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Latinwatch

Research Department

Fourth quarter 2005

Latin America: structural improvements to meet growth challenge
India and Brazil: the elephant and the toucan
Emerging markets: towards the washing away of "original sin"?
Under the microscope: Capital flows in Latin America

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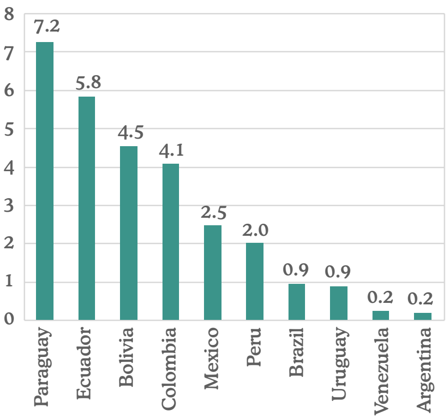
Inflows of remittances in Mexico and South America

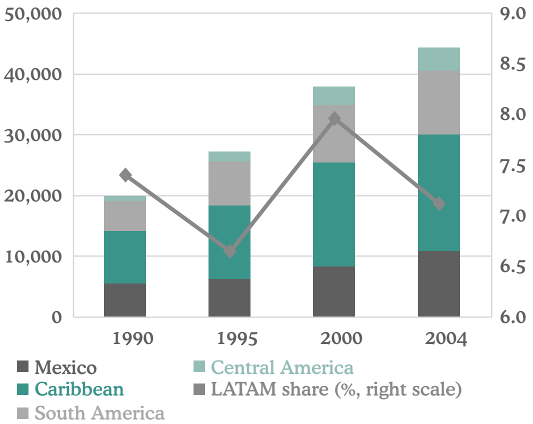
(% of GDP; 2004)



Source: BBVA using IDB and IMF data

Tourism earnings

(millions of dollars)



Source: World Tourism Organization

Editorial

International flows of capital continue to register a dynamic performance. The emerging economies, in particular, including Latin America, are benefiting from a favourable environment, with a combination of abundant liquidity, low volatility and reduced aversion to risk. This quarter we devote three articles to the analysis of these financial flows. In the first, we examine the forces that have driven developments in the past few years and the general outlook for the period ahead, highlighting the fundamental differences between Latin America and Asia. The second article takes a closer look at one type of capital flows, namely portfolio flows, and attempts to explain the nature of recent changes and assess the impact of the processes of financial integration. In the third article, we focus on the accumulation of reserves by the central banks of emerging countries, ending with an evaluation of the implications for economic policy management. The scenario for 2006 that can be drawn from this diagnosis is a positive one, with further inflows and a lower level of external vulnerability, albeit with a domestic source of potential instability associated with the electoral processes.

Besides capital and trade flows, there are other monetary flows whose growth or potential for expansion in the region is no less relevant. The first is the inflow of remittances sent by the 25 million Latin Americans that have moved away from their countries of origin in search of job opportunities. According to the Inter-American Development Bank (IDB), Latin America received some 45 billion dollars in 2004 in the form of remittances (double the amount it received in 2001). Three-quarters came from the United States, with Mexico alone accounting for over 16 billion. In relative terms, Central America and the Caribbean stand out, with remittances amounting to between 10% and 20% of GDP. Among the region's major economies, Colombia (4.1%), Mexico (2.5%) and Peru (2.0%) are the most noteworthy, all three of which would register external imbalances were it not for such inflows. A halving of the cost of transfers has permitted the sharp increase registered over the past five years, while flows have also become more regular. The nature and magnitude of the remittances also mean that they are in turn characterised as an element of development, and even as an anti-cyclical instrument in a number of countries.

Another important source of foreign currency for Latin America is tourism earnings. According to the World Tourism Organization (WTO), the region received over 60 million tourists in 2004, up from 37 million in 1990. Revenues from tourism amounted to over 40 billion dollars, more than double the figures for 1990, giving an average expenditure per tourist of 730 dollars. In spite of this, only Central and South America have recorded an increase in their share of world tourism over the past few years, in contrast to Mexico's share, which is down, and the Caribbean's, which has remained steady. The region accounts for 8% of total flows of people, and for 7% in monetary terms. In relation to GDP, tourism earnings in the major economies range between 0.5% in Brazil and 1.5% in Argentina, Mexico and Peru. Although far from negligible, these figures show the huge potential that exists for further growth given the region's undeniable natural and cultural attractions.

Thirdly, and finally, it is important to note the development of the local debt markets, which is the subject for one of the boxes in this issue of Latinwatch. The vulnerability traditionally introduced by the asymmetry of the balance sheets of the economic agents in Latin America, with their excessively dollarised liabilities, could be reduced if local currency denominated debt instruments had a greater acceptance. A case in point is Brazil, which placed in September for the first time in international markets a bond denominated in reals (for 10 years and for an amount equivalent to 1.5 billion dollars). This in turn could help to boost mortgage lending, as well as lay the basis for a lower level of dependence on foreign capital flows and the associated shifts in portfolio decisions.

I. International environment

The growth challenge for Latin America

For decades, Latin America performed poorly in the area of development. The relative position in terms of GDP per inhabitant has been declining steadily since the 1950s, with Chile the only exception. Although there have been periods of notable growth, these have always been largely nullified by sudden interruptions or by other regions with more dynamic performances. The average growth rate of GDP over the past 20 years barely exceeds 2%, and the volatility of growth has been pronounced.

Many different factors have given rise to this situation, ranging from an unsound macroeconomic management, both fiscal and monetary, and a certain degree of distrust of free-market mechanisms to a destabilising institutional weakness. The progress made over recent years points to a somewhat brighter outlook but the experience of earlier episodes also cautions prudence.

The notable advance in terms of GDP per capita and increasing protagonism that other emerging-market countries are registering is more objective. China has made spectacular progress in reducing its underdevelopment vis-à-vis the rest of the world over the past 25 years, while India and Turkey have also seen significant improvements. The competition of these buoyant countries is clearly visible in the figures for Foreign Direct Investment (FDI), which show a redirection of flows, at least in relative terms, away from Latin America to Asia.

The challenge of growth also requires prompt action to consolidate the current situation of democracy in the region. The huge levels of inequality and poverty encourage the emergence of populist movements. These risks increase enormously in electoral periods such as the particularly intense one beginning in all of Latin America at the end of this year and extending throughout 2006.

This rather gloomy analysis must nevertheless be set against the excellent situation in which we find ourselves at present. The rate of growth achieved in 2004 and 2005 is unusual in recent decades, with support coming from the favourable international environment, but also from the important structural advances in the region. The world economy, especially the United States and China, is still expanding at a healthy pace, commodities are experiencing a period of buoyant growth, and there is abundant liquidity in the markets.

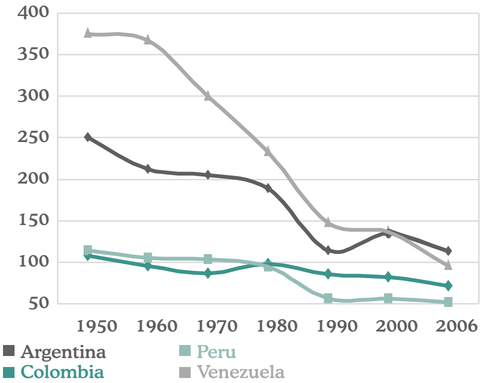
The question is whether this situation will lead to a soft landing or whether there is a real risk of a return to episodes like those experienced in 1995 and 1998. A global economic environment with an orderly slowdown in growth will largely determine whether the gains made in the areas of inflation, fiscal deficit, trade opening and fitter banking systems are locked in or not. Our central scenario includes conditions that buffer the effects on Latin America, precisely because we believe that the reforms are forceful enough to resist factors deriving from the current economic situation.

Economic growth in the United States is sustaining momentum

In the wake of Hurricane Katrina, there was uncertainty about how the rate of economic expansion in the United States would be affected. While there will be negative effects on growth in the third quarter of 2005, these will be offset in the fourth quarter of the year and the first quarter of 2006 by the reconstruction work in the affected areas. The biggest risk is not the transitory effect on economic activity in the area

GDP per capita

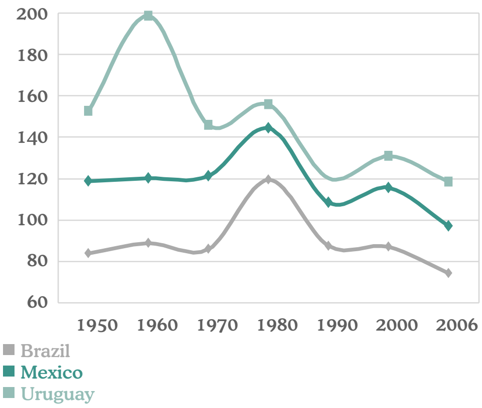
Proportion relative to world average



Source: BBVA using data from Groningen Growth and Development Centre and The Conference Board, Total Economy Database, 2005

GDP per capita

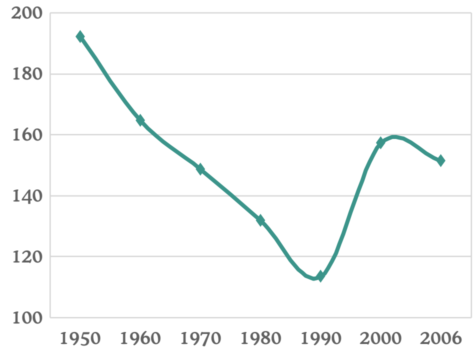
Proportion relative to world average



Source: BBVA using data from Groningen Growth and Development Centre and The Conference Board, Total Economy Database, 2005

Chile: GDP per capita

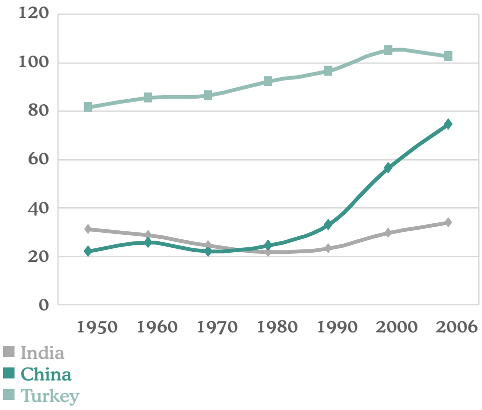
Proportion relative to world average



Source: BBVA using data from Groningen Growth and Development Centre and The Conference Board, Total Economy Database, 2005

GDP per capita

Proportion relative to world average



Source: BBVA using data from Groningen Growth and Development Centre and The Conference Board, Total Economy Database, 2005 affected, but rather the likely negative impact on confidence and consumer spending if energy prices stay as high as they are now. Oil and natural gas production seems however to be returing to normal faster than initially thought likely.

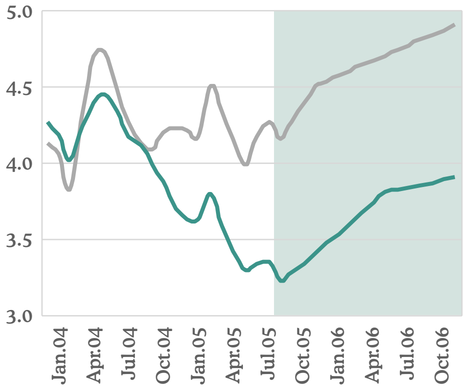
We are therefore sticking to our forecasts for economic growth in the United States for 2005 and 2006, at 3.6% and 3.2%. The economic performance in the first half of 2005 confirms our baseline scenario of growth converging towards potential on the back of solid fundamentals. The buoyancy of private consumption and the strong push from investment will continue to be the main supports for the US expansion. This economy will therefore continue to act as a stimulus for the Latin American economies.

The risks for the region would materialise in an alternative scenario in which either the imbalances in the US economy or an excessive run-up in oil prices provoke a hard landing in the US economy in 2006. The economic deceleration foreseen in the baseline scenario would then be more pronounced and long-lasting, weakening the outlook anticipated for Latin America.

Favourable context for low interest rates in international markets in the long term

The recent evolution of the world financial markets has been dominated by two interrelated factors: first, the doubts about the macroeconomic scenario, linked, as mentioned above, to the oil market; and, second, the continuing buoyancy of capital flows, in a context with world savings at high levels (see articles further along in this issue for a fuller analysis). Both elements are giving rise to an environment in which long-term yields are lower than had been expected, both in the United States and in Europe. This in turn is having a positive effect on financing in Latin America.

10-year interest rates and forecasts



■ USA
■ EMU

Source: BBVA

In the United States it is significant that 10-year interest rates are currently lower than those observed at the start of the upward cycle in interest rates in June of 2004. This despite the fact that official rates have risen from 1% to 3.75% over this period. It is no less striking, however, that in Europe 10-year interest rates are one percentage point below the average observed a year ago. In fact, making due allowance for the historical comparison, interest rates in Germany have reached levels not seen since the 19th century.

Two key questions therefore dominate the coming months. The first concerns the global economic environment and the possibility of a recession, with oil triggering a correction in expectations, particularly in household confidence given the increased indebtedness in recent years. In this case, long-term interest rates would factor in a recession and any rises would be limited. The second question is whether even with a macroeconomic environment characterised by strong US economic growth, long-term interest rates are going to remain at low levels, as a consequence of the behaviour of international capital flows.

Sources of uncertainty

All the indications are that the probability of a recession linked to oil price developments is low. Yet not all of the uncertainties have cleared away (see box later on). In the first place, it is to be expected that oil prices will fall back to levels closer to the equilibrium price. This is estimated at between 40 and 50 dollars. The current level of prices increases the supply of oil and reduces demand, and also makes it profitable to exploit alternative sources of energy. However, given the tight supply-and-demand conditions, the market is vulnerable to shocks and in a context of growing geopolitical risk, a scenario with higher oil prices is possible.

The second source of uncertainty relates to how monetary policy is managed. In economies such as the United States where capacity utilization rates are high, the upward bias in inflation associated with higher oil prices should result in further tightening of official interest rates, with a view to taking rates to more neutral levels in the first few months of 2006. It is reasonable to assume that the Fed will maintain a gradual tightening trend towards levels of interest rates around 4.75%.

