Latinwatch

Economic Research Department

Second quarter 2006

Political panorama in Latin America
Oil market: Hysteria or hysteresis?
Fiscal policy: With or against the cycle?
Do public spending and investment correlate with political and economic cycles?
Polarisation of trade policies

Index

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Editorial

The region is going through a busy electoral calendar. One important characteristic of this process not seen in previous electoral periods is the low level of financial volatility, not just in terms of interest rates and spreads, but also in exchange rates, which have continued to show considerable levels of appreciation in real terms. The reasons that lie behind these special circumstances are both exogenous and endogenous in nature. One is the relatively benign situation of the global economy. This is seen in the relatively high terms of trade and high levels of international liquidity, both of which in the end provide strong stimulus to growth. A second is that economies in the region are now in a stronger position from a structural point of view. After the adjustment in capital flows observed at the end of the 1990s, which affected countries in the region to varying degrees, there was a rapid return to macroeconomic stability, with low fiscal deficits and subdued levels of inflation. A third factor has been the ongoing efforts to achieve a greater openness in the region, with the level of openness to trade now twice as large as it was 10 years ago. And financial systems have been strengthened considerably, even in comparison with those of Eastern Europe and Asia (ex-Japan). These reasons explain why capital flows into the region have been increasing in spite of the electoral calendar.

A number of other characteristics nevertheless remain in place. The electoral economic cycle is still opportunistic in nature, there being a notable increase in current spending (particularly in current transfers) during the electoral year and greater capital spending in the year before the elections (see Article "Do public spending and investment correlate with economic and political cycles?"). However, it should be pointed out that this temptation to use public spending for electoral ends does not seem to have worsened fiscal deficits to any great extent, and countries in the region have kept fiscal results more or less within acceptable limits (see Article "Fiscal policy: with or against the cycle?").

Despite the good conditions this electoral year, the newly-elected governments will face a future international scenario that will not be so benign (Wall Street will be less favourable). Latin America's citizens are also demanding substantial improvements in their quality of life (Main Street will get more difficult), which will increase the temptation to resort to populist policies. Though unlikely to affect macroeconomic stability, this would have a negative impact on the functioning of markets and impair economic efficiency and long-term growth rates.

Faced with the dilemma of resorting to neo-populist practices (unsustainable in the long term) and keeping social pressures under control, there are two key tools: on the one side, to improve the quality and efficiency of public spending, increasing allocations to social spending, and on the other side, decisions relating to trade policy. With regard to the latter, the article "Polarisation of Trade Policies" in this issue of Latinwatch examines the arguments for and against the opposing trade strategies that are under debate in the region: whether trade should integrate with bigger markets through Free Trade Treaties (FTT) or seek out regional markets. It is obvious that, from the viewpoint of economic efficiency and specialisation, the first option will bring greater benefits for society as a whole, although there are certain sectors that could be adversely affected. In this respect, the new governments in the region will need to take advantage of the post-election "honeymoon periods", though these are becoming shorter, in order to approve important structural reforms before the respective congresses adopt political positions along dominant party lines during the period of the mid-term election cycle.

1. International environment

Emerging-market capital flows: rational exuberance?

Capital flows to emerging-market economies have picked up sharply in the early part of 2006. In fact, variable income net inflows in the first few months of this year add up to 110% of the total inflows registered in 2005, while fixed income inflows account for around 75% of the inflows received by these countries in the same year. As a result, asset prices in these economies have risen rapidly: stock market indices show significant gains, risk premia stand at all-time lows and currencies are appreciating. All of this in a context of relatively low levels of volatility. Thus, even though some cross-country differences are apparent, the overall scenario for the financial markets of the emerging-market economies can be considered very positive.

Whether or not this context will be sustained over the coming months is the main uncertainty for investors. Domestic factors will have a part to play in this, but external factors are of even greater importance. Although the improving fundamentals of many of the emerging-market countries are underpinning capital flow developments, there is no doubt that global economic conditions, with strong growth, low inflation and high liquidity, may have produced a situation in which investors have to some extent underestimated the risks.

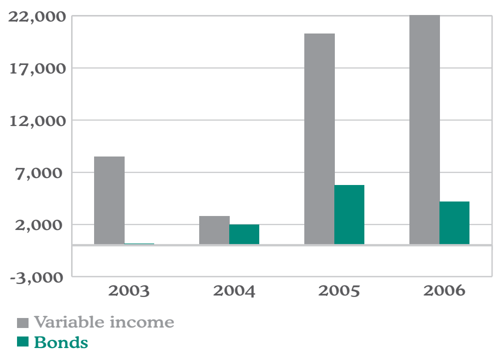
Dynamic global activity

In effect, global economic activity remains relatively strong despite the rise in oil prices. Although the final quarter data for 2005 were somewhat disappointing in Europe and the United States, the indicators for the first few months of 2006 are coming in ahead of expectations, especially in Europe. Economic growth in Japan and the United States, meanwhile, has also surprised on the upside, though to a lesser extent than in Europe. All the signs are that growth will remain high for at least the first half of the year, and then possibly slacken off in the second half.

In the United States, growth in disposable income has slowed sharply, while property wealth is expected to level off over the course of the year. This would point to a slowdown in the rate of increase of consumption in the U.S. economy and to slower domestic demand growth, which may be partially offset by stronger external demand. Slower growth in the United States is nonetheless likely to be compensated for by the upswing in activity expected in other economies. On the one hand, the recovery in business and consumer confidence in Europe is building up momentum, and should be accompanied by an improvement in the activity data, especially in economies, such as Germany's, where growth has been weak. Favourable financial conditions for companies and the pick-up in household disposable income, against the backdrop of continuing job creation, are solid foundations from which to kick start European domestic demand. Japan, meanwhile, continues to post strong GDP growth, at above potential rates, which could see the country move out of deflation in 2006.

Despite the upturn in growth, inflation remains within a relatively subdued range, particularly in the case of underlying inflation. Even in the United State, where capacity utilisation rates for labour and capital have risen significantly to levels above the historical averages, the upswing in energy inflation has barely filtered through into final prices. In fact, the behaviour of real wages, with practically zero rates of growth despite the cyclical situation of the economy, suggests to some extent that any increase in inflation is going to be relatively limited.

Emerging economies: net capital inflows
(billions of dollars)

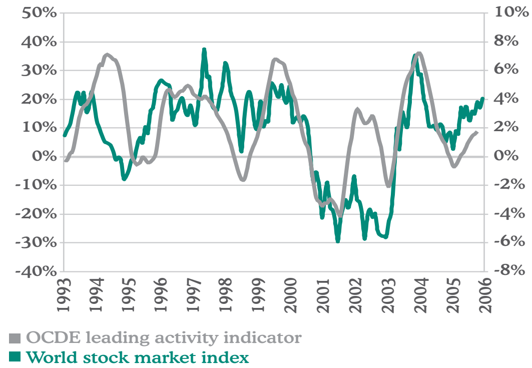


Sources: BBVA - Capital Flows, EPFR

Latin America: financial markets

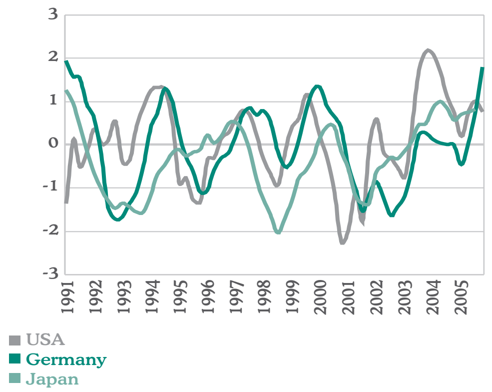
Sources: JP Morgan and Morgan Stanley

Leading activity indicators



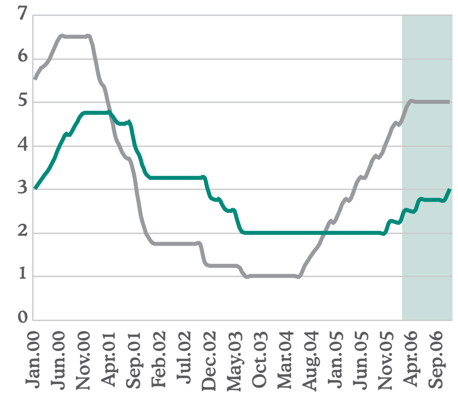
Sources: OCDE and Morgan Stanley

Bussiness confidence
(standardised indices)



