recovery in this type of lending after the approval in 2000 of the Commercial Insolvency Law. This new law gives better legal protection to creditors, but failed to bring about significant expansion in lending because of weak economic growth between 2001 and 2003.

Another limiting factor is the availability of other significant sources of funding apart from corporate bank lending, such as the ability of companies with high credit ratings to place paper in the national corporate debt market. Such debt issues are important because: 1) growth in pension funds has increased demand, thereby creating a market for private bonds; 2) securities certificates have been introduced. These have had a great deal of success as a corporate debt instrument as they are very flexible (tenure, reference interest rates and other factors).

Bank lending to companies and debt placements are complementary forms of funding. Given the above, it is not surprising that these two sources of funding together have shown positive real growth rates three years running.

Prospects

The continuance of the factors that have had a favourable impact on the evolution of lending in Mexico – low, fixed interest rates, a more efficient legal and institutional framework, greater competition in the banking sector and a pick-up in economic activity – will allow credit to continue to flow.

We expect consumer credit by the end of 2005 to be growing in real terms at over 30% driven by the new products that banks have introduced in the past few years. As regards housing loans, we expect growth in the outstanding loan portfolio slightly higher than that for consumer finance at between a real 35% and 40% by the end of the year due to strong competition among institutions to attract clients by offering them fixed and very accessible interest rates. Lending to companies will also continue to grow driven by increased economic activity. We estimate that loans to companies will be growing at around a real 8% by the end of the year. To the extent that the economy grows in a sustained manner, corporate credit could increase its growth rate due to its sensitivity to improved expectations.

Once the recovery phase for bank lending has run its course and its value as a proportion of GDP increases, it is possible that growth will slow. In this next phase, it is to be expected that growth in banking lending will stand at between 1.5 and two times the growth rate for the economy, in line with what happened in Mexico in the period of stable development from 1954 to 1970, Chile from 1992 to 1997 and South Korea from 1982 to 1997.

International Context

	Real GDP (%)				Consumer prices (%, end of year)			
	2003	2004	2005	2006	2003	2004	2005	2006
USA	3.0	4.4	3.6	3.2	1.9	3.3	3.1	2.8
EMU	0.7	1.7	1.4	2.2	2.0	2.4	2.1	1.6
Japan	1.4	2.7	1.5	2.0	-0.4	0.2	0.0	0.3
China	9.3	9.5	8.5	8.0	1.2	3.9	4.5	4.5

	Official interest rate (%, end of period)				Exchange rate (vs $, end of period)			
	01/07/05	Sep-05	Dec-05	Dec-06	01/07/05	Sep-05	Dec-05	Dec-06
USA	3.25	3.75	4.00	4.50				
EMU ($/€)	2.00	2.00	2.00	2.50	1.20	1.22	1.22	1.21
Japan (yenes/$)	0.10	0.10	0.10	0.10	112	107	105	100
China ($/cny)	5.58	5.58	5.80	5.80	8.28	8.28	8.28	8.28

Latin America

	Real GDP (%)				Consumer prices (%, end of year)			
	2003	2004	2005	2006	2003	2004	2005	2006
Argentina	8.8	9.0	7.0	4.5	3.7	6.1	10.9	10.0
Brazil	0.5	4.9	3.0	3.0	9.3	7.6	6.0	5.0
Chile	3.7	6.1	6.1	5.7	1.1	2.4	3.4	3.0
Colombia	4.1	4.1	3.8	3.5	6.5	5.5	5.0	4.7
Mexico	1.4	4.4	3.9	3.5	4.0	5.2	4.0	3.9
Peru	4.0	4.8	5.3	4.5	2.5	3.5	2.3	2.5
Uruguay	2.2	12.3	5.5	n.d.	10.2	7.6	5.5	n.d.
Venezuela	-9.2	17.9	3.9	2.3	27.1	19.2	20.6	23.5
LATAM [1]	**1.7**	**5.9**	**4.1**	**3.6**	**7.1**	**6.8**	**6.5**	**6.0**
LATAM Ex-Mexico	1.8	6.5	4.2	3.6	8.3	7.3	7.3	6.8

	Fiscal balance (% GDP)				Current account balance (% GDP)			
	2003	2004	2005	2006	2003	2004	2005	2006
Argentina [2]	2.3	3.9	3.7	3.4	6.0	2.2	0.9	1.2
Brazil	-3.6	-2.5	-3.0	-3.0	0.8	1.9	1.5	0.0
Chile [2]	0.0	2.5	2.4	1.2	-1.5	1.5	0.3	-2.1
Colombia	-2.7	-1.3	-2.5	-2.0	-1.3	-1.4	0.4	-2.1
Mexico	-0.6	-0.3	-0.1	-0.2	-1.3	-1.1	-1.5	-1.8
Peru	-1.7	-1.1	-1.0	-1.0	-1.5	0.0	-0.1	-0.5
Uruguay	-3.2	-1.8	n.d.	n.d.	-0.5	-0.8	n.d.	n.d.
Venezuela [2]	-5.1	-1.9	-1.8	-2.1	10.3	14.9	11.3	7.5
LATAM [1]	**-1.7**	**-0.8**	**-1.0**	**-1.0**	**0.8**	**1.3**	**0.6**	**-0.4**
LATAM Ex-México	-2.5	-1.0	-1.4	-1.5	2.2	2.7	1.9	0.4

[1] Average of the countries. [2] Central Government.