The third uncertainty involves the expectations channel. Although some channels along which oil impacts on the economy, such as wages, may have weakened, expectations become a key element, particularly in economies in which households are heavily indebted. A drop in confidence could bring about a fall in demand for assets such as housing and, consequently, a reduction in property wealth and consumption. In this case, in the United States, interest rates, after rising initially to brake inflation expectations, could begin to come down before the end of 2006.

The upward resistance of long-term interest rates supports capital flows towards emerging-market countries

Under the baseline scenario, therefore, strong economic growth will continue, albeit at lower rates than a year earlier, as monetary policy is tightened, especially in the United States, and the dollar exchange rate against the euro consolidates current levels or appreciates slightly. However, even under this scenario, it is possible that any increase in long-term interest rates will be of limited magnitude.

The reason for this is that demand for bonds is strong, which is linked to the process of financial globalisation. Real interest rates are the result of the interaction between savings and investment at a global level, particularly when investors reduce their domestic bias.

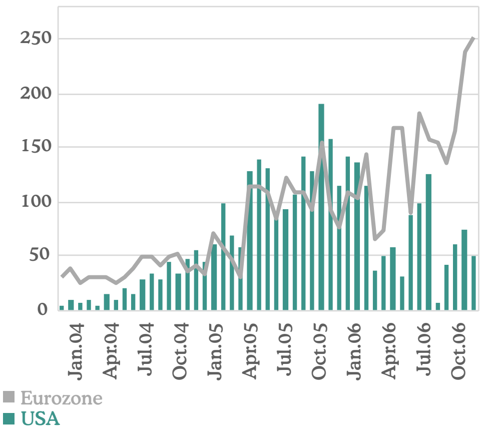
The industrialised countries have seen a decline in saving. However, saving is increasing in Asia, given the model of growth, and in the Middle East, as a consequence of the earnings of oil exporting countries. This could explain the fall in real interest rates. Moreover, when one analyses long-term nominal interest rates, global inflation expectations are at low levels, in part anchored by the gains in credibility achieved by central banks in recent years. This in turn helps to drive down yields. For its part, the low volatility of inflation has brought about a decline in the premia for maturity risks in the interest rates of longer-dated bonds.

Low interest rates generate capital flows in search of yield towards the emerging markets, such as for instance Latin America. As a result, their currencies appreciate, and to counter this appreciation these countries intervene in the foreign-exchange market. The rate of accumulation of reserves remains strong, although it has slowed from that observed in 2004. On the one hand, therefore, the level of domestic liquidity in these countries increases, while, on the other, this intervention is conducted through bond purchases, contributing to keep interest rates low, and thus closing a circle that constitutes an accelerator for world liquidity.

In view of the above, any increases in long-term interest rates are expected to be limited. 10-year yields could end the year 2006 at rates of 4.9% in the United States and at 3.8% in Europe. Moreover, the balance of risk to these forecasts lies on the downside if capital flows strengthen further.

Net debt issuance

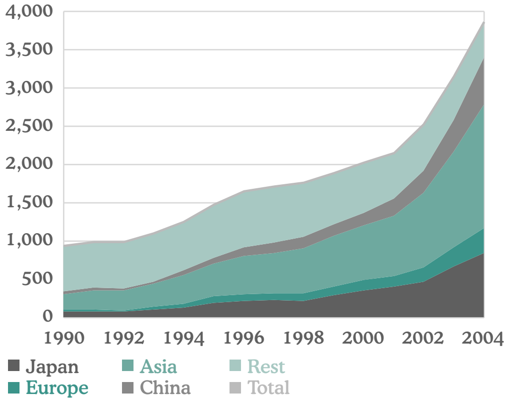
(billions of dollars)



Source: BIS

International liquidity: global accumulation of international reserves

(billions of dollars)



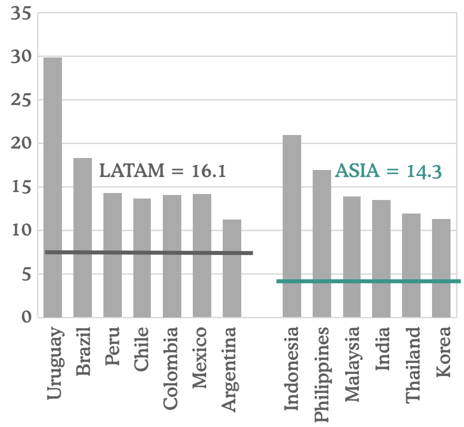
Source: IMF and Central Banks

Summary of forecasts
(averages)

Baseline scenario			
Official rates	Current	2005	2006
USA	3.50	3.20	4.70
EMU	2.00	2.00	2.15
10-year rates	Current	2005	2006
USA	4.17	4.30	4.85
EMU	3.12	3.40	3.65
Exchange rate	Current	2005	2006
Dollar-euro	1.23	1.20-1.25	1.17-1.25

Source: BBVA

BIS ratio 2004



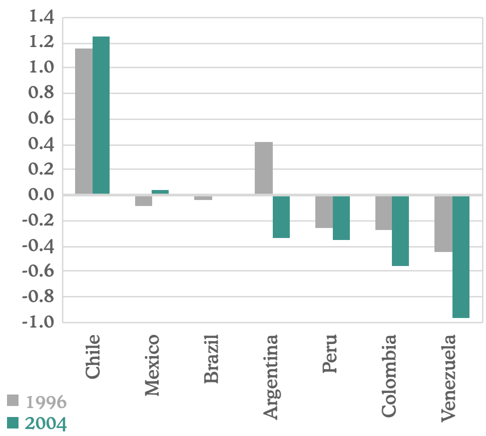
Source: BIS

Latin America: main elections 2005-2006

Country	Presidential	Legislative
Chile	Dec. 2005	Dec. 2005
Peru	Apr. 2006	Apr. 2006
Colombia	May. 2006	Mar. 2006
Mexico	Jul. 2006	Jul. 2006
Ecuador	Oct. 2006	Oct. 2006
Brazil	Oct. 2006	Oct. 2006
Venezuela	Dec. 2006	Dec. 2005
Argentina	2007	Oct. 2005

Source: BBVA

Synthetic index of institutional quality



Source: BBVA based on World Bank data. The index is drawn up using 6 World Bank indicators: voice and accountability; political stability; government effectiveness; regulatory quality; rule of law; control of corruption.

Structural improvements and strengths: the need for perseverance

The expected slowdown in world growth, the easing of the tensions in the commodity markets and tighter international financial conditions will not be, under our central scenario, of sufficient intensity to generate distortions in Latin America's growth path. There is a certain degree of probability of the risks materialising, however, and it is therefore useful to assess the region's ability to withstand adverse events.

At the beginning we mentioned the structural advances that have taken place in the Latin American economies. Thanks to a more orthodox monetary policy, the periods of hyperinflation experienced up to the middle of the 1990s now seem consigned to the past. Fiscal policy has followed a similar path, with a significant fall in the public deficit figures, not only because of the cyclical strength in recent years. Countries in the region in turn show a greater openness to trade, which has reduced their external vulnerability, the trend being to converge towards international levels. Finally, but certainly no less important is the improved levels of solvency, efficiency and profitability in the banking system, outperforming in the process other emerging regions such as Asia.

This picture points to a situation of lower vulnerability for Latin America than that which existed in 1994 and 1997, the years before the key crises during the last decade. However, although it would be a mistake to fall into pessimism, we must also guard against complacency. The consolidation of what has been achieved so far is essential, and of special note here are the democratic processes that were not mentioned above with the other achievements. The presidential and legislative elections over the next year and a half in all of the countries will be an ideal occasion to assess the political climate in the region.

The implementation of further reforms, in this case second-generation reforms, needs to be a crucial part of this agenda. In the first place, the independence of the central banks lends credibility to monetary policy and fixes expectations among the economic agents, aspects that in a number of countries cannot be taken for granted. Secondly, the levels of tax revenue of the public sector are very low compared with those of the industrial countries. This is the result of high levels of tax evasion and inefficiency in tax systems and gives rise to a limited capacity for stabilization of the economy. Thirdly, institutional quality, apart from citizens' right to vote freely, is an essential condition for efficient mechanisms for economic management and development to be put in place.

In sum, the current one is a propitious scenario for the challenge of growth. In the period ahead, everything will depend upon the ability to maintain the structural advances achieved and to deepen the reform process with other new ones.

India and Brazil: the elephant and the toucan

Two emerging giants

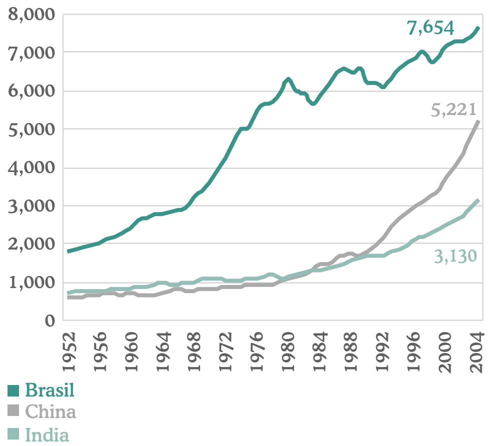
Latin America has not escaped the charms being cast by Asia. For the first time in its history, Latin America is building solid economic ties not only with one or two but three large growth areas: the United States, Europe and now Asia. Until the 1980s, the main source of support was the United States. In the 1990s, a second source appeared in the shape of a flood of European investment. And in this decade, as Asia reaches out towards the rest of the world, Latin America can now count on a third source of support for its economic development.

And China is not the only country involved. The Asian dragon was not the first to establish ties with Latin America. Many other Asian countries such as Japan and South Korea have been paving links between Asia and Latin America for decades. And it is not the last one either, now that the Indian elephant has come to the fore. Its trajectory is slower than the flight of the Chinese dragon, although with likely GDP growth of 7% in 2005, to describe its pace as sluggish is relative. And it could leave a deeper and more enduring mark: while China's population will age over the next few decades, India's demographic golden age has yet to arrive. By 2050, not only will it overtake China to become the most populated country on the planet, but its population will only recently have reached the age of majority, the moment when the working-age population reaches it maximum value relative to the total population. What is more, in the next 50 years, India will be the only country among the emerging giants whose working-age population will be growing at a higher rate than its total population.

Apart from its promising future, the India elephant has a great deal in common with emerging countries in Latin America, and in particular the Brazilian toucan. What the toucan lacks in population (equivalent to only 16% of that of India), it makes up for in surface area (2.5 times that of India). Both can, therefore, claim to be among the biggest democracies in the world. India's pride in its democratic traditions is evident in all political conversations. And quite rightly so. Since its independence in 1947, its vibrant parliamentary system has managed to hold together a mosaic of countries, ethnic groups, languages and religions unparalleled in the rest of the world (18 official languages and 7 religious groups). The vitality of Brazil's democracy is also not in dispute. If something positive can be taken from the current political noise, it is the manifestation of the freedom enjoyed by the media and civil society that prevails today in the country. And almost no other country in the world can boast of having elected a worker and trade unionist as president.

The Indian elephant and the Brazilian toucan also share the same dream of becoming active players on the world stage. India and Brazil are the only countries in the G5 that aspire to have a permanent seat in a reformed Security Council. Economic drive has been added to their physical dimensions for strengthening their arguments for becoming so. India recently put its foot on the accelerator by embarking in 1991 on a reform process that has allowed it to enjoy a significant increase in its annual growth rate, which has averaged 6% since then. With inflation under control at low levels (an average of 3% in the past decade), and record reserves (130 billion dollars by the middle of 2005, double that of Brazil), the Indian take-off constitutes another of the Asian miracles of this century. As regards the toucan, although it has not enjoyed an extended flight, its colours have not faded, with growth close to 5% in 2004, inflation moving towards official targets (5.2%) and its fiscal deficit kept in check, and even managing to boast a primary surplus above initial forecasts. Above all, and like its distant Asian neighbour, Brazil has also adopted a pragmatic gradualist approach in economic policy, combining fiscal and monetary orthodoxy, with social programmes aimed at relieving extreme poverty.

GDP per capita in dollars
(real PPP)



Source: Penn World Table, WEO 2005

However, what most draws the attention in the case of these two giants is that they are turning their focus to the outside world. Both have a long history of being economically inward-looking, but in the past few years, they have opted to take a more active role in global trade flows. This decision, along with all others, has also been gradual and pragmatic. In 1994, in the case of both countries exports accounted for little over 8% of GDP, making them the most closed of the large emerging economies (Chinese exports were already close to 22% of its GDP, and 15% in the case of Mexico). Ten years down the line, exports of the two giants were over 11% of GDP. While the Chinese dragon remains far ahead (35% of GDP), Mexico is beginning to come into view (28%). Brazilian exports will surpass 100 billion dollars in 2005, and its trade surplus will be close to 40 billion dollars. The South American country has managed to increase its openness to trade over the past 15 years from 10% to 20% of its PIB. Although it continues to lag China (52% of its GDP in 2004), Mexico (80%) and India (30%), Brazil's awakening as an exporting force remains one of the biggest inheritances of Lula and his minister Furlan.

Growing entrepreneurial vitality

This opening up to trade includes not only foreign investment in the two countries (still modest in India at 0.5% of

GDP; but more significant in Brazil, 3% of GDP), but also the growing appetite of Brazilian and Indian companies for overseas investments. In 2004, overseas investments undertaken by Brazilian companies totalled 9.5 billion dollars, a leap of 3700% with respect to the previous year. Companies such as Petrobras multiplied its presence in neighbouring countries, while Gerdau, Embraer Votorantim and Ambev went further afield. They not only invested in other emerging markets, but also diversified their industrial and financial portfolios to developed countries. In 2005, companies such as CVRD continue to look for opportunities outside their borders including in Europe, as manifest by recent rumours of interest in France's Eramet (we are talking here of an investment of more than 2 billion euros). Indian companies have also embraced globalization, investing in the United States, Australia, South Korea, Brazil and Europe, particularly in the United Kingdom, where India has become the seventh largest foreign investor. The veteran of recent overseas expansion is the country's largest conglomerate, the Tata group, whose interests stretch from steel to automobiles and new technologies. Tata stepped up its overseas expansion in 2001 with the acquisition of the British firm Tetley Tea, and went on to countries such as Singapore (it purchased NatSeel in 2004) and The Bermudas (it bought Teleglobe in 2005). On top of these deals are acquisitions such as Daewoo Motors in South Korea, investments by Tata Steel in South Africa and even some in the Spanish manufacturing sector. Its industrial technology unit, Tata Consultancy Services, was floated on the local stock exchange, and is now looking at a listing in New York, while it continues to invest in countries such as China, where it is planning to increase its workforce from 300 to over 3,000 over the course of the next few years.