Sources: IFO, ISM and Tankan

Official interest rates



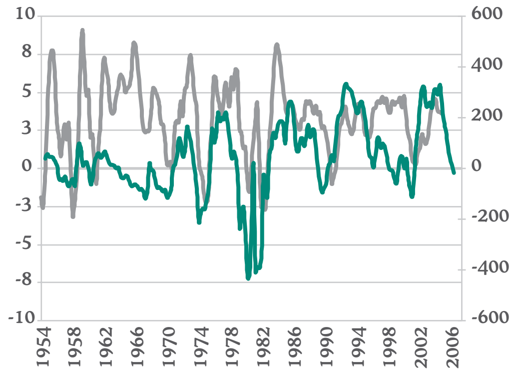
■ USA
■ EMU
Sources: Federal Reserve, ECB and BBVA

USA: Explanatory factors for 10-year interest rates

	10-year rates	Real rates
1990	8.70	4.00
2005	4.30	2.00
Change	4.40	2.00
Expectations of real rates	-90	
Expectations of inflation	-100	
Real term premium	-150	
Inflation risk premium	-30	

Source: BBVA

USA: Growth and 10-year/3-month spread (6 quarters ahead)



■ Growth
■ 10Y/3M spread
Source: BEA and Federal Reserve

Against this backdrop, U.S. monetary policy is nearing the end of the cycle of rate hikes, which could mean that official rates will stay at around 5%. There is no doubt that as the tightening cycle comes to an end, uncertainty about the future path of interest rates increases, following a period in which their behaviour is relatively predictable. In EMU, interest rates are expected also to move up gradually and much more slowly, to stand at 3% by the end of 2006. Japan, too, took the first step towards a change in monetary policy in March, announcing a modification of its policy of quantitative easing, which could signal the end of zero interest rates towards the end of this year. Overall, the major Central Banks are reducing the degree of relaxation that has characterised monetary policy over recent years. However, forecast interest rates are below the peaks seen in previous tightening cycles.

However, the industrialised countries are not the only ones posting strong rates of growth, and with an increasingly globalised world economy, economic developments cannot be explained without taking account of China's economic growth. This country's export-oriented growth model is continuing to provide the conditions for buoyant growth, especially in investment spending. In addition, the whole Asian region is benefiting from the synergies that this growth creates, including the Japanese economy itself. It is also important to highlight the role played by commodities, in particular some metal commodities such as copper and gold, which against all the odds have continued to register all-time high levels of prices. Commodity developments are in turn a growth driver for a number of Latin American countries.

A world with structural changes?

To a large extent, the key question is whether this situation can be sustained over time. There are undoubtedly several factors that support the possibility that the global economy is experiencing a structural change. Technological progress and the globalisation of activity, with new participants entering the market economy, are bringing about changes in the traditional transmission mechanisms of prices and wages. The credibility of Central Banks has contributed to keeping inflation in check. Also, the globalisation and diversification of financial markets, together with lower levels of macroeconomic volatility, have brought about a decline in risk premia, and hence a reduction in the levels of long-term interest rates.

The latter is one of the key differences of the current situation and may be the reason behind one of its biggest question marks: the fact that despite the increase in official interest rates in the United States, long-term interest rates have stayed relatively stable and that, as a result, there has been a significant flattening, or even a slight inversion, of the yield curve. An inverted yield curve normally precedes an economic recession, which begins on average four quarters later. That is to say, lower expectations of future interest rates were the main reason behind the flattening in the yield curve. However, on this occasion, it is possible to add a further reason for this decrease in the slope of the yield curve. In effect, as was recently pointed out by Bernanke, the flattening of the yield curve is probably due to a decline in the risk premium linked to falling macroeconomic uncertainty and rising demand for bonds by economic agents who are not very sensitive to risk-return criteria. This explanation could mean that a flat yield curve is compatible with stable growth in the next few months, rather than portending an economic recession.

In addition to these structural factors, a number of short-term factors are contributing to reduce the risks in the current situation. In the first place, the gradual upward adjustment of official interest rates constitutes a first step towards limiting the surplus liquidity which could have led investors to underestimate the risk attached to some assets. Secondly, the difference between the growth rate of domestic demand in the United States and that of other economies is narrowing as growth in Europe and Japan picks up momentum and growth in the real-estate sector and consumption slows in the United States. Finally, robust growth in China, at higher than expected rates, is enabling this country to slowly adjust its exchange rate with the dollar.

Risk scenarios unlikely

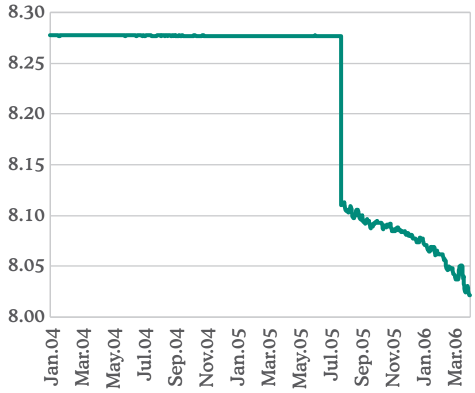
Despite the structural changes that underpin our baseline scenario for world economic growth, various factors could emerge as risks to global activity. One is the possibility that investors' risk assessments are too low. A rise in asset prices when households are highly indebted could lead to some degree of economic adjustment. A second factor of uncertainty is the very high and rising U.S. current account deficit. Particularly because part of the deficit is being financed by the surpluses of oil-exporting countries and official capital flows from countries that are accumulating reserves, especially the emerging-countries of Asia, as they try to stop their currencies from appreciating.

Together with the above-mentioned structural and short-term factors supporting economic growth, it should be noted that, in any case, it is difficult to predict either the form of a potential adjustment or the factor likely to trigger it off. A real shock, for instance a surge in oil prices linked to a big drop in supply, might not necessarily drive up inflation, and could result in an economic recession and lower interest rates. A financial shock, with increasing risk aversion and investors demanding higher returns on U.S. assets, along with a falling dollar, would result in a sharp increase in bond yields in the United States. A mistake in monetary policy, for instance if interest rates were pushed up too high, leading to a slump in real-estate assets, could bring about a severe recession and a fall in interest rates in the future. Obviously, all of these scenarios would have a more negative impact on asset prices if they were accompanied by a rise in inflation, and if doubts were to arise about U.S. productivity gains or if countries were to backtrack on their commitments to globalisation with the adoption of protectionist measures in world trade. The map of risks is therefore wide-ranging and the trigger for an adjustment difficult to anticipate. In any case, weighing up the different factors lending support or adding risk, the conclusion is that there is only a low probability of these adjustment scenarios occurring in the current environment.

Long-term interest rates with limited rises and a stable dollar

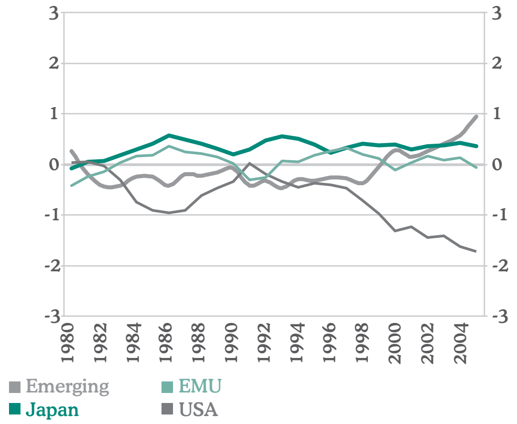
In our central scenario for the leading economies, the slope of the U.S. yield curve is expected to stay relatively flat, although as uncertainty about monetary policy increases and some non-resident capital flows weaken, it may show a slight inversion. Long-term interest rates should stand at 4.8% and 5.1% on average in 2006 and 2007, respectively. After falling sharply in 2005, European long-term interest rates will remain at historically low levels due to the limited upward movement expected in official rates and strong demand for long-term assets on the part of domestic investors, largely as a result of regulatory changes. On average, therefore, 10-year rates in Europe are expected to stand at 3.7% in 2006 and 4.1% in 2007, almost one percentage point below those of the United States. This interest rate differential will continue to be an important support for the dollar, which is likely to range between 1.21 dollars to the euro in 2006 and 1.25 in 2007. The U.S. current account imbalance, however, means that the risks to this outlook for the dollar are on the downside.