	Exchange rate (vs $, end of year)				Interest rates (%, end of year)[3]			
	2003	2004	2005	2006	2003	2004	2005	2006
Argentina	2.96	2.99	2.95	3.00	3.7	3.1	6.0	10.0
Brazil	2.89	2.72	2.70	2.90	16.5	17.8	18.0	16.0
Chile	603	576	575	578	2.3	2.3	4.3	6.0
Colombia	2865	2404	2400	2561	8.0	7.8	7.3	8.0
Mexico	11.24	11.15	11.40	11.80	6.0	8.7	9.8	8.8
Peru	3.47	3.28	3.27	3.30	2.5	3.0	3.5	4.3
Uruguay	29.19	26.56	25.50	n.d.	7.5	5.7	n.d.	n.d.
Venezuela	1600	1920	2150	2580	15.1	12.4	12.5	12.9

[3] For each country interest rate see the following page.

	Argentina			Brazil		
	2004	2005f	2006f	2004	2005f	2006f
GDP (%)	9.0	7.0	4.5	4.9	3.0	3.0
Consumer prices (% end of year)	6.1	10.9	10.0	7.6	6.0	5.0
Trade balance ($bn)	13.2	9.5	8.1	33.7	35.0	22.0
Current account (% GDP)	2.2	0.9	1.2	1.9	1.5	0.0
Reserves ($bn. end of year)	19.6	23.2	26.7	52.7	61.0	60.0
Exchange rate (end of year vs US$)	2.99	2.95	3.00	2.72	2.70	2.90
Fiscal balance (% GDP) [1]	3.9	3.7	3.4	-2.5	-3.0	-3.0
Interest rate (end of year) [2]	3.1	6.0	10.0	17.8	18.0	16.0
Real effective exchange rate (end of year. dec-97=100)	50	55	59	65	68	65

1/ Argentina: Central Government Balance. Excluding privatisation receipts
2/ Argentina: 30-d deposits interest rate in pesos; Brazil: SELIC rate

	Chile			Colombia		
	2004	2005f	2006f	2004	2005f	2006f
GDP (%)	6.1	6.1	5.7	4.1	3.8	3.5
Consumer prices (% end of year)	2.4	3.4	3.0	5.5	5.0	4.7
Trade balance ($bn)	9.0	7.5	3.1	1.1	2.2	-1.0
Current account (% GDP)	1.5	0.3	-2.1	-1.4	0.4	-2.1
Reserves ($bn. end of year)	16.0	16.0	16.0	13.5	15.8	16.2
Exchange rate (end of year vs US$)	576	575	578	2404	2400	2561
Fiscal balance (% GDP) [1]	2.5	2.4	1.2	-1.3	-2.5	-2.0
Interest rate (end of year) [2]	2.3	4.3	6.0	7.8	7.3	8.0
Real effective exchange rate (end of year. dec-97=100)	84	86	86	83	85	82

1/ Chile: Central Government
2/ Chile: Official interest rate (from August 2001 in nominal terms); Colombia: 90-d DTF interest rate

	Mexico			Peru		
	2004	2005f	2006f	2004	2005f	2006f
GDP (%)	4.4	3.9	3.5	4.8	5.3	4.5
Consumer prices (% end of year)	5.2	4.0	3.9	3.5	2.3	2.5
Trade balance ($bn)	-8.8	-10.0	-12.0	2.8	3.0	2.5
Current account (% GDP)	-1.1	-1.5	-1.8	0.0	-0.1	-0.5
Reserves ($bn. end of year)	61.5	64.0	63.0	12.6	14.2	15.0
Exchange rate (end of year vs US$)	11.15	11.40	11.80	3.28	3.27	3.30
Fiscal balance (% GDP)	-0.3	-0.1	-0.2	-1.1	-1.0	-1.0
Interest rate (end of year) [2]	8.7	9.8	8.8	3.0	3.5	4.3
Real effective exchange rate (end of year. dec-97=100)	107	107	104	90	92	92

2/ México: 28-d Cetes interest rate; Peru: Interbank interest rate

	Uruguay			Venezuela		
	2003	2004	2005f	2004	2005f	2006f
GDP (%)	2.2	12.3	5.5	17.9	3.9	2.3
Consumer prices (% end of year)	10.2	7.6	5.5	19.2	20.6	23.5
Trade balance ($bn)	0.2	0.0	0.0	22.1	20.4	15.3
Current account (% GDP)	-0.5	-0.8	n.d.	14.9	11.3	7.5
Reserves ($bn. end of year) [3]	1.9	2.3	n.d.	24.1	22.7	22.8
Exchange rate (end of year vs US$)	29.19	26.56	25.50	1920	2150	2580
Fiscal balance (% GDP) [1]	-3.2	-1.8	n.d.	-1.9	-1.8	-2.1
Interest rate (end of year) [2]	7.5	5.7	n.d.	12.4	12.5	12.9
Real effective exchange rate (end of year. dec-97=100)	75	81	78	91	96	97

1/ Venezuela: Central Government
2/ Uruguay: 30-d BCU Papers interest rate in pesos; Venezuela: 90-d Certificado Participaciones rate
3/ Venezuela: including FIEM

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