It is precisely the dynamism of the business community in India and Brazil that distinguishes the two countries. While the overseas forays of Indian companies are less spectacular and broadly-based than those carried out by Brazilian companies, the make-up of the Indian business sector is particularly dense. The Indian stock markets have more listed companies than any other emerging country (4,700 compared with 1,400 in China, 370 in Brazil and 150 in Mexico). This explains why international investment funds have placed more than 7 billion dollars in the year so far in Indian stocks. A rapid glance at the internationally-renowned Forbes list of the biggest 2,000 companies in the world in terms of four criteria (sales, earnings, assets and market capitalization) confirms this observation: 30 Indian companies are included in the list, the same number as Spain (30) and above China (21), and Brazil and Mexico (both have 18).

Contrary to what one might think, many of these companies have high value-added. Included among the 30 Indian companies in the Forbes list is Mittal Steel, the biggest steel manufacturer in the world. But not only large conglomerates such Tata and Reliance stand out in the international rankings. State-of-the-art companies such as Ranbaxy in the biotechnology sector, and Wipro and Infosys in the technological and computer services sector are also up there. The latter has a workforce of 25,000 with an average age of 26. But it is only one of many such companies in a flourishing sector that has become the technological showcase of a country where services account for 50% of GDP. India has become one of the main production centres for more than 150 multinationals attracted by low costs and the high quality of the country's engineers and computer scientists who make up an armada of over one million people. Even Chinese investors such as Huawei have shown interest in the Asian Silicon Valley, investing in a number of innovation and research units in Bangalore. As a result, the Indian technological services industry will book revenues of over 20 billion dollars in 2005. It is worthy pointing out that the potential of the country goes hand in hand with its noted ability to produce technical experts and engineers: the 380 universities in the country supply the market annually with 300,000 engineers and 9,000 doctors in addition to the professionals trained overseas, mainly in the United States and the United Kingdom.

Brazil is not far behind in technological progress. Over the past five years, mining company CVRD has shared the honour of being the "biggest exporting company in Brazil" along with Embraer. The latter has become one of the biggest manufacturers of airplanes in the world. It currently has 16,500 workers, a number of whom form part of the body of 125,000 scientists and engineers in Brazil. Another sector that is pushing ahead is information technology, which in 2004 alone grew by 8.5%, booking turnover of close to 20 billion dollars. This sector, unlike its Indian counterpart, has yet to venture overseas, confining itself to meeting very strong domestic demand. By way of example, 97% of Brazilian taxpayers filed their income tax declarations through the Internet in 2004.

Both countries face the same challenge: the war against poverty. In order to wage this war, they must maintain or accelerate growth, continue to modernize their agricultural sector, and reduce the high transactional costs of bloated bureaucracies and poor infrastructure. It may be that neither becomes a tiger, and that the metamorphosis of the elephant and the toucan will be a long time in coming. However, as democracies both may have a comparative advantage in the battle to defeat poverty. Economists such as Dani Rodrik and the Nobel prize winner, Indian Amartya Sen himself, underscore the idea that democracies are more capable of absorbing conflicts and tensions generated by economic take-off in environments with pockets of extreme poverty without undue turmoil or repression. In this sense, the development of the Indian elephant and the Brazilian toucan could emerge as examples to follow among the competing development models that currently exist in the world. Both could become economic and political forces to be reckoned with in this century. If they manage to do so, it will have also been by adhering to the democratic ethos.

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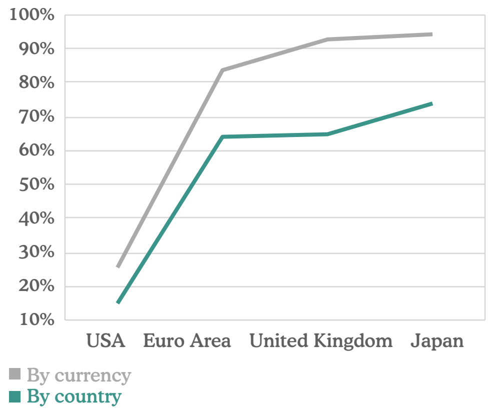
Emerging markets: towards the washing away of "original sin"?*

"Original sin": many countries, few currencies

One of the characteristics of the international debt markets is that issues are concentrated in a small number of currencies. Ninety-five percent of debt instruments are issued in the four most important global currencies (dollar, euro, sterling and yen), while only 72 percent of total debt is issued by residents of the countries or areas of these currencies. The gap that results from these different degrees of concentration means that non-residents of these four areas issue a considerable part of their debt in currencies that are not their own.

Distribution of international debt by issuer and currency

(cumulative, % of total, 2004)



Source: BBVA using BIS data

This stylised fact gives rise to what Eichengreen *et al*[1] described as "original sin". This refers to the inability of a country to issue debt in the international markets in its own currency. One of the measures the authors use to quantify this phenomenon is the following:

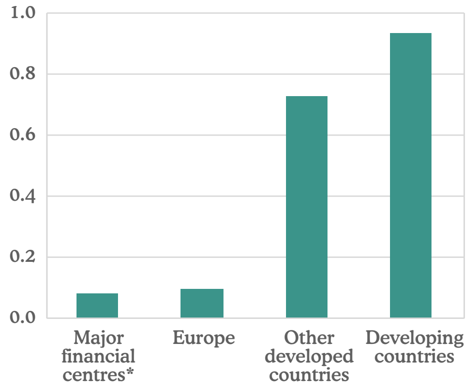
$$\text{MAX}\left[1-\frac{\text{Instruments in currency i}}{\text{Instruments issued by country i}},\ 0\right]$$

If the indicator is equal to zero, this means that all of the instruments issued by country "i" are denominated in this country's currency. That is to say, it is free of "original sin". On the other hand, the greater a "sinner" a country is, the more the indicator approaches[1]. This phenomenon is not exclusive to emerging markets. In fact, a large part of the debt issued by some developed countries is denominated in foreign currencies, although to a lesser extent than in the case of developing countries.

However, the focus of this analysis is normally on emerging markets, given that these suffer more directly the negative consequences of "original sin". What are these consequences? The most significant of these is an imbalance on

A measure of "original sin"

(the closer to 1, the greater a "sinner")



* USA, Japan, United Kingdom and Switzerland

Source: Eichengreen *et al.* (2003)

domestic balance sheets. That is to say, movements in the real exchange rate bring about wealth effects that have an impact on activity and the macroeconomic policies of the country in question. Thus, the times of difficulty in terms of capital flows, which tend to cause the real exchange rate to depreciate, generate a negative wealth effect that erodes the solvency of the country in question. Eichengreen *et al* show that the currency in which liabilities are denominated determines the sovereign currency rating of a country more than the extent of its indebtedness does. Specifically, the "absolution of sin" would raise this rating by around five notches. The balance sheet effects also influence the way in which monetary policy is put into practice. In general, more expansionary policies cause the exchange rate to depreciate, reducing the net wealth of the country in question. In this way, monetary policy becomes pro-cyclical and economic cycles more volatile[2].

Towards the forgiveness of sin? A more liquid market

Over the past few years, emerging debt markets, particularly those in Latin America, have made progress as regards issues denominated in local currencies. The IMF has been analysing the progress made in the region, particularly in Mexico, Colombia and Brazil[3]. In the case of the latter, for example, a 10-year real-denominated bond was recently placed in the international markets for the first time ever. The issue was well received by investors. Some international credit organizations have also started to issue debt denominated in Latin American currencies to finance their projects. For example, the Inter-American Development Bank (IDB), which has traditionally issued triple A bonds in dollars, in April placed a bond denominated in Mexican pesos for the first time ever. Subsequently, issues were made in Colombian pesos and Brazilian real. This support provided by the

* We would like to thank Verónica Baldovino for her contribution.

1 See Eichengreen, Hausmann and Panizza, "The Pain of Original Sin" (2003), in Eichengreen and Hausmann (editors), *Debt Denomination and Financial Instability in Emerging-Market Economies*, Chicago: University of Chicago Press (2005).

2 In this case, the relevant measure of volatility is gross domestic product measured in the currency in which liabilities are denominated. The evidence demonstrates that GDP volatility in constant dollar terms is greater than that of GDP measured in the local currency.

3 See Global Financial Stability Report, April & September 2005, International Monetary Fund.

multilateral organizations is obviously particularly significant for the development of this market.

JP Morgan has recently begun to draw up the Government Bond Index-Emerging Markets (GBI) for this type of debt. This index complements the EMBI family of emerging market bond indices which refer to external debt issued in dollars and which act as the benchmark in the international markets. The introduction of the GBI reflects the growing demand among international investors for such assets. It is important to point out that the GBI not only covers international bonds. In many countries the development of instruments of this sort is mainly taking place in local financial markets, but they are still attractive to international investors[4] . While "original sin" refers to issues in the international markets, the development and deepening of local markets could constitute an important step in the right direction.

Only 16 of the emerging market countries form part of the GBI-EM, 4 of which are in Latin America: Mexico, Brazil, Colombia and Chile. The importance of Latin America in the index is small (10%) in comparison with its share of the dollar-denominated debt market (60%). This is largely due to the as yet limited participation of Brazil, the country with the highest capitalization in the sovereign debt market in dollars. In the case of Mexico, which is second in importance in terms of dollar-denominated debt capitalization, a similar situation exists, although the gap between the two types of debt is not so large.

Current share in benchmark indices

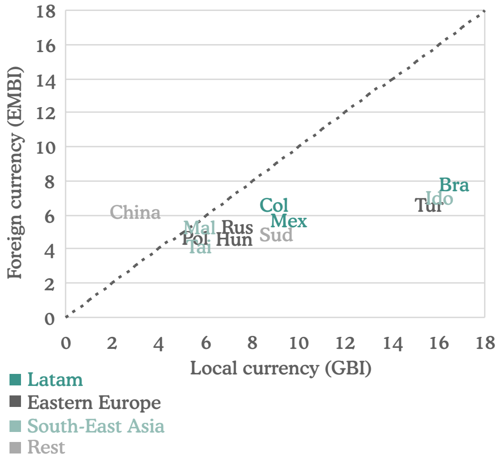
	GBI-EM (local currency)	EMBI + (dollars)
China	25.7	—
India	13.3	—
South Africa	12.4	1.8
Mexico	8.7	18.7
Malaysia	6.2	—
Colombia	2.1	3.4
Turkey	1.0	9.2
Brazil	0.6	23.7

Source: BBVA using JP Morgan data

Another important aspect is the yield of the instruments. In general, as can be seen in the adjoining graph, the markets usually penalise local debt issues with higher interest rates in order to cover against exchange-rate risk.

Brazil and Turkey, two countries where monetary conditions are still tight, are among the countries with the highest interest rates in comparison both with other economies and with their own dollar-denominated instruments. It should be highlighted that local currency debt has been no exception in the emerging market debt rally and the search for yield that has characterized the markets since the beginning of 2003. In fact, in the current context of currency ap-

Average rate of return of the bond portfolio of each country in local currency and dollars

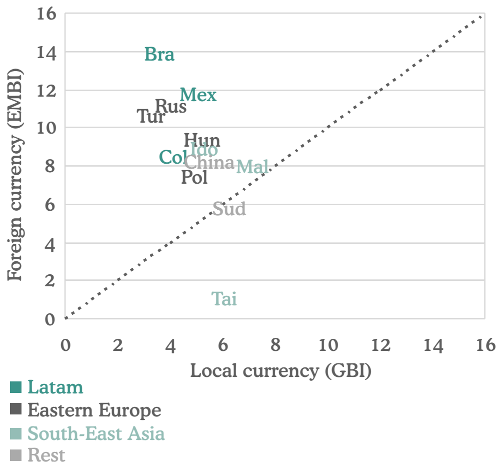


Source: BBVA using JP Morgan data

preciation pressures, this type of debt becomes even more attractive[5] .

Finally, another point to note is the maturity of the issues. Once again, the uncertainty generated by the exchange-rate risk or, where applicable, the cost of protecting against this risk, increases with the maturity of the asset. As a result of this, it is logical to imagine that it will be lower than that of dollar-denominated bonds.

Average maturity of the bond portfolio of each country in local currency and dollars



Source: BBVA using JP Morgan data

Brazil and Mexico are two of the countries that have the shortest maturities for their issues in local currency, especially bearing in mind that they have the longest maturities for dollar-denominated issues. This fact, together with their low weightings, highlights the fact that there is still ample scope in Latin America for the development of this new local currency debt market.

4 Mexico is a good example. The participation of foreigners in the Mexican market has risen from 4% at the beginning of 2004 to around 20% at present.

5 Over the past year, local currency yields in many of the countries in the sample have fallen by more than the rates in dollars.

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Unexpected events driving oil prices

Recent events that have had an impact

The fragile equilibrium between supply and demand, as reflected in the existence of surplus short-term production capacity of only 2% of demand, makes the oil market extremely sensitive to any combination of adverse events. The past quarter was particularly hectic, throwing up four significant events that have had a strong impact on the oil market.

The first of these was the death of King Fahd. Although his successor was no surprise, newly crowned King Abdullah comes from a line of succession comprising a generation that is in its eighties. This situation suggests an uncertain future as regards the establishment of a more rigorous government that has been seen to be a key element in the stability and unity of the world's largest oil producer. In addition, there are opposing stances towards the West within the line of succession, which adds greater uncertainty as regards the future of the monarchy.

The second event is the crisis in Iran. The election of the ultra-conservative Ahmadinejad as President reverses the reformist movement. One of the first moves of the new Government was to take the nuclear programme back down off the shelf in an act of clear defiance of the United States and Europe. This has created a situation that will be difficult to resolve through diplomatic means, and increasingly heightens the possibility of serious geopolitical conflict.