China: yuan/dollar exchange rate since July revaluation



Source: Bloomberg

Current account balance (% of world GDP)



Source: IMF

	2005	2006	2007	2005	2006	2007
USA	End of period			Average		
Official rates	4.25	5.00	5.00	3.20	4.90	5.00
10-year rates	4.50	5.20	5.10	4.30	4.80	5.10
EMU						
Official rates	2.25	3.00	3.25	2.00	2.60	3.20
10-year rates	3.40	3.80	4.20	3.40	3.70	4.10
CURRENCIES						
Dollar-euro	1.19	1.23	1.26	1.24	1.21	1.25

Source: BBVA

The oil market: hysteria or hysteresis?

Between June 2004 and March of this year, world oil demand increased by 3.8% (3 million barrels daily). This rise is clearly due to a structural change in the oil market, where 70% of growth in demand in the past few years has come from the emerging-market countries (40% from China). This development seemed to be signalling a market in which demand would outstrip supply. However, over the same period the OECD countries have built up a total of some 255 million barrels of inventories, taking the total inventory stock to the equivalent of 137 days of current OPEC production (including Iraq). Yet, paradoxically, the price of Brent has doubled since June 2004. It seems therefore that the current price cycle, corrected for the effect of the hurricane season, has uncoupled from the supply and demand fundamentals observed in the market.

Any analysis of the oil market should involve the use of hysteresis models. Expectations are of significant weight, and are an exogenous variable which has been subject to continuous changes, resulting in new long-term equilibrium levels for the endogenous variables. The factors shaping expectations are related to the fact that the emerging-market countries, the current drivers of demand, will have growing energy requirements as their consumption per inhabitant converges with that of the industrialised countries. However, this process has been taking place at a slower than expected rate because of the efforts these countries have made to improve energy efficiency. The increase in demand will therefore be lower than initially anticipated.

On the supply side, the market perception is that the non-OPEC producing countries face falling rates of production, the view being that these countries can do little to remedy this. However, this overlooks the fact that, with real oil prices above $40, 95% of the projects unfeasible at prices around $20 would make economic sense. Although the rate at which these investments are made and the time needed for this new production to come on line must be taken into account, they could potentially lead to the development of 128,000 million barrels of oil reserves, the equivalent at present of 1,500 days of world demand and 4,153 days of OPEC production.

As for the geopolitical risk, we can identify two components: a structural risk associated with the Middle East and short-term risks, as at present with the situation in Iran and Nigeria. One key feature that emerges when we analyse oil market shocks that give rise to supply fears which finally do not materialise is that the price rises they produce are of a magnitude and duration that are similar to those caused by actual falls in production. In fact, the former account for a greater proportion of the historical changes in Brent crude prices than the latter, and are having a pronounced impact on prices at present. These factors, together with the high global liquidity, have fuelled constant pressure from speculative buying. This leads to demand that takes no account of the current supply-demand equation, which in part explains the behaviour of inventories.

The situation in Nigeria

An armed group calling itself the Movement for the Emancipation of the Niger Delta (MEND), formed in December 2005, is demanding greater local control over oil resources and less power for foreign oil companies. In their fight to achieve these goals, the militants have launched a number of attacks on oil installations, which have resulted in a fall in production of approximately 600,000 barrels a day. The International Energy Agency has said that OPEC has covered the shortfall in Nigeria, an OPEC member, and that no emergency policy for the oil inventories held by the OECD countries is needed. Nigeria, meanwhile, announced a prompt return to normal levels of production. This risk factor is beginning to exert a greater effect because of the importance of oil supply disruptions in the current cycle.

The situation in Iran

The main factor of geopolitical risk affecting the oil market is the difficult situation in Iran after its decision to resume uranium enrichment for the generation of energy. This move is viewed with suspicion in the West since more energy could be generated from hydrocarbons and because of fears that Iran intends to produce the fuel for nuclear weapons. The case has brought a unanimous declaration from the United Nations Security Council demanding a complete cessation of all uranium enriching activity in Iran by the end of April.

The key question is: will this dispute end in an export embargo on Iran? The answer is no less relevant. From Iran's point of view, it has less room for manoeuvre in the event of an embargo than might be expected. Its international reserves, excluding gold, only amount to 10 months of imports (22% of GDP), while public spending, at 40% of GDP and with a high share of direct subsidies to the population, is highly dependent on tax receipts from oil (55-60% of the total). From the West's point of view, spare capacity in the oil-producing world is so low that it would barely be possible to compensate for an interruption in Iranian oil exports (2.9 million barrels daily), thereby leading to a pronounced impact on prices in the short term. It would seem, therefore, that there are objective conditions for putting off making decisions while an attempt is made to find an honourable solution for both sides.

To put the situation in context, the episodes of disruption to Iranian oil supplies since 1985 have normally been transitory. Production was generally restored within a few quarters and the disruptions were relatively small in terms of the size of lost production (on average 5%, with a peak of 10%, which today would represent 200,000 and 400,000 barrels daily, respectively). During these episodes, other suppliers quickly increased production, which attenuated their impact on the price of oil (a cumulative increase of 3% in real terms four quarters after the disruption, followed by an equally gradual fall). However, a fall in production today 5 times larger than the maximum registered in the past could not be made up by the other oil suppliers, and would bring about a steep rise in real oil prices. The levelling off in the prices of oil futures around current price levels would appear to indicate that a low probability is being attached to an embargo scenario, but also the persistence of this risk premium in the market in the months ahead.

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Commodities

How sweet it is!

During the first quarter of 2006, the price of sugar rose by 90% compared with the same period of the previous year to levels close to 20 cents per pound. Sugar is therefore the latest of a series of raw materials which have registered significant increases in prices over the past few months. Latin America has been an important sugarcane producer for some time and farmers in countries such as Brazil, Colombia, Cuba, Guatemala and Guyana in particular have benefited from the current market conditions. Within this group, Brazil and Colombia stand out as the world's largest and seventh-largest sugar exporters in volume terms.

The reasons behind the increase in prices are diverse. In the first place, India, one of the biggest world producers, has suffered severe droughts which have turned the country into a net sugar importer. This country is particularly important since it is the world's largest consumer of sugar. Other producers which have suffered unfavourable weather conditions such as Australia and Thailand (droughts) and the United States (Hurricane Katrina) have also contributed to the supply shortage and the run-down in inventories.

Secondly, world economic growth has clearly had a positive impact on the market. In particular, sugar imports in countries such as China, Russia and South Korea are still running at relatively high levels. This despite the increasing competition sugarcane producers face from companies that make artificial sweeteners.

A third fundamental factor behind the current situation is the growing use of sugar in the production of ethanol. As part of its energy policy and in order to reduce reliance on oil, Brazil has made a big push to encourage the development of flexible-fuel vehicles driven by a mixture of alcohol and petrol. The rise in oil prices has boosted demand for ethanol produced from sugarcane in the domestic market (it is estimated that 50% of sugarcane production in Brazil is put to this use)[1], reducing the volume of the crop for making sugar and exerting upward pressure on international prices. Other countries interested in diversifying their sources of energy are also moving in this direction. This is the case of Colombia, where petrol by law must contain 10% ethanol in cities such as Cali and Bogotá. And in a recent state of the union address, President Bush himself spoke of plans for the United States to obtain fuel from ethanol.

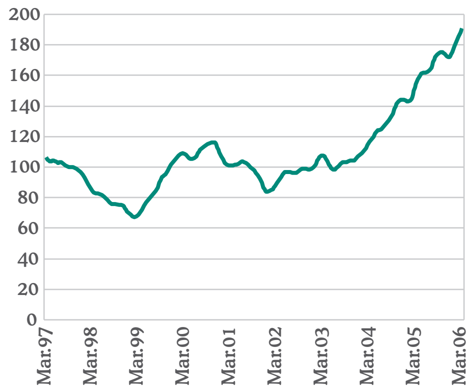
Environmental protection is also playing a part in sugar price developments. Countries like Japan view the Brazilian experience as an alternative means of reducing emissions of carbon dioxide and other gases so as to comply with the obligations imposed by the Kyoto protocol.

Finally, it must be said that it is still too early to determine whether or not this is a permanent change in sugar prices. In particular because part of the run-up in prices is due to speculation, though how much this accounts for is not yet clear. Producer countries should therefore be conservative and seek to manage their extraordinary sugar revenues as prudently as possible.