The third element is the current hurricane season in the North Atlantic. A total of 21 tropical storms and 11 hurricanes have been forecast, of which more than half could turn out to be major. So far, there have been 17 storms, 9 of which reached hurricane force, with two months remaining in the season. The area worst hit has been the Gulf of Mexico where 28% of the oil in the United States is produced. The area also accounts for 60% of US crude imports, 47% of the country's refining capacity and 20% of natural gas output. As such, the oil market is particularly sensitive to the storm season.

The fourth element is the heightened problems of the US refining industry. Prior to the impact of the hurricanes, activity at 11 refineries was paralyzed to varying degrees by a series of incidents. This was reflected in a higher-than-expected fall in inventories of petrol, and a smaller-than-expected build-up of distillate inventories in the summer period.

The simultaneous occurrence of these four situations, which individually have a low probability of happening, is behind the 30% rise in the price of Brent since May of this year.

The situation in Iran: the biggest impact on the market

Beyond the short-term impact of the hurricane season, the size of which will depend on the extent of the damage and the recovery time for a key area for the oil industry, the biggest impact on the market is without doubt the evolution of the conflict surrounding Iran's nuclear programme, given that the country produces 4 million barrels of crude oil a day. What set this off was the relaunching of Iran's so-called civil nuclear programme in defiance of a ban imposed by the UN energy programme. The West views this as a step towards producing nuclear weapons.

The United States and the European Union have rejected Iran's arguments, and are seeking to have the issue dealt with by the UN Security Council. This would entail setting an ultimatum, which if not complied with would lead to military and economic sanctions, and could eventually include an embargo on Iran's exports. However, China and Russia, which are permanent members of the Security Council, and as such have a veto, are opposed to any immediate action against Iran.

Iran has reacted angrily to Europe's proposed resolution, and has threatened to go further by renewing its uranium enrichment programme, as well as withdraw its commitment to comply with the so-called Additional Protocol to the Nuclear Non-Proliferation Treaty, which allows for surprise inspections.

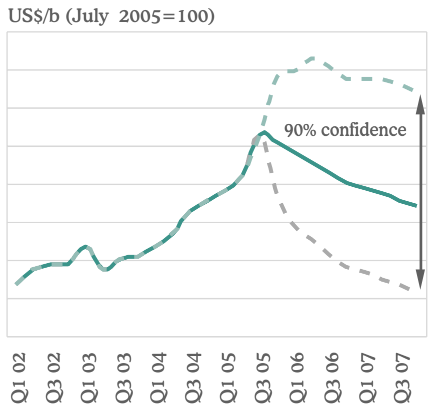
It will be difficult to find a diplomatic solution to this situation. This is the most important issue currently, and as a result, the market will remain under pressure in the face of the possibility of Iranian exports being excluded from the market or otherwise.

Updated price scenario

One of the main features of the market is the strong persistence of the impact on prices of news and concerns regarding the future equilibrium between supply and demand for crude oil. The four factors identified above require an update of the scenario for Brent crude prices.

The new baseline scenario envisages the damage from the hurricane season being short-lived, with the factor generating most uncertainty being the possible halt to Iranian exports. This scenario would translate into an average price for 2005 of 55.9 dollars a barrel, an increase of 12% with respect to the previous scenario, while for 2006 the average price is raised by 20% to 54.6 dollars a barrel.

Estimated Brent oil price 2005-2007



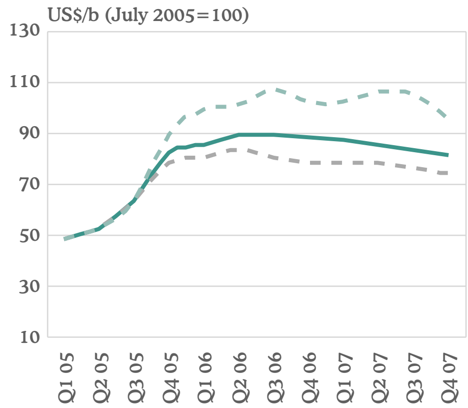
Source: BBVA Banco Provincial Research Department

However, the situation in Iran opens up a risk scenario with a probability of between 10-15% involving the withdrawal of this country from production for a period of over one year. This would take the price of oil for 2005 to 61.2 dollars a barrel (9% higher than in the baseline scenario) and to 89.9 dollars a barrel in 2006 (64% above the baseline).

For 2007, the baseline scenario envisages an average oil price of 46.2 dollars a barrel, while under our risk scenario the price would reach 84 dollars a barrel.

Risk scenario: Brent oil price 2005-2007

Probability between 10-15%

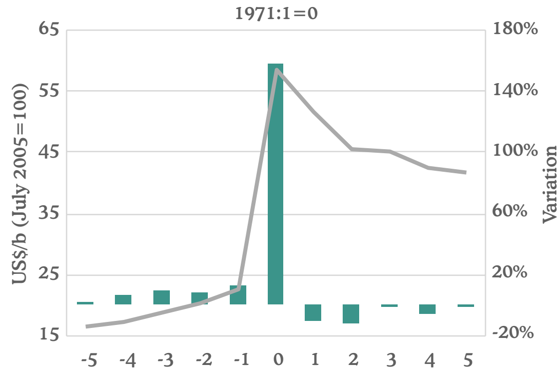


Source: BBVA Banco Provincial Research Department

The key question to be answered is whether we are facing a prolonged upward movement towards a new equilibrium level or whether the current situation is an overreaction that will be followed by a correction to a lower price level.

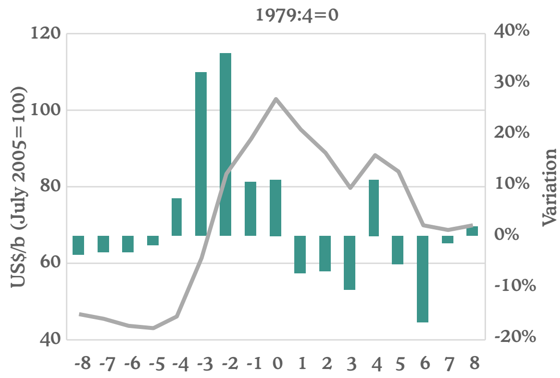
An analysis of the historical behaviour of oil prices shows that the current cycle of constant price increases is atypical, and one that has already run for 9 quarters, the longest such cycle since 1957. Permanent changes in the levels of prices have generally been characterised by rapid upward movements, in contrast to processes of more gradual increases in prices in which price levels do not become consolidated and converge to a lower level (see adjoining graphs). This classic behaviour of the market, together with an improved supply performance in the medium term, suggests that the current phase of overreaction will be followed by an adjustment to levels closer to 40 dollars a barrel than to today's 63 dollars.

Oil prices during 1971 Arab embargo



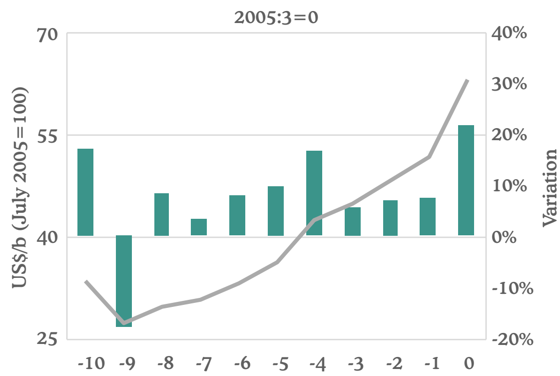
Source: BBVA Banco Provincial Research Department

Oil prices during 1979 Iranian revolution



Source: BBVA Banco Provincial Research Department

Oil prices in current situation



Source: BBVA Banco Provincial Research Department

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Commodities

The Katrina effect

Over the past 2 months, the commodity market has been hit by a series of events. The most significant is that associated with the effects of the hurricane season on oil production. In particular, the fall in oil extraction and refining activity in the area of the Gulf of Mexico has had a marked impact on the price of crude (see box on oil).

In the wake of Hurricanes Katrina and Rita, speculative buying of commodities has surged in response to the need for reconstruction in the affected areas. One example is copper, which has continued to register record highs, with the price reaching 180 c/lb on September 23. This all-time high nominal price level represents a rise of over 40% compared with that observed barely one year ago.

Also, the potential second-round effects on prices associated with the increase in the price of oil has set alarm bells ringing against inflation. In this sense, demand for hard assets such as gold has increased considerably. Over the past 2 months, gold prices have increased by 13%, to currently stand at record nominal levels of over 470 cents per ounce.

At the same time, sugar prices have continued to trend upwards, driven by the events mentioned above. In concrete, the growing demand for ethanol as an alternative source of fuel could have a significant effect on the price of sugar over the next few years.

Finally, coffee is showing a different trajectory. After peaking at its highest level for 5 years, the price of coffee has fallen back by over 30% since last March. In the period ahead, however, prices could begin to pick up again, mainly because of poor harvests in Vietnam and possibly Brazil.

The BBVA-MAP index[1] continues to rise

The BBVA-MAP index is still running at historically high levels. This is the result of the fact that both oil and copper have high weightings in the index (49% and 10% respectively) and that both have posted pronounced increases over the past few months. Specifically, the index is up by over 25% so far this year.

When oil is excluded from the index, the increases in the prices of commodities such as copper, gold and sugar are seen to have been offset by lower prices for coffee and soya beans and the increase in the price of natural gas. Over the past few months, therefore, the non-oil index is practically unchanged.

With respect to the country indices, the position of each country with regard to oil production or consumption continues to be the main factor determining whether an index is rising or falling. In particular, Argentina, Colombia, Mexico and Venezuela are still benefiting from the current situation in the energy sector. Chile and Peru, as copper producers, also show gains so far this year, whereas in Brazil higher sugar prices have not been sufficient to compensate for the increases in the price of a barrel of oil.

[1] The BBVA-MAP index is a weighted average of the prices of the main commodity and agricultural exports of Latin America.

BBVA-MAP

(3-month moving average - 1995=100)

Source: BBVA

Slight corrections expected in the medium term

The surprises in the market have forced us to revise our commodity price projections for the end of the year. For most of the products included here, the revised price scenario is positive. Moreover, although the downward adjustment of the prices of these products is only expected to begin to be felt next year, the adjustment is unlikely to be pronounced in any of them, meaning that commodity prices should stay at relatively high levels.

BBVA-MAP commodity index

(% change as at September 2005)

	Since January 2003	Last 12 months	2005
BBVA-MAP	71.67%	26.17%	26.30%
Ex-oil	33.35%	10.02%	1.62%
COMPONENTS			
Metals	72.22%	14.21%	4.14%
Agriculturals	25.57%	16.26%	5.23%
Energy	104.11%	37.46%	50.89%
COUNTRIES			
Argentina	20.04%	9.91%	12.24%
Brazil	-3.19%	-2.32%	-7.60%
Chile	53.77%	10.03%	4.21%
Colombia	59.42%	25.08%	21.84%
Mexico	62.01%	24.16%	29.80%
Peru	34.89%	10.20%	2.09%
Venezuela	104.11%	39.64%	48.94%

Commodity prices

	Annual average			End-year
	2003	2004	2005*	2005f
Coffee (USc / lb)	65,0	85,1	120,0	105,0
Copper (USc / ton)	81,0	126,0	156,6	155,0
Gold (US$ / ounce)	363,9	409,6	431,6	440,2
Oil (US$ / barrel)	29,6	38,6	53,9	60,5
Soya (US$ / ton.)	238,0	267,0	245,5	236,0

*/ Until September
f/ forecast

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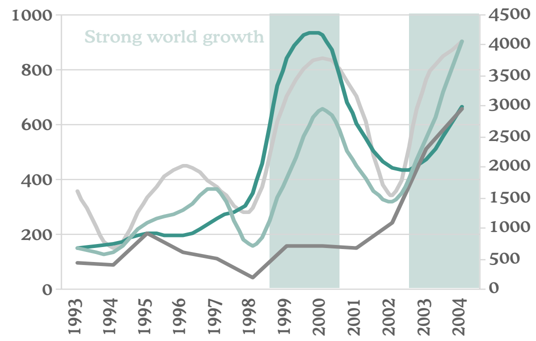
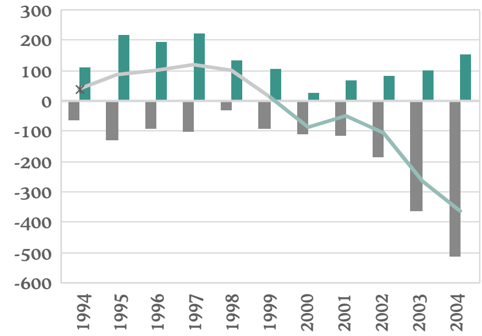
International capital flows
(billions of dollars)



Portfolio flows · Direct investment · Reserves · Total

Source: FMI

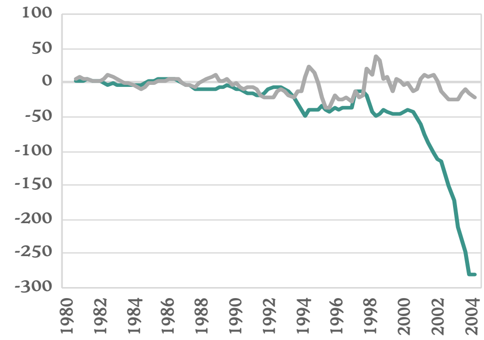
Emerging markets: net capital flows
($bn)



Net importers of capital · Financial flows · Accumulation of reserves · Net exporters of capital

Source: FMI

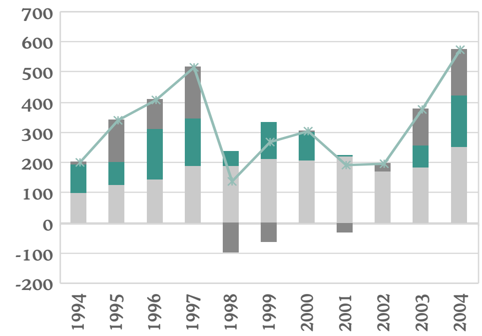
Change in reserves ($mn)



Latam · Asia

Source: IMF and IFS

Emerging markets: capital inflows
($bn)



FDI · Portfolio · Other · Total

Source: IMF

III. Under the Microscope: Capital flows in Latin America

Latin America within the context of a recovery in international capital flows

International capital flows in 2004 registered a notable increase in all categories for the second year in a row from international reserves to direct investment. Recent developments in the financial markets point to a continuation of this trend. The combination of abundant liquidity as a result of low global interest rates, low volatility and low aversion to risk on the part of international investors paint an encouraging picture for emerging economies. In this context, one of the main drivers of capital flows has been the search for yield, which has encouraged massive flows of foreign capital to emerging economies. In the specific case of Latin America, there are additional factors that have had an influence on capital flows: i) the increase in the prices of commodities; ii) an improvement in macroeconomic fundamentals; and iii) in some cases a tightening of monetary conditions that has made carry trade one of the most popular plays in the past year.

In this context, the aim of the series of three articles included in this edition of Latinwatch is to further analyse capital flows in emerging economies along three lines. The first of these focuses on the evolution and composition of capital flows to emerging economies, highlighting the differences/similarities between Latin America and Asia. The second of these articles examines one particular type of capital flows – portfolio investments – which has historically been considered the most volatile. The aim is to provide an answer to two important questions: Is the narrowing of spreads more the outcome of local or global factors? Has the heightened integration of markets been accompanied by greater volatility in capital flows? Lastly, in the third article we look at the reasons behind the accumulation of international reserves and the implications this poses for the monetary authorities of emerging economies.

Recent developments and prospects for capital flows

Capital flows towards emerging markets as a whole have been growing in parallel with current account surpluses, moving above levels seen prior to the crises that have taken place. Although there have been fluctuations, foreign direct investment, which is considered as the most stable source of financing, has increased thanks to the favourable investment climate. The recovery in portfolio investment in 2003 and 2004 has been particularly significant, and to a lesser extent bank lending, which was negative for four years in a row.

The pattern of recovery in capital flows towards emerging economies has been very different in Latin America and Asia excluding Japan as seen in financial account balances (excluding reserves, the accumulation of which has been clearly led by Asian countries, with China at the fore). Asia has relatively rapidly recovered incoming capital flows since the crisis of 1998, to the extent that flow volumes are now almost at pre-crisis levels. Within Latin America, the Argentine crisis in 2001 not only has prevented a recovery in flows, but also led to a two-year drought in terms of net international financing. Only recently has the net balance in the financial account turned positive.

What is particularly revealing is the different pattern shown by foreign direct investment. Net inflows of FDI to Latin America have been falling since 2000 (end of the period of privatizations), and have barely managed to stabilize in the past two years. Meanwhile Asia, with China as the main recipient, has been gaining ground with net inflows doubling those of Latin America. In terms of GDP, FDI in Latin America has been cut by practically half in less than four years from 3.2% in

2001 to 1.5% in 2004. FDI in Asia currently represents 1.7% of GDP, compared with 1.2% in 2001. One of the questions posed by this situation is what impact Asia, or more specifically China, is having on FDI flows to Latin America. Although the empirical evidence is still scant, a few recent studies show that in effect there has been a substitution effect between China and Latin America in the past decade. This effect may be more marked for countries such as Mexico and Colombia[1].

Asia is also ahead of Latin America in terms of portfolio investment and bank loans. Net flows into equities in Asia[2] have been very large (mainly to China and India), and are more than compensating for the net purchases of overseas fixed-interest instruments by the region – a process that is closely linked to the accumulation of reserves[3]. However, in the case of Latin America, net inflows of portfolio investment dropped sharply at the end of the 1990s, and in the past few years, it has been the only emerging region where net portfolio flows have been negative[4]. The balance has only barely started to turn positive in 2005 due to purchases of Mexican and Brazilian bonds by foreigners. Asia has also recently taken over from Latin America as the region that receives most bank loans. This form of funding has increasingly given way to fixed-interest instruments. The reason behind this lies in the fact that lending to Brazil, which previously was a major recipient of such finding, has fallen, while capital has also exited Argentina and Venezuela[5].

The figures available highlight the increasing role that Asia has assumed in international capital flows. Not only as countries that fund others with savings shortfalls such as the United States, but also in particular as recipients of capital flows. This could give rise to a certain degree of concern on the part of a region such as Latin America because of the growing competition it implies in the capture of international funds. But this does not necessarily mean a fall in funds towards Latin America in absolute terms provided that the volume of capital flows increases.

What is to be expected over the next few years? Although the current situation is not without risk, the central scenario for the next two years is for a continuation in global growth without significant inflationary pressures. In addition, there are expectations that liquidity will continue to be abundant, and therefore, international capital flows will continue to increase. By type of flow, the situation for international reserves seems clearer, in that a slowdown in the rate of accumulation from that of last year is already apparent[6]. With respect to FDI, merger & acquisition data show that funds associated with this activity are increasing and could continue to do so in 2006. Forecasts for portfolio flows, particularly fixed-interest, are positive. The main risk rests in sharp increases in interest rates in developed countries, mainly the United States (a scenario that is considered to be highly unlikely). Beyond this, Latin America faces the important challenge in the medium term of not losing more ground in FDI flows, which are becoming increasingly concentrated in a limited number of countries.

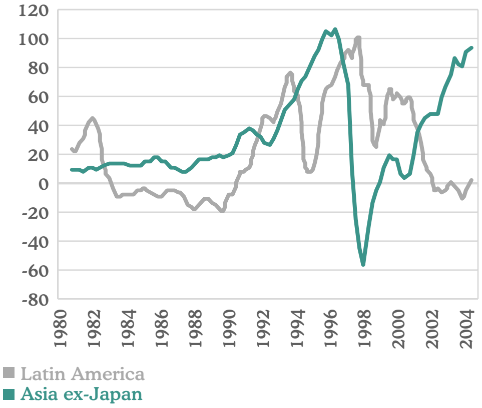
Latin America: how can the volatility of flows be reduced?

At the same time as the emerging-market economies have been benefiting from flows of international capital, these countries have taken a

1 See García-Herrero, A. and Santabárbara, D. (2005), "Does China have an impact …".
2 The size of the capitalization of this market is clearly having an impact here.
3 China and other economies in the region have made massive purchases of US Treasury bonds in the past few years. China, for example, is now the second biggest holder of Treasury bonds after Japan.
4 However, part of this is due to the greater propensity of institutional investors, particularly pension funds, to invest overseas as a result of regulatory frameworks that are more open to such investment.
5 For a more detailed analysis of this component of capital flows see Rodríguez, J. & Santiso, J. (2005).
6 Although the change in the exchange-rate system for the yuan last summer has barely altered the scenario, in practise it would imply lower levels of intervention by China and other economies in the region to check the appreciation of their currencies.

Financial account balance

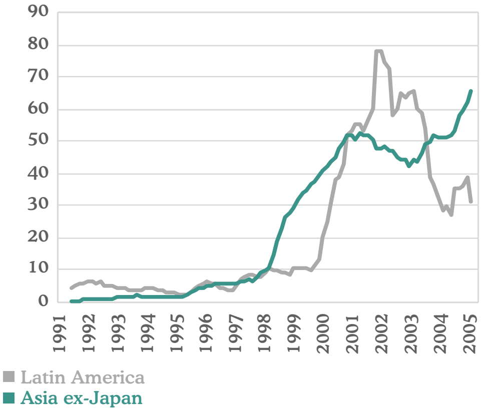
($bn)



Source: IMF and IFS

Foreign direct investment

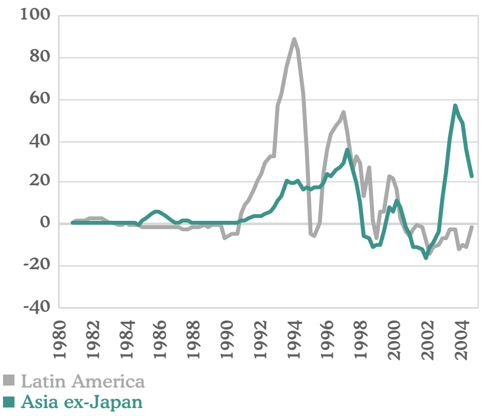
Net flows, $bn



Source: IMF and IFS

Net portfolio investment

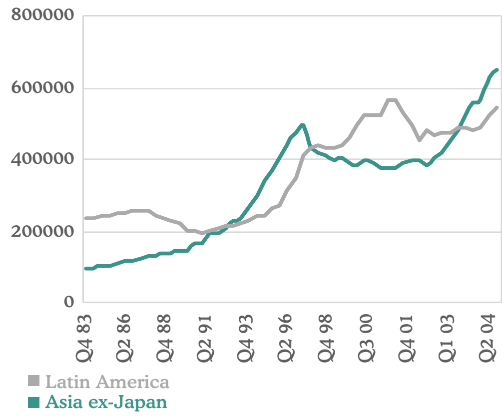
$bn



Source: IMF and IFS

Consolidated loans

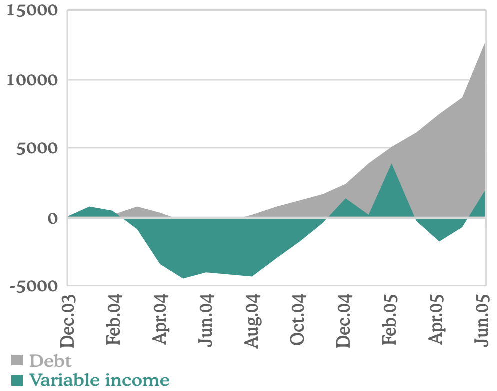
$mn



Source: BIS

Latin America: investment fund inflows

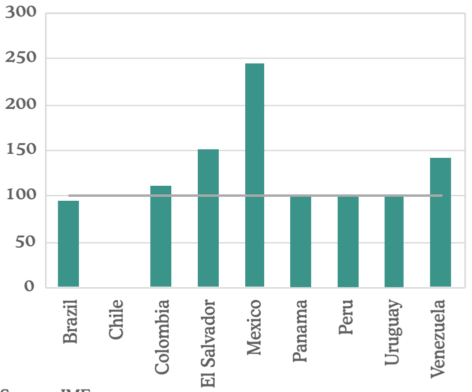
Total accumulated, $mn



Source: Emerging Portfolio Fund Research

Latin America: covered issuance of sovereign foreign debt

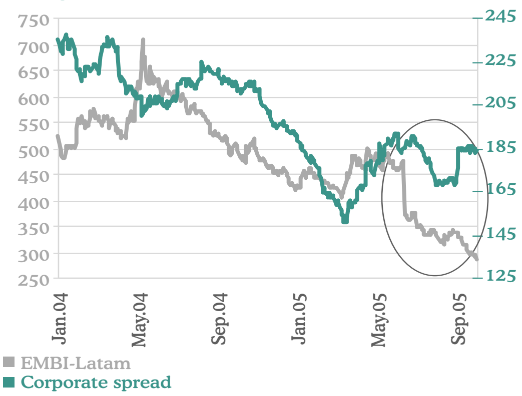
(as percentage of estimated debt issuance in 2005)



Source: IMF

Corporate spread vs EMBI Latam

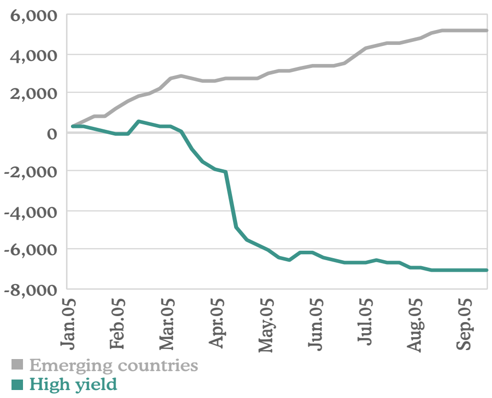
Basis points



Source: Datastream

Fixed-income fund inflows

Cumulative, $mn



Source: Emerging Portfolio Fund Research

number of steps aimed at meeting the major challenge: the stabilization of capital inflows[7].

Apart from the cushion that the accumulation of reserves affords against currency depreciation, the Latin American countries are taking advantage of the favourable financial conditions to strengthen their financial situation. On the one hand, many of these countries have already covered their borrowing requirements for 2005, and are even pre-financing debt for 2006. The characteristics of the new issues are also allowing them to reduce their external dependence: issues that have longer maturities, are in local currency and are not indexed to the exchange rate or inflation or short-term interest rates[8]. What is more, local currency denominated issues, the latest example of which was seen in Brazil, have been well received by the market, and the volume of such issues has risen to the point where it has prompted the creation of a new index[9]. In this way, and also thanks to the appreciation of the majority of the emerging market currencies against the dollar over the past year, the ratios of debt to GNP and debt servicing to exports have been coming down.

Turning to other matters, the growth of a stable investor base and the resulting development of a regulatory framework are proving to be key factors in achieving greater depth in local markets, especially the bond market, and in reducing the volatility in the markets. The growing weight of pension funds, with a volume of managed assets in relation to GDP that has increased ninefold over the past decade, is one of the clearest examples. Similarly, the growth of investment funds has been very strong, with assets under management currently the equivalent of over 15% of GDP. The figures are more modest for insurance companies, at less than 5% of GDP, except in the case of Chile. All that said, it is still the foreign institutional investors that play the dominant role in the emerging markets. This is even more true for Latin America than for Asia, given the large volume of assets managed in relation to the size of local markets. The good performance of the emerging-market assets during the past year has made them increasingly attractive for some international investors[10].

One final aspect worthy of consideration is the contagion effect. In this sense, it is interesting to note a number of episodes – the downgrading of GM and Ford in the spring and reports of corruption in Brazil – which seem to have put the vulnerability of capital flows to the region to the test. Spreads in Latin America appear to have decoupled from developments in corporate spreads, which rose during the spring, including in Mexico despite its close ties with the automobile sector. The data for flows of variable income funds show that the emerging-market countries seem to be benefiting from the outflow of capital from the high yield market. The probability of a sudden capital flight from Latin America therefore seems to be low, even though the key challenge will come in 2006 when there are elections in most of Latin America.

IMF (2004), “Institutional Investors in Emerging Markets, April, 2004.

García Herrero, A. and Santabárbara, D. (2005), “Does China have an impact on Foreign Direct Investment to Latin America?”, Working Paper, 0517, Bank of Spain.