Across-the-board rises in the BBVA-MAP

During the first quarter of 2006, the BBVA-MAP index rose by 11% relative to the final quarter of 2005. Among the most spectacular increases worthy of mention were those registered in the prices of sugar (43%), zinc (36%), silver (20%) and aluminium (17%). Smaller rises were also registered by gold (14%), coffee (13%), copper (11%) and oil (9%), though in terms of the impact on our index these rises are more important. In fact, the only important raw material for the region not to post higher prices during the past quarter was soya. The main reason for this was the good harvest prospects in Argentina, Brazil and the United States, which should keep prices in check.

BBVA MAP
(3-month moving average, 1995=100)



Source: BBVA

Looking forward, we have again revised up our forecasts. Greater uncertainty and excess liquidity have created a speculative commodity premium which we nevertheless believe will be corrected in the near future. As we have mentioned in previous issues of Latinwatch, even though we forecast a correction in commodity prices, there is a feeling that a structural change has taken place which should benefit the region in the medium term.

Commodity prices

	Annual average			
	2004	2005	2006/f	2007/f
Coffee (USc / lb)	85	116	114	120
Copper (USc / ton)	126	166	201	125
Gold (US$ / ounce)	410	445	560	575
Oil (US$ / barrel)	39	56	61	57
Soya (US$ / ton.)	278	235	220	205

f/ forecast

[1] See United States Department of Agriculture (2006), World Sugar Situation, December 2005.

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Argentina: A stronger government in the run-up to 2007

Growing political strength of the Executive

President Kirchner, who took office in May 2003 with only 22% of the vote, has succeeded in considerably strengthening his political position after almost three years in power. The government maintains an approval rating of 54%, with its "ability to resolve the problems of the people" being its most highly regarded feature. The Di Tella University's Confidence in the Government Indicator remains well above the average for the period 2001-2006 despite its understandable fall from the record levels reached during the government's initial period in power.

The parliamentary elections held in October 2005 led to an increase in the ruling Front for Victory's (FV) representation in Congress. In the Senate, where the constitutional reform of 1994 assigned three seats to each province (two of which are assigned to the party or coalition winning the most votes and one to the second most voted group), the fragmentation of the Peronist movement led to a fall in the representation of the opposition parties. In the province of Buenos Aires, for example, the President's wife Cristina Kirchner garnered most votes followed by Hilda Duhalde, which meant all three senators representing the province are from the Justicialist movement. The Front for Victory holds 41 of the 71 seats in the Senate, the Radical Civic Union (UCR) 13, with the balance held by other parties (provincial, opposition or other factions of the Peronist movement).

In the Chamber of Deputies, the ruling party has the largest presence, with 118 out of a total of 256 seats. The next biggest group is the UCR (36 members) followed by Duhalde's Federal Peronism group (31 members). The rest of the seats are occupied by the centre-left ARI group of Elisa Carrió, which has 13 members, the centre-right PRO group of Mauricio Macri with 11, along with other provincial, socialist and independent parties.

FV does not have enough members to make a quorum or for the approval of laws which require a two-thirds majority in the lower house. However, the reform of the Supreme Court approved in February demonstrated that the Kirchner administration is capable of winning the support of other Peronist factions without any great problem. The opposition, including both the left and the right, which joined forces against the reform, could still not muster enough support to block the law.

Given this composition of Congress, it is evident the Executive is not facing problems of governability. Although the legislative so far has not played a major role in politics since the President has largely resorted to the use of decrees arguing need and urgency, it is obvious he would not face major difficulties in obtaining parliamentary approval of laws if so required.

The President's economic policy

After the resignation of Economy Minister Roberto Lavagna in November 2005, the President has taken on an increasingly active role in economic management, intervening directly, for example, in the price agreements reached with a number of production sectors from the end of last year. The main lines of economic policy, however, have not undergone major change, with the tenets of a high exchange rate and fiscal solvency that have formed the pillars of management from the start still in place.

A large budget surplus seems to be one of the features of the Kirchner administration, both at the provincial level as governor of Santa Cruz, as well as at the national level in more recent years. Fiscal solvency affords him more freedom when it comes to the markets and international organizations, while at the same time at the national level strengthening his political arm by allowing the discretional use of subsidies and transfers to the provinces. This use of the surplus that had been built up was evident during the period of the parliamentary elections in October 2005. Primary spending, which had been growing at an average rate of 20.7% during the first seven months of the year, accelerated to an annual 27.8% during the period August-November.

The challenges for 2007 and afterwards

Although he has not officially announced it, President Kirchner could stand for re-election in 2007. In the probable case of being voted in again, it is foreseeable Argentina could maintain a primary surplus of over 3% at least through to 2010. However, a scenario could evolve in which expansion in primary spending once again outstrips the rate of growth of revenues ahead of the presidential elections, which would partly undermine fiscal solvency.

Another feature that is likely to remain in place is the accumulation of foreign reserves by the Central Bank. Strong intervention by the BCRA in the foreign exchange market since 2003 has allowed it to increase reserves by over US$ 18 billion. At the start of this year, the government availed itself of these reserves to pay off all loans from the IMF (about 9.5 billion dollars) ahead of schedule in order to free itself from the requirements imposed by the organization in the area of structural reforms, particularly bringing utility rates into line, and finding a solution to the hold-out problem in the country's debt restructuring.

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Brazil: the run-up to the elections is not affecting the country's economic performance

The country goes to the polls on October 1, 2006. Voters are being asked to elect the President of the Republic, a new National Congress (with all of the members of the lower house and a third of the Senate due for renewal) as well as governors and representatives for all of the states.

Campaigning for the elections officially begins in July, although the corruption scandals surrounding President Luiz Inácio Lula da Silva´s Labour Party (PT), which have occupied the press headlines for several months, have signalled the direction being taken by the opposition, which has already revealed a number of its cards.

The presidential candidate of the main opposition Brazilian Social Democracy Party (PSDB) has already been named. The PSDB finally opted for Geraldo Alckmin, who up to then had been governor of the state of São Paulo, instead of the mayor of the city of Sao Paulo, José Serra, who lost to Lula in the presidential elections in 2002. Alckmin won the support of the party bases as a "tucano" candidate in a primary election when previously it was the party hierarchy that chose the presidential candidate. One of the other reasons behind the choice of Alckmin as the PSDB's presidential candidate is the fact that after six years as governor of Sao Paulo, he left office with an approval rating of 66%.

Although the parties have yet to present their electoral programmes, the PSDB has already announced that it will run on two main issues: the fight against corruption on the political front, and enhancing growth in order to reduce unemployment on the economic front. These are the two areas the opposition has latched on to in the past few months to criticise the current government, which is surrounded by accusations of corruption, and which has managed average economic growth of 2.6% in the period 2003-2005. This has done little to reduce unemployment, which is currently running at 10.4%.

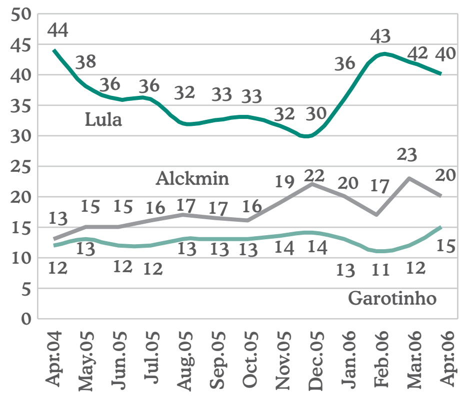
In response, the PT will present an electoral programme that is a continuation of current policy, emphasizing the government's achievements in the area of macroeconomic stability as a result of a successful combination of fiscal and monetary policy, and proposing the need to keep this in place.

The political crisis within the party sparked by the corruption scandals, which has led to the resignation of the person most identified with these economic achievements, Economy Minister Antonio Palocci, does not appear to have affected the confidence of either domestic or foreign economic agents. Not even the appointment of Guido Mantega to take over from Palocci sparked a negative reaction in the markets. Mantega had on occasion criticized the country's economic policy, particularly the monetary policy of the Central Bank for placing far too much emphasis on containing inflation.

However, the new minister has said he will not change economic policy, which he considers to be one of the most solid pillars of the Brazilian system. To back this up, he has surrounded himself with an economic team with a reputation for being pro-market.

We will have to wait a few months to know whether the current economic team will accompany Lula in his new mandate if he wins the elections. What is clear is that the crisis in the PT has not affected financial variables nor the chances of Lula being voted in again. His approval rating as head of government stands at 37%, the same levels as former president Fernando Henrique Cardoso at the end of his first mandate.

Survey of voter intentions (%)



Source: Datafolha

In addition, opinion polls indicate Lula would beat Alckmin in a possible second round of voting for the presidency.

The key to the outcome of the elections is the third party on the list, the Brazilian Democratic Movement party (PMDB). The PMDB is the third biggest party in the country in terms of its representation in the lower house, and also has the biggest number of senators. Currently, the PMDB along with other minority parties is in a coalition with the PT.

Although it has yet to be confirmed that it will present its own candidate for the presidential elections, it appears that this in fact will be the case. The candidate best positioned for nomination is Anthony Garotinho, who came third in the 2002 elections while standing for the Brazilian Socialist Party (PSB), which currently also forms part of the PT coalition government.

In the case of its presidential candidate not making it through to the second round, the PMDB could be key in deciding who governs the country for the next four years, since an alliance is feasible with either of the two parties with the best chances of winning. What is certain is that given its importance, both the PT and the PSDB would invite the PMDB to form part of the next government.

In any case, the probability of the next four years on the political front being a continuation of the current situation can in no way be ruled out. That is to say, a fragmented Congress made up of more than a dozen political groups, albeit aligned in pro-government and opposition blocs, which will make the approval of the reforms the country needs difficult. These, among others, include labour reforms, changes to the social security system for the private sector and further reforms of the tax system.

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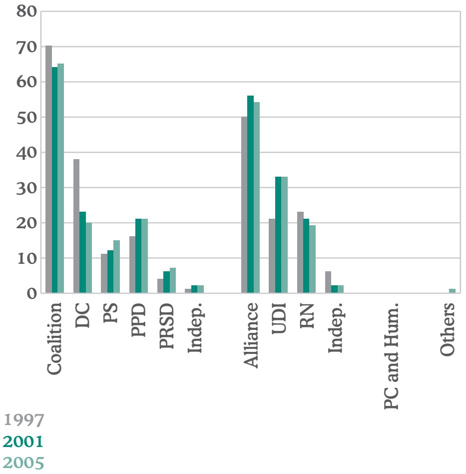
Chile: Overall continuity but change of style

The political scenario after the elections

The presidential and parliamentary elections of last December, which in the case of the former led to a second round of voting in January, confirmed the dominant position of the centre-left coalition that has governed Chile since 1990. However, unlike in previous elections, this time around the coalition also gained a majority in both houses of parliament.

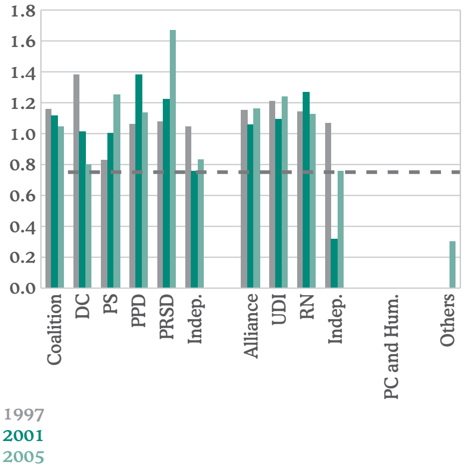
Number of deputies by party



Source: BBVA

The current two-party electoral system means that two candidates are elected for each parliamentary district in such a way that in order for one party to win both seats available it has to double the votes given to the second most-voted party. This encourages the formation of broad coalitions and tends to result in parliamentary groups being evenly matched. In fact, the Coalition of Parties for Democracy (centre-left) has enjoyed small majorities in the Chamber of Deputies since 1990, and although it has gained more directly-elected seats in the Senate than the opposition, it has had to govern with the opposition either holding the majority in the upper house

Index of electoral effectiveness (% elected/% votes in deputies)



Source: BBVA

or the same number of seats because of the existence of institutionally-appointed senators. The constitutional reform of 2005 finally removed these non-elected senators, which meant that for the first time since 1990, the Coalition holds a majority in both houses, albeit small and fragile.

The other significant change is the relative loss of power of the Christian Democratic Party (centre) within the ruling coalition. Although it won the same number of votes as in previous elections, it lost five seats in the Senate out of the 10 up for grabs to other parties within the coalition, which means the upper house not only has a majority that backs the government, but is also more to the left politically than before.

The first moves by the government of Michelle Bachelet

In her campaign, Bachelet highlighted the need to improve social protection, with special emphasis on pensions, and the need to implant a more participative style of government with greater representation for women. On the economic front, she started off with a quite critical stance towards the current "model" only to end up highlighting continuity with the previous governments of the Coalition. In her first appointments and political moves, she has kept strictly to the pledges she made during her campaign, particularly those made towards the end of it. She named well-respected technocrats to the key posts in the government's economic team, which is headed by Andrés Velasco (independent) at Finance, and drew up a cabinet in which men and women have equal representation. She has also taken the first important steps to beef up the Social Security system. Apart from announcing that she will send a bill to parliament calling for the lowest pensions to be increased with the help of state financing, she also set up a commission made up of technocrats with recognized professional skills and from a range of different backgrounds. Within three months, and after broad consultation, the commission will propose measures to introduce changes to the pension system without altering its foundations.

Her first steps as president have been met with wide approval, and the perception exists that in fundamental areas the Government will seek broad agreements with the opposition on legislation in priority areas (changes in the area of social security and the electoral system), which should ensure a considerable amount of continuity. Although a lot has been said about changes to the style of government, with more room being created for direct participation by citizens, this has yet to take any concrete shape, and it is, therefore, too early to pass any judgment in this area,.

Now that the initial period of the government has served to quell fears and clear up doubts, the main concern that remains has to do with how the government might react in a less favourable economic environment. However, everything would seem to point to the government not being disposed towards breaking with pillars of the economic policy that has been followed so far.

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Colombia: The scenario for the presidential elections in May

The political situation in Colombia

The political situation in Colombia with respect to the presidential elections to be held on May 28 appears relatively clear-cut. There are five leading candidates in the elections: the incumbent president, Álvaro Uribe; Horacio Serpa, who came out on top in the Liberal Party internal election; Carlos Gaviria, who won the nomination of the Alternative Democratic Pole; and the independent candidates Antanas Mockus and Álvaro Leyva. The political positions of the candidates can be described in the following fashion: Álvaro Uribe occupies the centre-right. Horacio Serpa and the Liberal Party represent the centre-left. Carlos Gaviria and the Alternative Democratic Pole are to the left of the political spectrum. The political stance of Antanas Mockus and Álvaro Leyva is harder to define. Mockus comes from an academic background and is seen as standing outside traditional party lines. This gives him the profile of being a reformist, which is attractive to academic circles. However, his political orientation could be described as being centre or centre-right. Álvaro Leyva's political roots rest in the Conservative Party (centre-right). However, his political capital has been built up by his involvement in the various peace processes in the country. Leyva appears to have won the confidence of the FARC, the main left-wing guerrilla organization in Colombia, and probably because of this he claims to be able to end the war within six months if he were elected president.

The Congressional elections held on March 12 suggest that political support for Uribe remains firm. Of the 102 seats up for grabs in the Senate, two of which are assigned to indigenous groups, the Uribist parties won 68, the opposition 28, and independent groups 4. In the Chamber of Representatives, the Uribist group fared less well but the election still went in their favour. Of the 165 seats disputed in the Chamber of Representatives, Uribist groups obtained 96, opposition groups 45 and independents 24. The favourable outcome to the elections for Uribism would seem to indicate that the economic reforms announced by the Government for the next legislature, which is due to commence on July 28, will not meet major stumbling blocks. The Government has announced three major reforms during the next legislature: a "structural" tax reform, a constitutional reform in which powers will be transferred from the central government to the regional governments and a reform of the financial system. Within this wish-list, the reform of the state pension system is conspicuous by its absence.

The polls carried out in the wake of the parliamentary elections in March indicate that Uribe has sufficient support to win the presidential race in the first round. The numbers are as follows: Uribe has the backing of 56% of the electorate, Serpa 25%, Carlos Gaviria 9% and Antanas Mockus 2%. The balance is made up of support for Álvaro Leyva and undecided voters

Thus, the remaining political uncertainty which exists in Colombia is whether Uribe will be re-elected in the first round, or whether, as appears likely, the vote will go to a second round. The other uncertainty that remained, which was whether Uribism would win absolute control of Congress, has already been resolved. A sweeping victory for Uribe in the presidential elections would have profound political consequences in Colombia. In the first place, it would probably signal the political death of Horacio Serpa, who has suffered three defeats in his attempts to win the presidency, two at the hands of Álvaro Uribe. Secondly, the Liberal party would have to rethink its political direction. It should be recalled that President Uribe's political roots are in the Liberal Party. But since he decided to stand for president outside party discipline in 2002, and won, Uribism has increasingly distanced itself from the Liberal movement. Behind this distancing lies a backdrop of significant ideological import. Uribism has been attracting the most right-wing elements in the Liberal Party, and has struck up an alliance with the Conservative Party, the traditional centre-right grouping in Colombia. On the other hand, the Liberal Party under the reins of Serpa has increasingly adopted a centre-left, Social Democrat line which is very critical of the current president.