Rodríguez, J. and Santiso, J. (2005), “Banking on democracy: the political economy of international bank flows in emerging markets”. Paper presented at the Annual Meeting of the Latin American and Caribbean Economic Association, Paris, October, 2005.

Williamson, J. (2005), “Curbing the boom-bust cycle: stabilizing capital flows to emerging markets”, Institute of International Economics.

7 See Williamson (2005).
8 See article, “Emerging markets: towards the washing away of “original sin”.
9 The new GBI-EM benchmark index launched by JP Morgan for local currency issues of international debt by emerging-market counties.
10 See IMF (2004), “Institutional investors in emerging markets”.

Portfolio flows: lower volatility and greater integration

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In the 1990s, capital flows towards emerging markets underwent profound changes. At the end of the 1980s and the start of the 1990s, a series of reforms were introduced aimed at liberalizing capital markets. These reforms facilitated access to local markets for international investors, and international markets for local investors. The economic-financial literature shows that this liberalization process marked a turning point in the evolution of capital flows towards these countries. Focusing essentially on portfolio flows, a number of different authors[1] have shown that the increase in capital flows towards emerging markets leads to a lowering in the cost of capital and greater financial integration. Two markets are said to be integrated when a project with identical risk has equal expected returns in the two markets. In addition, it has been observed that when barriers to investment between countries are partially or totally removed, markets become more efficient because local investors are no longer captive and can invest in foreign stocks with higher returns.

Despite the fact that integration brings benefits, one of the arguments most used against market liberalization is that greater integration produces an increase in volatility. Empirical evidence indicates otherwise. What is more, in the worst of cases, an increase in capital flows does not affect volatility, and in the best of cases it reduces it.

The economic orthodoxy adopted by the majority of countries in Latin America along with great global liquidity has meant that from the end of 2002, dollar-denominated EMBI bond spreads have fallen to historically low levels. From the point of view of equities, although accumulated funds invested in the region have not undergone significant change, individual flows have. The attached graph shows the negative impact in three countries[2], while the graph for Mexico and Brazil shows a positive impact.

It is a fact that the benefits derived from capital market reforms vary in time and are sensitive to economic fluctuations. In the past few years, a number of events have taken place that have had a positive impact on emerging markets and their integration to a greater or lesser extent. On the one hand, there has been a negative impact on the perception of investors of the intrinsic risk of investing in these markets, and therefore, a drop in flows towards them. An example of these events is found in the different crises that took place between 1997 and 2002. On the other hand, there is abundant global liquidity, which has had a positive effect by lowering Latin American spreads since the end of 2002.

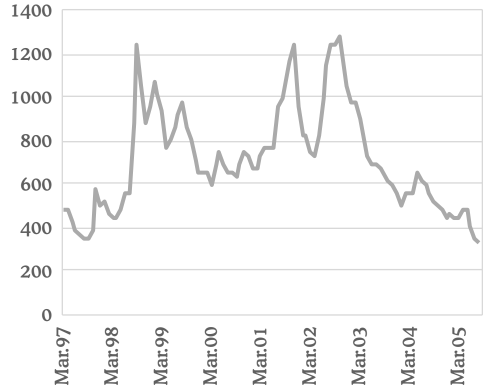
The purpose of this study is to analyse the increase in capital flows from two points of view. In the first place, we look at the volatility of equity flows in the period 1995-2005. Secondly, we examine the impact of the greater integration of capital markets on spreads (EMBI+). We separate local effects from international ones.

Financial crises: a new structural change in flows?

The figures used for the analysis are particularly revealing[3]: inflows in investment funds that specialize in equity investments in emerging markets. On analysing these figures it can be seen that, just as has been argued by those who are in favour of the opening of capital markets, the recent increase in flow volumes has given rise to a reduction in volatility. This conclusion was reached by estimating the conditional variance of the monthly capital flow series for each of the countries in the region and

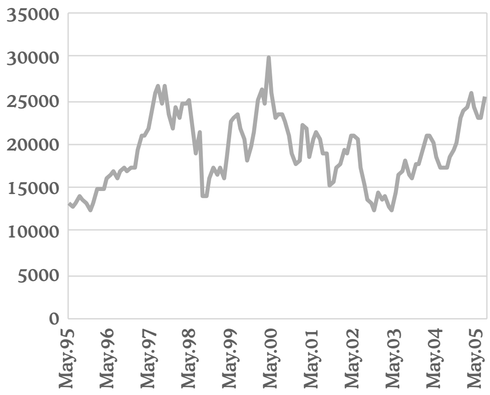
[1] For example, Bekaert & Harvey (1998), Tesar & Werner (1995).
[2] Controlling for market capitalization, it can be seen that the negative effect is less pronounced given that the capitalization of the markets in question has fallen considerably.
[3] We would particularly like to thank Ian Wilson and Dwight Ingalsbe of Emerging Portfolio Fund Research for letting us use their data on asset ownership and net flows towards emerging markets. For more information see www.epfr.com

EMBI Latam



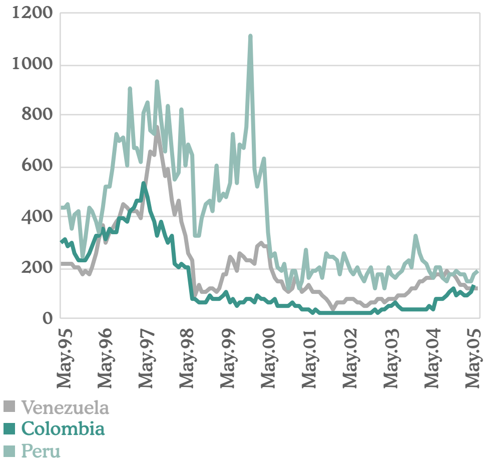
Source: JP Morgan

Latin America: accumulated total flows
(millions of dollars)



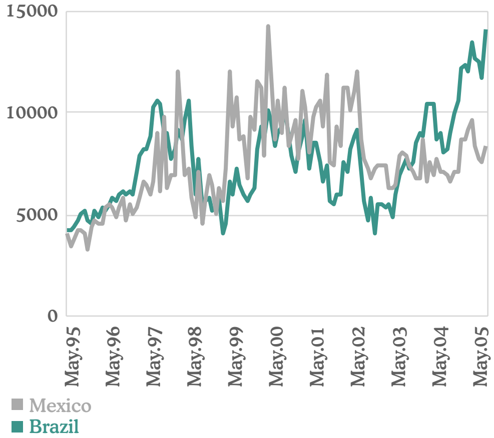
Source: Emerging Portfolio Fund Research

Accumulated total flows
(millions of dollars)



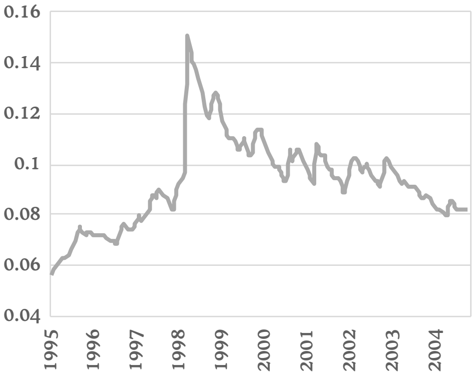
Source: Emerging Portfolio Fund Research

Accumulated total flows
(millions of dollars)



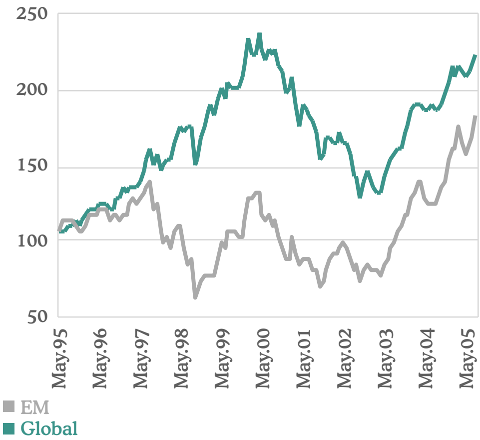
Source: Emerging Portfolio Fund Research

Latin America: estimated volatility in equity flows



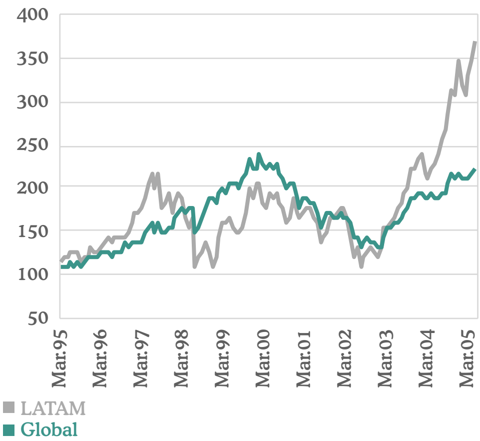
Source: Emerging Portfolio Fund Research and BBVA

MSCI: global vs emerging markets



Source: JP Morgan

MSCI: global vs Latin America



Source: JP Morgan

the corresponding figure for the region as whole using a GARCH (1,1) (generalized autoregressive conditional heteroscedasticity) model. This model was originally suggested by Bollerslev (1989).

The attached graph shows the estimated volatility of the series for net capital flows towards investment funds that specialize in equities for the region as a whole. A clear reduction in volatility, which has remained stable at low levels since 2000, can be seen. In addition, the estimator of the persistence of volatility, which lies between zero and one (the higher the persistence the more the figure approaches one), stands at 0.88. In other words, the persistence of volatility is high, with periods of low volatility such as at present followed by low volatilities and vice versa. However, this coefficient is relatively low in terms of the estimates generally obtained for financial series, which are closer to 0.95. This feature is also seen in the analysis of the series by country, with estimates of persistence of between 0.61 for Colombia and 0.89 for Peru.

Co-movement or integration? Local or global factors?

Very often, we erroneously speak of a greater (or lower) degree of integration of markets based on the correlation between indexes or returns on certain assets. What really takes place in some cases is a greater degree of co-movement between different capital markets, given that two countries can be perfectly integrated but the correlation between them low for the simple fact that their industrial structures are totally different. In any case, there is a greater degree of integration of markets at present than there was 15 years ago. The attached graph shows that the extent of the co-movement between emerging and developed markets is high. However, if you look at Latin America on its own, you can see less co-movement with the global market, to the point that what we have is divergence from it.

In the light of this, it is interesting to determine to what extent current prices for certain assets in emerging markets can be explained by their integration with developed markets or on the other hand by local factors. The answer to this question depends to a large extent on movements in the price levels in emerging markets in reaction to changes in international conditions. This is a particularly interesting point given that current excess global liquidity is putting downward pressure on yields in developed markets, and leading to the search for alternative investments in emerging economies. If these conditions were to change, and capital inflows fall, would emerging markets revert to their previous situation, or are the reforms introduced in these countries sufficient to sustain the current situation in the markets in the region? We specifically try to answer this question by analysing panel data for Latin American spreads.

Using panel data techniques we have analysed the main determinants of the spreads of seven countries in the region (Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela). In order to do so, we have used quarterly data from the second quarter of 1999 to the second quarter of 2005 (the sample includes 25 observations per country), this being the widest period for which a common sample is available.

On analysing the literature devoted to empirical studies on sovereign spreads, we can see a great deal of diversity as regards the exogenous variables used. In this regard, the articles of Beck (2001) and García-Herrero and Ortiz (2005) are a good reference point. However, the regressors that determine the evolution of spreads in the medium term can be grouped into three main categories. Firstly, there are exogenous variables that can be classified as macroeconomic such as GDP growth, inflation, the real exchange rate, the openness of the country to trade and the volume of real reserves. After a series of trials, inflation – frequently used as a proxy for the quality of economic management – was incorporated into the analysis. The second category includes solvency variables for each country. After evaluating our modelling exercise with different variables of this type, we opted to use the ratio of reserves to imports, which empirically shows an inverse relationship with spreads. Thirdly, it is also important to use variables that approximate the levels of global interest rates, since these have a positive relationship with spreads, even though this relationship can break down during financial crises. In this regard, we have considered 10-year interest rates in the United States and the VIX index, which as the implicit volatility of options contracts on the S&P 500, provides a good measure of the level of uncertainty in the markets and therefore has a positive relationship with spreads[4] .

The adjoining tables present the results of the different estimations carried out by means of a pool with dummy variables for each country and robust estimation of the variances. The first table reports the results for the whole area with the 4 explanatory variables, which are significant and have the expected signs. With respect to the sensitivity of the EMBI to international factors, according to the model, an increase of 1% in US 10-year interest rates would give rise to an increase of 2% in the region's spread, while the reaction to a one-percentage point change in the volatility of the S&P 500 is of the order of 3%. As regards the local variables, a rise of 1% in inflation would bring about an increase of 4% in the EMBI, which is also highly sensitive to changes in the ratio of reserves to imports. As for the estimations, the model generally overestimates slightly towards the end of the sample, as can be seen for example in the adjoining graph for the EMBI of Mexico. This is an argument in favour of the hypothesis of a possible structural change in the spreads series, since the local and global factors included in the sample since 1999 do not capture all the decline in the EMBI indices of the past 2 years.

It is also interesting to repeat this exercise using only data for Mexico and Chile, since the behaviour of these two countries was different, possibly because of their closer ties with the US economy. The results show that these two countries are more sensitive to changes in US 10-year interest rates. A change of one percentage point in the rate of interest leads to an increase of 13% in the EMBI. Although the VIX and inflation are robust to the change in the region considered, the sensitivity of the local solvency variable represented by the ratio of reserves to imports increases notably. To sum up, despite the importance of global factors in determining the EMBI differential, there are local factors that may support this variable in the face of possible future variations in international liquidity conditions. Also, in an analysis of the data for the remaining five countries, the effect of the two international factors turns out not to be significant, whereas the two local factors are significant and have the expected signs.

Therefore, in a regional analysis, the local and global factors are important, but if we analyse separately Mexico and Chile, the sensitivity to the international factors increases. In any case, it can be concluded that the local factors could offset the effects that may stem from future changes in international liquidity conditions.

Beck, R. (2001), Do Country Fundamentals Explain Emerging Market Bond Spreads?, Working Paper, No. 2001/02, Center for Financial Studies, Frankfurt.

Bekaert, G. and C.R. Harvey (2001), Capital Flows and the Behavior of Emerging Market Equity Returns, in Sebastian Edwards (editor), Capital Flows to Emerging Markets (University of Chicago and NBER, Chicago).