If Serpa suffers a major loss in the presidential elections, as seems likely to be the case, it would appear the Liberal Party has only two options left open to it: make its opposition to the president more radical, which would probably lead to it becoming an appendage to the more radical Democratic Alternative Pole. This would be a listless outcome for one of the major political forces in the history of Colombia. The other option would be a shake-out in the current direction taken by the party, which would bring it closer to the president. On a speculative basis, the outcome of currying to the president would be to acknowledge Uribe as the natural leader of the Liberal movement. But at the same time, it would also presumably entail a political agreement which would open the door to a more "social" orientation in the conduct of economic, social and political policy of the current administration. In a certain sense, what is at play here is the continuity of a two-party system in which both groups more or less occupy the centre, or a radicalization along right-wing, left-wing lines. Political radicalization is not a common phenomenon in Colombia, but it does not appear to be absurd to assume this could be a possible outcome of current circumstances. If that extreme were to occur, the left-wing would obviously be in the minority for the meantime, and would have to gauge over the next four years whether it was capable of transforming itself into a politically effective opposition group with the possibility of winning real power.

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Mexico: Looking ahead to the July 2 elections

Less than ninety days to the elections

On July 2, Mexican voters will elect a new President for the period 2006-2012, as well as the 500 lower house representatives and 128 senators that make up the National Congress. There are also local elections for the mayorship of Mexico City, the Legislative Assembly and 16 delegates to the federal district, as well as for the governorship of the states of Guanajuato, Jalisco and Morelos, in addition to the legislatures and municipalities of a number of states. In total, 1,431 political posts are up for grabs. Formal campaigning for the presidential race began on January 19. Of the five candidates running, only three have any real chance of winning: Andrés Manuel López Obrador (PRD), Felipe Calderón Hinojosa (PAN) and Roberto Madrazo (PRI). López Obrador is being backed by two other parties, the PT and the Democratic Convergence group, while Madrazo has the support of the PVEM. The PAN candidate is the only one who has not forged electoral alliances with other political parties.

The opinion polls have come out in favour of López Obrador

From the start of the presidential race, almost all of the opinion polls have placed López Obrador as the candidate likely to receive most votes, while Calderón and Madrazo are in a close tie for second place. According to the latest polls, the PRD candidate had an advantage of between seven and ten percentage points over his closest rival. As an average of the eight most recent polls, 37.1% of those surveyed said they planned to vote for López Obrador, 30.0% for Calderón and 26.8% for Madrazo.

Mexico: Popularity of presidential candidates (March 2006, %)

	AMLO (PRD)	Madrazo (PRI)	Calderón (PAN)	Difference 1° - 2°
El Universal	38.0	21.0	25.0	13.0
Parametría	40.0	29.0	29.0	11.0
Reforma	41.0	25.0	31.0	10.0
Milenio	38.0	30.0	29.0	8.0
Mitofsky	38.0	29.0	31.0	7.0
Mark. Pol.	37.0	29.0	32.0	5.0
Arcop	31.0	23.0	27.0	4.0
GEA-ISA	34.0	28.0	36.0	2.0
Average	37.1	26.8	30.0	7.5

Source: National polls of the respective firms

Only one poll puts Calderón ahead of López Obrador. Five of the eight polls indicate a virtual dead heat between Calderón and Madrazo. Part of Madrazo's hopes rest in the organizational powers and election experience of the PRI. Calderón has relied on a massive media campaign to get his message across to voters. Independently of the support shown for the different presidential candidates, a poll by the daily El Universal showed that 42% of those surveyed believe López Obrador will win the elections. Only 19% thought either Calderón or Madrazo would win.

A similarly tight race is expected for Congress

Some polls indicate the race for the Chamber of Deputies could be equally tight. The latest survey by Mitofsky placed the PRI-PVEM alliance in first place with 37% of the vote, compared with 33% in the poll it carried out in February. Next on the list of voter intentions was the PAN, with 33% of the vote (compared with 30% previously), while backing for the PRD-PT-Convergence fell to 29% from 34%. On the other hand, a survey by the daily Reforma put PRD and its political allies at the head of voter intentions with 35% of the vote (up from 32% previously), followed by the PAN with 34% (32% previously) and PRI-PVEM with 28% (down from 32% previously). These figures suggest that voters feel comfortable with the idea of a split parliament. However, hope remains that the political parties will reach agreements that will be positive for the performance of the economy and the future prosperity of the country.

The economy has not emerged as a major issue in campaigning

In the first two months of campaigning for the presidential race, the candidates for the PRD, the PAN and the PRI have made little mention of their economic plans. During the debates with the candidates organized by one of the major television channels towards the end of 2005, it was evident that there was common ground among them as regards the need to maintain macroeconomic stability, fiscal discipline, a free floating exchange rate system, and the independence of the central bank. All of them also coincided in the need to achieve higher GDP growth and stronger job creation, although there were some differences as to how to achieve this.

Economic matters will be afforded more detailed attention when the candidates hold their two televised debates. The first of these is due to take place on April 25, with the second debate scheduled for June 6. According to the information available, López Obrador will appear only in the second of these debates. Other key dates in the political calendar include September 1 when President Vicente Fox is due to give his sixth and last state of the nation address, and December 1 when the new president is due to take office.

The decisive stage of the presidential race will begin in the second half of April. In the final stage of campaigning, candidates will intensify their efforts to win the support of voters who have yet to make their minds up. Electoral campaigning will start to really heat up during May and June, which is when the financial markets will play closer attention to the race. The margin of victory of the winning candidate is a key element to be taken into account. In the 2000 elections, the winning margin was six percentage points, equivalent to 2.4 million votes. The infrastructure the Federal Electoral Institute can call on to organize the elections as well as the well-earned credibility it has gained for itself will ensure the polls will be transparent and reflect the wishes of the electorate.

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Peru: Politics, the economy and the run-off ballot

A scenario of uncertainty

The elections held on April 9 did not completely dissipate the political uncertainty. With over 90% of the votes counted, Ollanta Humala, the Union for Peru candidate, had picked up 30.8% of the vote and will contest the run-off ballot for the presidency. The favourite to face him in the run-off in the third week in May is ex-president Alan García (APRA), who polled 24.3% of the vote, ahead of National Unity candidate, Lourdes Flores, with 23.7% of the vote.

Politics and the economy

Following a change in electoral and political scenarios, as in the presidential elections of April and May 2001, it is possible to highlight two key characteristics. In the first place, the short-term financial variables (interest rates, the exchange rate, country risk, and the stock market) were significantly affected, the greatest impact being felt in the week before the run-off vote. And secondly, these effects were not permanent; quite the contrary, in fact, since after this period when it became clear that the new government was committed to maintaining economic stability, the financial variables returned to their original levels. The transitory nature of the political shock is confirmed by the econometric models, specifically in this case by an unrestricted VAR model (see Situación Perú, Q3, 2005).

On the basis of the foregoing, one can see relatively similar trends in the behaviour of the financial variables during the 2001 electoral period and the current one in 2006. However, it should be pointed out that this time around some economic variables have reacted with greater volatility and even temporarily further ahead of the elections. Thus, unlike the 2001 electoral process, in which virtually no economic volatility was registered before the first round, in the current process the financial variables have been more sensitive since the fourth quarter of 2005 when polls were indicating some unexpected results. A comparison of both processes also shows that a scenario of political stress has not yet been reached, since this generally comes about between the first and second round of the elections, the effect on the financial indicators increasing as the date for the run-off approaches (approximately in the second fortnight in May).

The electoral scenario in 2006 is obviously quite different from the one in 2001 in terms of the economic situation in both periods. In effect, the previous general elections were held at a time when the Peruvian economy was still recovering from the effects of the different crises in Asia, Russia and Brazil, as well as the political shock arising from the abrupt termination of the Fujimori government. The world economic environment was also not very favourable, and in general the country's financial indicators were a source of concern. 2006, on the other hand, sees the Peruvian economy in an expansionary cycle at its height and in step with the international scenario, with metals prices booming, the banking system in its best shape ever and reserves at a level that provides adequate protection against vulnerability. In this sense, due to the economic supports we have just mentioned, one might expect any eventual scenario of political stress that may arise in the weeks prior to the second round ballot to be less intense than in the 2001 election.

And after the second round?

An analysis of the stress scenarios in previous electoral periods shows that the shocks that affect the financial variables tend to be temporary. In general, the volatility that exists is the result of the uncertainty created by the messages delivered during the election campaigning, in particular when the issues highlighted are those which the economic agents find most unnerving. Normally, once a candidate is elected, and their economic policy actions are seen to differ little from those a country requires for economic stability (fiscal and monetary) and respect for institutions (the rules of play), the markets tend to quieten down. In certain situations when doubts about the likely economic management of presidential candidates are particularly intense, the market normally requires reassurance from them in the form of certain signals even before they are elected.

In this sense, a case in point is that of Inácio Lula da Silva, the president of Brazil, in whom the markets initially placed little trust, giving rise to a scenario of financial volatility in Brazil and contagion throughout the region. However, after clear signals from the Lula da Silva government in, for example, the appointment of a Central Bank head with a reputation for orthodox economic management and with the respect of the markets, as well as a number of measures aimed at controlling inflation, ensuring fiscal stability and encouraging private investment, market fears were quickly quelled. In this line of thinking, the markets will keep a close eye on the decisions taken by whoever wins the elections. Now more than ever it will be important to send out clear signals about preserving macroeconomic stability and playing an active role in a globalised world more open and competitive than ever before, where the presence of private capital (both national and international) is vital.

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Venezuela: Macroeconomic determinants of popularity

Oil makes its mark

In this box we undertake a statistical study of the macroeconomic determinants of popularity or the approval rating of Venezuela's presidents. In order to do so, we draw on the surveys conducted by the private firm Consultores 21 S.A., for the period between the first quarter of 1989 and the fourth quarter of 2005. The methodological approaches used have recently begun to be successfully employed in the study of political phenomena[1]. We analyse the interrelationship between popularity and the following macroeconomic variables: oil prices (in real terms), public spending (in real terms), inflation, non-oil gross domestic product (in real terms) and real exchange rates (the bilateral Venezuela-USA exchange rate). One of the study's key elements is that all of these variables, except for the price of oil, and including popularity itself, are treated as endogenous variables (that is to say, we consider the simultaneous interaction among all of them, including the possible effect of popularity on economic policy decisions).

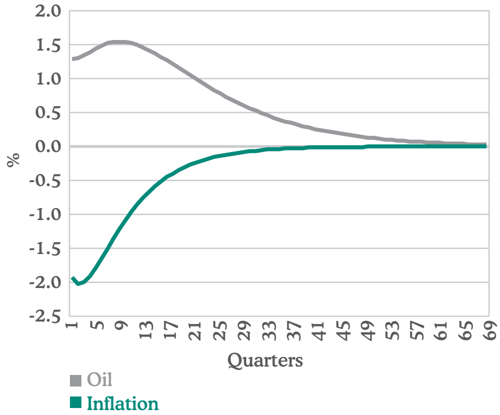
The following are the main results of the study:

1. Taken together, the macroeconomic variables considered account for approximately 19% of the short-term fluctuations and 54% of the long-term fluctuations in popularity. Conversely, fluctuations in the popularity of the president are found to have no impact, either directly or indirectly, on the evolution of the macroeconomic variables. In this sense, the evidence indicates that Venezuela's governments are generally not able to exercise enough control over the macroeconomic environment to allow them to counteract effectively adverse movements in their approval ratings, especially at times when oil prices are low. In fact, as we describe in the next point below, the political fate of the country's governments is usually determined to a large extent by the sharp and uncontrollable volatility of international oil prices and domestic inflation.

2. The fluctuations in oil prices and inflation are the ultimate macroeconomic determinants of the swings that take place in the popularity of Venezuela's presidents. That is to say, they reflect in large part all of the changes in the macroeconomic environment and macroeconomic policies that have a noticeable impact on popularity. In concrete, variations in the price of oil explain just over 5% of the changes in presidential approval ratings in the short term and just over 20% in the long term. Inflation, meanwhile, accounts for 12% of changes in the president's popularity in the short term and 18% in the long term[2]. Graph 1 shows the impact on the president's popularity of a standard increase in the price of oil and inflation.

Graph 1.

Change in presidential popularity after a standard increase in the price of oil and inflation

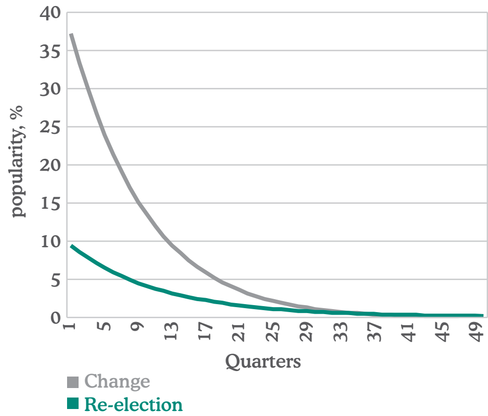


Source: BBVA

3. Venezuela is a good example of the so-called "honeymoon effect". Immediately after an election, re-election or presidential ratification, there is an abrupt rise in the president's popularity, followed by a gradual fall. In other words, the incoming president is received with much greater levels of popular support than the outgoing president enjoyed at the time of the elections. The size of this rise in support, in the case of Venezuela, stands on average at 35 percentage points when it is a new president that is taking up office and at 10 percentage points in cases of re-election or ratification of the same person as president (see Graph 2).

Graph 2.

"Honeymoon" effect when the president changes or is re-elected



Source: BBVA

[1] Specifically, we estimate a Bayesian vector autoregression model with Litterman's prior (well-suited for the analysis of times series whose autoregressive representation is close to a random walk, as is found in the case of the variables considered here, including popularity). Choleski's decomposition is used to capture structural innovations. Our approach therefore follows closely the methodological considerations proposed by the political scientists Patrick T. Brandt and John R. Freeman in their recent article "Advances in Baynesian Times Series Modeling and the Study of Politics: Theory Testing, Forecasting and Policy Analysis", Political Analysis, 2006, 14 (1), pp. 1-36.

[2] Recall that Venezuela's oil export income is the source of over 80% of the country's external income and more than 50% of its tax revenues.

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III. Under the microscope

With or against the cycle?

Fiscal policy in Latin America

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How have countries in the region responded to the changes observed over the past few years? Most of the academic world argues that the ability of governments to react is crucial for the smooth economic management of the cycle. According to this view, if the government detects the existence of an imbalance in the economy, it should take resolute action to correct it. For example, if the economy shows signs of excess demand (domestic demand growth above the rate of increase of the supply of goods), inflationary pressures with undesirable consequences may build up, and the government must therefore use all the means at its disposable to prevent such a situation arising. One of the instruments the government can use to moderate the economic cycle is fiscal policy.

The aim of this article is to determine whether the governments in Latin America are using fiscal and spending policies to smooth the cycle in the region. This question takes on particular importance in view of the fact that, as we stress in this publication, all of the countries in the region find themselves in a year of intense electoral activity.

In this sense, several studies (see Alberola and Montero (2005) and Alesina and Tabellini (2005)) indicate that in Latin America governments do not seek to implement anti-cyclical policies. On the contrary, there is evidence that the state acts as an accelerator of the cycle, increasing spending and debt when it should be saving. For example, take the following equation used by Alesina and Tabellini to determine whether or not fiscal policy is pro-cyclical:

$$\Delta S_t = \alpha + \beta Y_t + \gamma X_t + \theta S_{t-1} + \varepsilon_t \quad (1)$$

where Δ is an operator that signifies change with respect to the period immediately before, S_t denotes the central government surplus as a percentage of GDP in the year t, Y_t is the difference in percent between observed GDP and potential GDP or the output gap, X_t measures the deviation of the terms of trade relative to their long-term trend, while ε_t is an error term. Given our definition for S_t and Y_t, a policy is considered to be pro-cyclical if the β coefficient is negative, that is to say, if when the economy is growing at above-potential rates, the government decides to reduce the fiscal surplus. Likewise, the inclusion of the terms of trade is due to the fact that for many of these countries, the main source of fiscal revenue is taxes on production and exports of raw materials. Finally, we include the level of fiscal balance with a lag due to the possibility that governments are more willing to spend because they have a high fiscal surplus.