Bollerslev, T. (1986), Generalized Autoregressive Conditional Heteroscedasticity, Journal of Econometrics, 31, pp. 307-327.

García-Herrero, A. and A. Ortiz (2005), The Role of Global Risk Aversion in Explaining Latin American Sovereign Spreads, Working Paper, No. 0505, Bank of Spain.

Tesar, L. and I. Werner (1995), U.S. equity investment in emerging stock markets, World Bank Economic Review, 9, No.1, pp. 109-130.

[4] Finally, while we considered a fourth group of variables that describe characteristics of bonds such as volume and maturity, we were unable to use variables of this type in the analysis because of the non-availability of data.

Dependent variable: Log (EMBI) of the whole area (7 countries)

	Coeff.	t	P>|t|	Cte. Country bp
Inflation	0.04	6.69	0.00	
VIX	0.03	1.86	0.11	
10-year rates (US)	0.02	1.65	0.15	
Reserves/ imports	-0.12	-1.83	0.11	
BRA	-1.28	-17.06	0.00	454
CHI	-2.73	-73.52	0.00	106
COL	-1.57	-30.98	0.00	340
MEX	-2.44	-9.63	0.00	142
PER	-1.32	-14.19	0.00	437
VEN	-1.63	-19.17	0.00	320
constant (ARG)	7.40	6.06	0.00	1,631

$R^2 = 0.85$

Source: BBVA

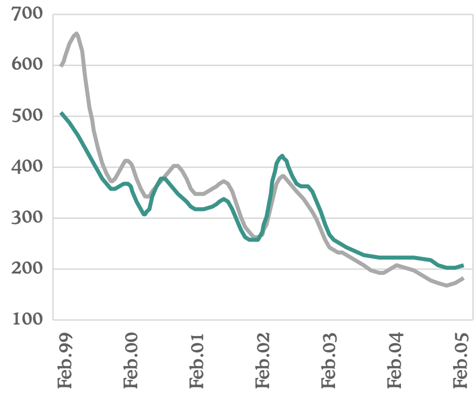
Dependent variable: Log (EMBI) of Mexico and Chile

	Coeff.	t	P>|t|
Inflation	0.06	20.80	0.03
VIX	0.04	224.09	0.00
10-year rates (US)	0.13	27.58	0.02
Reserves/ imports	-0.20	-21.58	0.03
CHI	-0.97	-101.74	0.01
constant (MEX)	3.61	75.68	0.01

$R^2 = 0.97$

Source: BBVA

EMBI Mexico spread: estimation and original series



Original series
Estimation

Source: JP Morgan and BBVA

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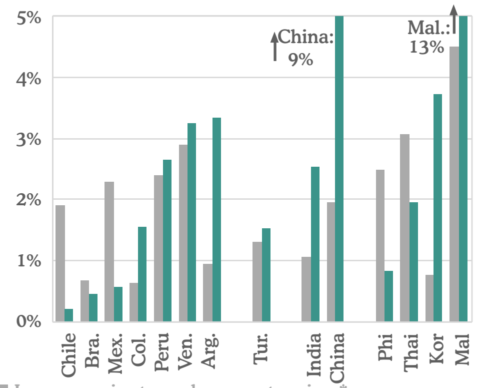
Accumulation of reserves

(% of GDP)



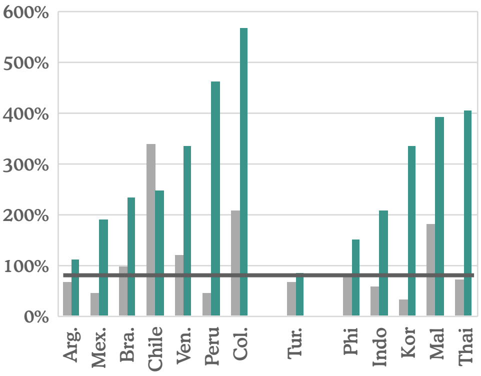
■ Increase prior to exchange-rate crises*
■ Current situation (04-05)

* Latam: post-tequila to Russian crisis; Turkey: 1993 to devaluation of lira in 2001; Asia and others: 1993 to Asian crisis in 1997.

Source: BBVA using IIF and Datastream data

Reserves as % of short-term foreign debt stock

(maturity under one year)

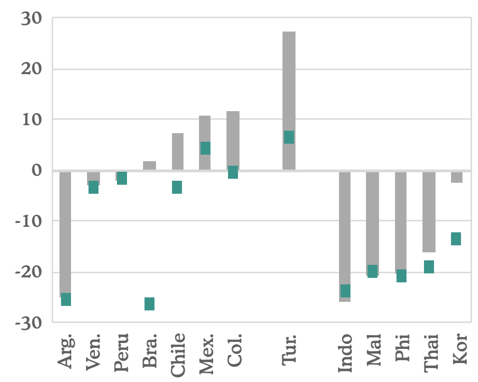


■ Pre-exchange-rate crisis *
■ Current

* Calculated the year before the exchange rate system is abandoned in each of the countries.

Source: BBVA using IIF data

Deviation of real effective exchange rate from its long-run equilibrium level according to PPP*



■ Current
■ One year ago

* A positive sign means the currency is overvalued in real terms.

Source: BBVA

Analysis of the accumulation of reserves in emerging economies

In the past two years, international reserve flows have acquired a leading role in the evolution of international capital flows. The accumulation of reserves in emerging markets has been significant, particularly in the Latin American region, although with differences among countries. Peru, Venezuela and Argentina are the countries that have accumulated most reserves relative to GDP. It is difficult to say what the optimum level of reserves is. The International Monetary Fund (IMF) has analyzed some measures of an "adequate level of reserves"[1], such as, for example, the ratio of reserves to imports or short-term foreign debt (maturing in less than a year). The IMF has identified the latter as the important indicator in the context of the past few years, in which exchange rate and balance of payments crises have been more closely linked with capital market funding than trade financing. The comparison of the ratio in periods immediately prior to exchange rate crises (and in some cases, debt crises) with the current situation of each of the countries in question is a case in point (see graph). Apart from a fairly general significant increase in the ratios, we can also observe that in many cases they are above levels that would be deemed to be sufficient to cover short- and medium-term debt maturities[2]. As indicated below, this reserve "comfort zone" is positive from the point of view of solvency and the cost of external financing, and, therefore, favours growth.

The phenomenon of strong reserve accumulation is not new to Latin America. After the collapse of the Latin American financial markets brought on by the Mexican crisis in 1994-95 and prior to the crisis in Russia, there was also a significant accumulation of reserves, particularly in the three countries mentioned above. Why, therefore, are recent developments attracting attention? During those periods mentioned above, the situation in Latin America was different from what it is at present. The current account deficit was high (around 4% of GDP) and comfortably covered by considerable net capital inflows. Within the context of fixed or semi-fixed exchange-rate systems, this situation led to a positive rate of change in foreign reserves.

But things have changed a great deal. With the Russian crisis, which led to a sudden halt in capital flows towards emerging countries, Latin America entered a period of severe downturn in economic activity. A series of debt crises and sharp currency devaluations took place, with most of the exchange-rate regimes in the region being abandoned for systems that were more flexible, with the exception of Venezuela. The current account deficit narrowed by 2 percentage points of GDP within two years before turning to a surplus, which still remains the case[3]. This pattern of events was pretty much the same in other emerging economies. Asian countries also suffered severe adjustments to their balance of payments position after the 1997 financial crisis accompanied by significant changes to their exchange-rate systems, which in general terms became more flexible[4]. However, the difference with Latin America is that net entries on the financial account have once again become significant (see first article). This, along with a current account surplus of 4% of GDP, helps explain why Asian countries are known as accumulators of reserves par excellence.

That said, this situation throws up a number of questions about the future. Are there limits to the increasing acquisition of reserves? Is this phenomenon the reflection of "fear of floating" within the context of ex-

1 See Beaufort Wijnholds J. O. and A. Kapteyn (2001), Reserve Adequacy in Emerging Market Economies, *IMF Working Paper, 01/143.*

2 Turkey and Argentina are the countries that have experienced the most recent crises; 2001 and 2002 respectively. This helps explain why they have lower reserve ratios than other countries in the sample, beyond the fact that their foreign debt levels still leave them subject to risks.

3 Driven in many cases by a positive terms of trade shock.

4 Currently, Hong Kong still maintains a fixed exchange-rate regime (currency board). China, Malaysia and Singapore have their currencies pegged to a basket of foreign currencies.

change rates that in theory are more flexible? Is there any inconsistency with domestic policies, particularly monetary policy?

Why do central banks build up reserves?

Changes in reserves allowed by monetary authorities result from a number of different objectives that are not necessarily exclusive of each other. Previously, the studies that were carried out focused on explaining periods in which reserves were run down in order to defend a certain exchange-rate regime and prevent a crisis from happening that in the end-run was inevitable. Obviously, the limits of such action were determined by the stock of a country's reserves.

But currently the pressures on currencies are upward, and therefore, the objectives are different from those before. There are three main reasons why Central Banks intervene actively in the currency markets, according to a recent study carried out by the BIS[5] . The first of these is what could be called a target level. That is to say, maintaining a competitive exchange rate in order to support the foreign sector and growth. However, the real effective exchange rate (REER), which is the relevant competitiveness variable, cannot be controlled for extended periods of time. Efforts to avoid a nominal appreciation of the currency entail the purchase of reserves which leads to an expansion in the monetary base, and given the demand for money in the economy, an increase in inflation that helps bring about an adjustment in the real exchange rate. At the moment, recent experience shows that, in general, countries that had undervalued currencies a year previously are still in that situation[6] . Countries that stand out are Argentina and the majority of Asian countries, which are precisely those that have accumulated most reserves in terms of their ratio to GDP over the past year.

The second of the reasons has to do with exchange rate volatility. That is to say, the rejection to a greater or lesser extent of the exchange rate as a price-adjustment mechanism of the economy. This "fear of floating", even in periods when currencies are appreciating, has been the norm recently in some emerging countries. Dividing the sample according to the IMF's classification, within the "more floating" group, Brazil and Turkey are the two countries identified by the IMF as having recently allowed the greatest amount of volatility in their currencies, which at the same time have appreciated[7] . On the other hand, among the dirty float group, the currencies of Peru and Argentina have suffered the least amount of volatility, which in fact has dropped in the past year (see graph). That said, the position of their respective currencies with respect to their equilibrium levels is very different. The under-valuation of the Argentine peso could be a reflection of a bias towards the first objective, that is, the competitiveness of the export sector. In the case of Peru, the fact that the exchange rate has hardly deviated from its long-term rate could be due to the restriction imposed by the still high level of dollarisation of its economy. In this case, avoiding sudden balance sheet effects is a key factor in maintaining macroeconomic stability, and also highlights the problems involved in floating in an economy that operates with two currencies. In any case, as can be seen in the graph for Peru, the exchange rate and volatility appear to be two sides of the same coin.

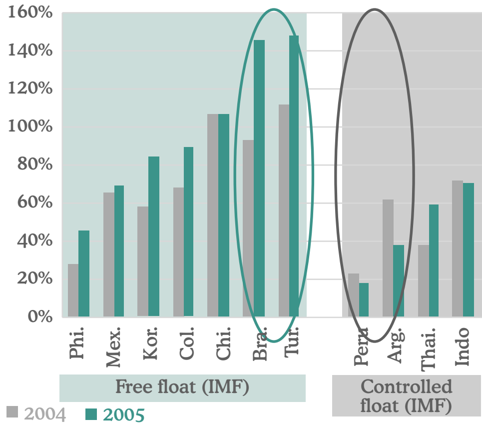
The third and final reason is the accumulation of international reserves at times such as at present when the capital flow situation is favourable with the aim of enhancing foreign solvency. The ratio of reserves to short-term foreign debt shown in the graph above would seem to be a clear indication of this. Currently, the emerging world appears to be relatively well "bullet-proofed" against a downturn in the international financial situation. This has paved the way for an upgrading in the debt ratings of a large number of countries in the past year and a half, and a continuing and significant fall in the cost of international funds.

5 See BIS (May 2005), *Foreign exchange market intervention in emerging markets: motives, techniques and implications*, BIS Paper No 24.

6 In the sample of countries analysed in this article, Brazil and S. Korea are the exception (see graph).

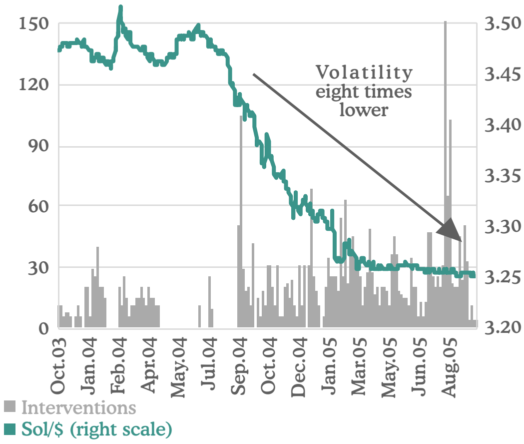
7 Although both have intervened at times in the currency market.

Annualized average volatility relative to volatility of dollar-euro rate



Source: BBVA

Peru: interventions and sol/$ exchange rate



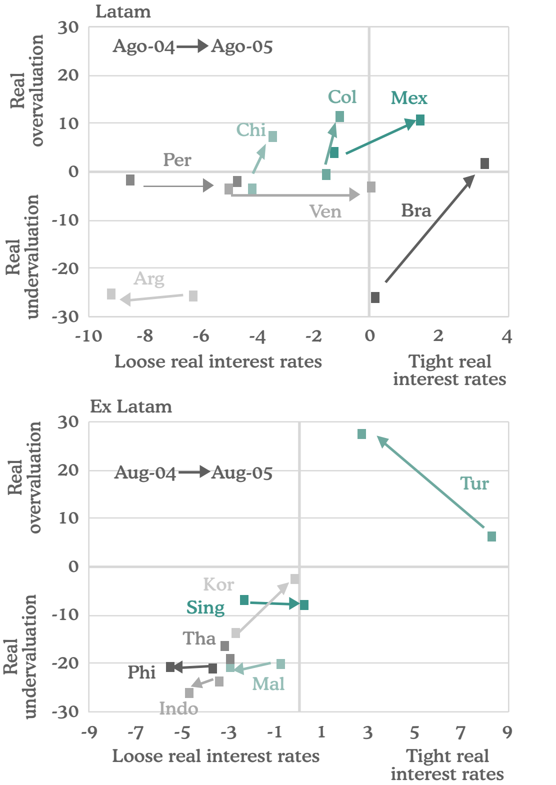
Source: BBVA using Bloomberg data

Maturity distribution of instruments issued by Central Banks (% of total)

	Under 6 months	6 months to 1 year	1 to 3 years	Over 3 years
Kor	5	17	66	13
Phi	—	6	—	94
Mal	51	49	—	—
Thai	—	100	—	—
Arg	Average maturity is 3 months			
Peru	8	51	41	—
Ven	100	—	—	—

Source: BBVA using Monhaty *et al* (2005) and national official data

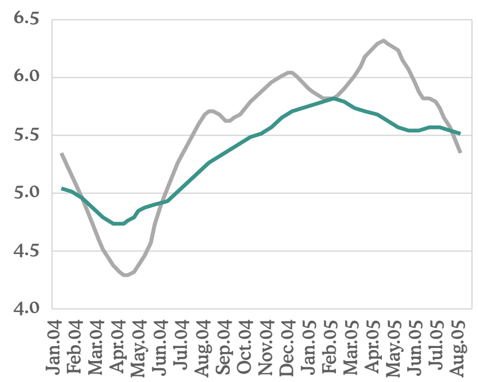
Real currency overvaluation and spread between real interest rates and their historical average*



* The bottom left-hand table implies that monetary conditions are loose both because of real interest rates and real exchange rates.

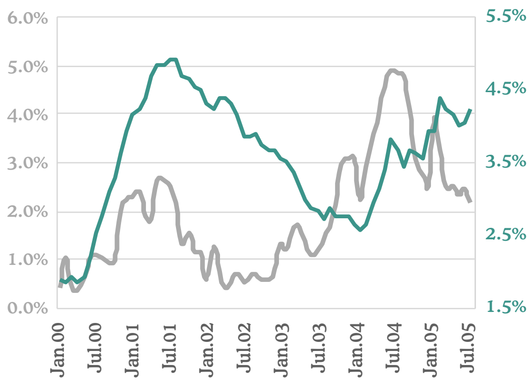
Source: BBVA

Headline and underlying inflation in Latin America (% annual)



Source: BBVA using Bloomberg, Datastream and national official data

Inflation in Asia*



* Weighted average of China, Indonesia, Thailand, Singapore, The Philippines, Malaysia and S. Korea.
Source: BBVA using national official data

A dilemma for monetary policy?

The purchase of international reserves by central banks initially leads to an increase in the stock of money in circulation in the economy. This in principle implies a relaxation of monetary conditions. In a context such as at present of strong economic growth in which emerging countries are well advanced in the economic cycle, currency intervention policies could generate a potential problem for the implementation of monetary policy and the control of inflation. The way in which central banks usually address this potential problem is through sterilization policies to mop up possible excess liquidity in the market. With respect to Latin America, the two countries that stand out for their use of sterilization are Argentina and Peru, the two most "interventionist" countries. In the year to date, the Central Bank of Argentina (BCRA) has sterilized practically all of the liquidity injected into the market. The Central Bank of Peru (BCRP) for its part has significantly stepped up the issue of Certificates of Deposit (sterilization instruments). The stock of these instruments currently represents about 80% of the monetary base, compared with 50% in 2003.

That said, it is difficult to maintain a policy of sterilized interventions for a long period of time. Sooner or later, the market will start to demand higher interest rates in the instruments of sterilization and/or lower tenures. An increase in interest rates attracts more flows of capital, which once more starts to put upward pressure on the currency, which in turn would require further intervention. If maturities are also lowered, this could cause financing problems for the Central Bank. In fact, looking at the structure of maturities, beyond the fact that these already tend to be relatively short-term instruments, a concentration of the shortest maturities could be a source of concern (see table). Despite the increasing use of sterilization, interest rates in the majority of cases are from an historical point of view at low levels, particularly in those countries that are intervening most in their currency markets. Once again Peru and Argentina fall into this group, as do most of the Asian countries. In addition, in cases in which the exchange rate is kept at levels that undervalue the currency, the monetary conditions created are even more relaxed (see graphs). Argentina, which appears to be a clear example of this, has increased its level of monetary relaxation in the past year, unlike the rest of the countries in the region, but in a manner similar to most Asian countries.

This reaction of some central banks, which a priori could be described as "slow", is nonetheless not at the moment being reflected in negative developments in either inflation or inflation expectations in Latin America as a whole. It is not surprising that high interest rates in Brazil and Mexico, although these are already starting a downward cycle, along with the strength of the two countries' currencies, make it increasingly likely that they will meet their respective inflation targets. But even in the case of countries such as Peru, inflation has not only been kept in check, but has also started to slow significantly in the past year. Headline inflation is currently around 1.2%, while underlying inflation is below 1%, well below the BCRP's target of 2.5%. Argentina is a different story, with inflation of around 10%, and with no expectations for an improvement in the short term. In this case, in the absence of adjustments in monetary policy, inflation will little by little do the work of correcting the under-valuation of the currency. This is the case of Asia where some inflationary pressure in general is starting to show itself. Excluding China, where most prices are controlled, inflation has accelerated by around 1.5 percentage points in the past year, while in many countries, such as Thailand, the Philippines, Malaysia and Indonesia, it has already exceeded targets.

Recent experience indicates that a permanent policy of sterilized intervention appears to have limits; above all in countries that seek to maintain highly competitive levels for their exchange rates, and at the same time pursue inflation targets. These appear to be the countries that are experiencing a monetary policy dilemma.

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	1.3	2.0	2.0	2.4	2.2	1.9
Japan	1.4	2.7	2.0	2.5	-0.4	0.2	0.0	0.3
China	9.3	9.5	9.3	8.5	1.2	3.9	2.5	2.5

	Official interest rate (%, end of period)				Exchange rate (vs $, end of period)			
	30/09/05	Dec-05	Jun-06	Dec-06	30/09/05	Dec-05	Jun-06	Dec-06
USA	3.75	4.25	4.75	4.75				
EMU ($/€)	2.00	2.00	2.00	2.50	1.20	1.22	1.22	1.21
Japan (yenes/$)	0.10	0.10	0.10	0.10	114	105	104	102
China (cny/$)	5.58	5.58	5.80	5.80	8.09	8.05	7.90	7.75

Latin America

	Real GDP (%)				Consumer prices (%, end of year)			
	2003	2004	2005	2006	2003	2004	2005	2006
Argentina	8.8	9.0	8.0	5.5	3.7	6.1	10.9	10.0
Brazil	0.5	4.9	3.3	3.0	9.3	7.6	5.2	5.0
Chile	3.7	6.1	6.3	5.3	1.1	2.4	3.8	2.7
Colombia	4.1	4.1	4.2	3.5	6.5	5.5	4.9	4.5
Mexico	1.4	4.4	3.0	3.0	4.0	5.2	3.8	3.7
Peru	4.0	4.8	5.7	4.7	2.5	3.5	1.8	2.5
Uruguay	2.2	12.3	5.5	n.a.	10.2	7.6	5.5	n.a.
Venezuela	-9.2	17.9	7.3	2.0	27.1	19.2	16.8	15.3
LATAM [1]	**1.7**	**5.9**	**4.4**	**3.5**	**7.1**	**6.8**	**5.9**	**5.5**
LATAM Ex-Mexico	1.8	6.5	4.9	3.7	8.3	7.3	6.7	6.2

	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	1.4	1.4
Brazil	-3.6	-2.5	-3.0	-3.0	0.8	1.9	1.8	1.0
Chile [2]	0.0	2.5	4.2	2.6	-1.5	1.5	0.5	-1.0
Colombia	-2.7	-1.3	-1.6	-2.0	-1.3	-1.0	0.9	-2.3
Mexico	-0.6	-0.3	-0.1	0.0	-1.3	-1.1	-1.1	-1.3
Peru	-1.7	-1.1	-1.0	-1.0	-1.5	0.0	-0.1	-0.5
Uruguay	-3.2	-1.8	-2.5	n.a.	-0.5	-0.8	0.6	n.a.
Venezuela [2]	-5.1	-1.9	-0.9	-1.6	10.3	14.1	14.1	8.7
LATAM [1]	**-1.7**	**-0.8**	**-0.8**	**-0.9**	**0.8**	**1.3**	**1.4**	**0.4**
LATAM Ex-Mexico	-2.5	-1.0	-1.2	-1.3	2.2	2.6	2.7	1.4

[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	2.90	2.90	3.7	3.1	6.0	10.0
Brazil	2.89	2.72	2.40	2.90	16.5	17.8	18.8	16.0
Chile	603	576	545	545	2.3	2.3	4.5	6.3
Colombia	2865	2404	2300	2496	8.0	7.8	7.0	7.3
Mexico	11.24	11.15	11.06	11.64	6.0	8.7	8.5	7.7
Peru	3.47	3.28	3.27	3.30	2.5	3.0	3.3	4.3
Uruguay	29.19	26.56	25.50	n.a.	7.5	5.7	n.a.	n.a.
Venezuela	1600	1920	2150	2150	15.1	12.4	12.2	11.9

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

Argentina

	2004	2005f	2006f
GDP (%)	9.0	8.0	5.5
Consumer prices (% end of year)	6.1	10.9	10.0
Trade balance ($bn)	13.2	10.1	8.5
Current account (% GDP)	2.2	1.4	1.4
Reserves ($bn. end of year)	19.6	26.5	33.4
Exchange rate (end of year vs US$)	2.99	2.90	2.90
Fiscal balance (% GDP) [1]	3.9	3.7	3.4
Interest rate (end of year) [2]	3.1	6.0	10.0
Real effective exchange rate (end of year. dec-97=100)	50	54	61

Brazil

	2004	2005f	2006f
GDP (%)	4.9	3.3	3.0
Consumer prices (% end of year)	7.6	5.2	5.0
Trade balance ($bn)	33.7	41.0	30.0
Current account (% GDP)	1.9	1.8	1.0
Reserves ($bn. end of year)	52.7	55.0	55.0
Exchange rate (end of year vs US$)	2.72	2.40	2.90
Fiscal balance (% GDP) [1]	-2.5	-3.0	-3.0
Interest rate (end of year) [2]	17.8	18.8	16.0
Real effective exchange rate (end of year. dec-97=100)	65	76	64

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

Chile

	2004	2005f	2006f
GDP (%)	6,1	6,3	5,3
Consumer prices (% end of year)	2,4	3,8	2,7
Trade balance ($bn)	9,0	9,0	6,2
Current account (% GDP)	1,5	0,5	-1,0
Reserves ($bn. end of year)	16,0	16,0	16,0
Exchange rate (end of year vs US$)	576	545	545
Fiscal balance (% GDP) [1]	2,5	4,2	2,6
Interest rate (end of year) [2]	2,3	4,5	6,3
Real effective exchange rate (end of year. dec-97=100)	84	90	91

Colombia

	2004	2005f	2006f
GDP (%)	4,1	4,2	3,5
Consumer prices (% end of year)	5,5	4,9	4,5
Trade balance ($bn)	1,4	2,7	-1,3
Current account (% GDP)	-1,0	0,9	-2,3
Reserves ($bn. end of year)	13,5	15,6	15,9
Exchange rate (end of year vs US$)	2404	2300	2496
Fiscal balance (% GDP) [1]	-1,3	-1,6	-2,0
Interest rate (end of year) [2]	7,8	7,0	7,3
Real effective exchange rate (end of year. dec-97=100)	83	90	84

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

Mexico

	2004	2005f	2006f
GDP (%)	4.4	3.0	3.0
Consumer prices (% end of year)	5.2	3.8	3.7
Trade balance ($bn)	-8.8	-9.3	-10.8
Current account (% GDP)	-1.1	-1.1	-1.3
Reserves ($bn. end of year)	61.5	64.0	63.0
Exchange rate (end of year vs US$)	11.15	11.06	11.64
Fiscal balance (% GDP)	-0.3	-0.1	0.0
Interest rate (end of year) [2]	8.7	8.5	7.7
Real effective exchange rate (end of year. dec-97=100)	107	110	105

Peru

	2004	2005f	2006f
GDP (%)	4.8	5.7	4.7
Consumer prices (% end of year)	3.5	1.8	2.5
Trade balance ($bn)	2.8	3.5	3.0
Current account (% GDP)	0.0	-0.1	-0.5
Reserves ($bn. end of year)	12.6	14.2	15.0
Exchange rate (end of year vs US$)	3.28	3.27	3.30
Fiscal balance (% GDP)	-1.1	-1.0	-1.0
Interest rate (end of year) [2]	3.0	3.3	4.3
Real effective exchange rate (end of year. dec-97=100)	90	90	90

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

Uruguay

	2003	2004	2005f
GDP (%)	2.2	12.3	5.5
Consumer prices (% end of year)	10.2	7.6	5.5
Trade balance ($bn)	0.2	0.0	0.0
Current account (% GDP)	-0.5	-0.8	0.6
Reserves ($bn. end of year) [3]	1.9	2.3	n.a.
Exchange rate (end of year vs US$)	29.19	26.56	25.50
Fiscal balance (% GDP) [1]	-3.2	-1.8	-2.5
Interest rate (end of year) [2]	7.5	5.7	n.a.
Real effective exchange rate (end of year. dec-97=100)	75	81	81

Venezuela

	2004	2005f	2006f
GDP (%)	17.9	7.3	2.0
Consumer prices (% end of year)	19.2	16.8	15.3
Trade balance ($bn)	21.4	25.4	20.7
Current account (% GDP)	14.1	14.1	8.7
Reserves ($bn. end of year) [3]	24.1	26.6	25.4
Exchange rate (end of year vs US$)	1920	2150	2150
Fiscal balance (% GDP) [1]	-1.9	-0.9	-1.6
Interest rate (end of year) [2]	12.4	12.2	11.9
Real effective exchange rate (end of year. dec-97=100)	91	92	105

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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