In order to determine whether governments in Latin America traditionally implement pro-cyclical fiscal policies, equation (1) was estimated for the seven major countries in the region (Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela) using the ordinary least squares method. The data were obtained from the statistical database of the International Finance Institute, which includes information from 1978 to 2005[1].

The results of our estimation of (1) are presented in Tables 1 and 2[2] [3]. Three groups of countries can be distinguished. In the first place, for Colombia and Venezuela we cannot reject the null hypothesis that the β parameter is equal to zero. Secondly, Argentina, Chile and Peru stand

Table 1.

Estimations of (1) with Lambda=6.7

	Beta	Gamma	Theta	R^2
Argentina	0.16**	0.07**	2.32**	0.58
Brazil	-1.68**	0.95**	-1.78***	0.53
Chile	0.29***	0.08**	3.60***	0.69
Colombia	-0.06	0.15***	-0.39	0.51
Mexico	-0.37**	**0.18	-2.09***	0.67
Peru	0.18**	0.07	2.80***	0.65
Venezuela	-0.15	0.12**	-1.27***	0.68

*, **, ***, correspond to confidence levels of 90, 95 and 99 percent, respectively.

[1] Given the trade diversification observed during the last 20 years in Mexico, the terms of trade do not seem to be a good way of estimating movements in fiscal revenues. In this case, therefore, we use the price of oil directly.

[2] Apart from the exogenous variables in (1), we included dummy variables whose coefficients and levels of significance are not reported. The main aim of this was to take account of atypical observations in the sample and to correct for the inclusion of debt-service payments in the fiscal deficit. A more detailed explanation of this is available from the author on request.

[3] The output gap was obtained by calculating trend GDP for the different countries using the Hodrick-Prescott filter with γ=100. The calculations were repeated with lower values of γ (6.7), which imply a lower level of smoothing of the trend and shorter cycles. Both results are presented in the adjoining tables.

Table 2.
Estimations of (1) with Lambda=100

	Beta	Gamma	Theta	R^2
Argentina	0.10**	0.06*	-0.33**	0.59
Brazil	-1.57**	0.61*	-0.47***	0.55
Chile	0.17***	0.11***	-0.66***	0.74
Colombia	-0.11	0.06***	-0.04	0.57
Mexico	-0.30**	0.12**	-0.32***	0.67
Peru	0.09*	0.03	-0.80***	0.60
Venezuela	-0.07	0.09***	-0.82***	0.73

*, **, ***, correspond to confidence levels of 90, 95 and 99 percent, respectively.

Table 3.
Estimations of (1) with Y in t-1

	Beta	Gamma	Theta	R^2
Argentina	0.07	0.09**	-0.28*	0.50
Brazil	-0.38	0.61	-0.56***	0.46
Chile	-0.12	0.06	-0.20	0.50
Colombia	-0.01	0.09**	-0.07	0.51
Mexico	0.12	0.11*	-0.33***	0.61
Peru	-0.09	0.05	-0.59***	0.55
Venezuela	-0.09	0.10***	-0.77***	0.67

*, **, ***, correspond to confidence levels of 90, 95 and 99 percent, respectively.

Table 4.
Estimation with panel data
(Fixed effects)

Coefficient	Estimation	Est. error	t statistic	Prob.
Beta	-0.03	0.07	-0.41	0.69
Gamma	0.07**	0.03	2.23	0.03
Theta	-0.46***	0.06	-7.15	0.00
R^2	0.28	Durbin-Watson stat		1.96

*, **, ***, correspond to confidence levels of 90, 95 and 99 percent, respectively.

out as the countries in which fiscal policy is clearly anti-cyclical during the period in question. Finally, for Brazil and Mexico, the coefficient β is negative and significant. In the light of this, therefore, the assertion that fiscal policy has been pro-cyclical in the region is at the very least debatable.

In order to test our results, we have undertaken two more exercises. First of all, we take account of the fact that in our estimation of equation (1) there may be a problem of endogeneity: government spending and the output gap can be determined simultaneously. As a means of correcting the possible bias resulting from this, we use the output gap as the instrumental variable but with a one period lag. The results are presented in Table 3[4]. Secondly, in Table 4 we report an estimation with panel data. In both cases, the results continue to cast doubt on the pro-cyclical nature of fiscal policy in Latin America, since the β coefficients are not significantly different from zero.

Finally, caution must be exercised in interpreting these results. Although we have attempted to control for atypical observations, the region has gone through a period of reforms (especially in the case of social security systems) and high macroeconomic volatility (with deep recessions and financial bail outs) which may be influencing the results.

Fiscal policy in Latin America in the period 2004-2005

Given these doubts concerning the pro-cyclicality of fiscal policy in the region during the recent past, the question that now needs to be answered is whether in the current economic boom, the governments of Latin America are straying from a neutral or anti-cyclical stance. In order to analyse this question, we have defined what is known as the structural balance (see OECD (2006)):

$$S^*/Y^*=T^*/Y^*-G/Y^*$$

where S^* is the structural balance, Y^* is potential GDP, T^* are structural fiscal revenues and G denotes government current spending excluding debt-servicing costs[5]. According to this methodology, a policy is restrictive (expansionary) in a particular year if the change in the structural balance is positive (negative).

The variable T^* is obtained as follows:

$$T^*=T(Y^*/Y)^{\beta}$$

Here, T denotes fiscal revenues excluding those from taxes on the production and export of raw materials[6]. As an initial exercise, we present the results obtained after calculating the structural deficit using an elasticity of β=1. In concrete, we take the situation in the years 2004 and 2005 as a example. In Graph 1, the horizontal axis shows the point in the economic cycle at which the countries in the region found themselves during these two years. The vertical axis, meanwhile, shows the change in the structural balance as a percentage of potential GDP. The conclusion that can be drawn from this graph is that during 2004 most of these countries implemented fiscal policies that may be considered as being anti-cyclical or relatively neutral, with the exception of Mexico and Venezuela. There are two points to note here. First of all, the increase in spending observed in these two countries may be the result of a rise in the equilibrium price of oil. At least in the case of Mexico, the relationship between potential GDP and oil production is no longer so important as it was in the past. Therefore, our estimation of structural fiscal revenues could be underestimating the improvement in the long-term financial position of the government, and, in that case, our assessment of fiscal policy during the cycle could be different (once again, at least in the case of Mexico). Further on in this article we offer a solution to this problem. Secondly, the present definition of the proper-

[4] Only the data for an output gap obtained using γ=6.7 are included.
[5] Due to the fact that many of these countries have no spending that changes automatically with the cycle (for example, unemployment insurance), it is common for the government's current spending to be taken as structural.
[6] This definition is different to that used by organisations such as the OECD. However, the fact that many of these countries receive extraordinary income from the exploitation of natural resources makes a different specification essential.

ties of fiscal policy refers only to changes, not to levels. In the case of Venezuela, this is an important distinction, since the biggest increase in spending under the Hugo Chavez government was seen in 2001 (from 19% of GDP to approximately 22%). Despite this, during 2004 Venezuela had what according to our definition can be considered the most expansionary fiscal policy in Latin America.

The differences between 2004 and 2005 in terms of position in the economic cycle and fiscal policy are clear to be seen. Most of the countries grew at rates close to or above potential during 2005, while fiscal policies were more relaxed compared with what was observed in 2004. Once again, it should be stressed that when we define a fiscal policy as being expansionary, we are not taking account of either the level of the structural balance or the size of public debt. For example, Argentina is one of the countries with the biggest fall in the structural balance in 2005. However, the country's public accounts were still running a surplus of over 1% of GDP[7] .

An alternative definition of structural revenues used in this study is given by:

$$T^*=T(Y^*/Y)^{\beta}(X^*/X)^{\gamma}$$

where X again denotes the terms of trade of the country in question. In this definition, we include the fiscal revenues that were previously excluded (from raw materials). In order to calculate the elasticities β and γ, we follow the standard methodology to estimate the following equation:

$$Log\,(T_t) = \alpha + \beta\, Log(Y_t) + \gamma\, Log\,(X_t) \qquad (2)$$

Here, the variables are measured in real terms. Table 5 displays the results for each country except for Brazil and Argentina for which data on fiscal revenues are unavailable for all of the sample. Surprisingly, the terms of trade elasticity is significant only in the cases of Colombia and Venezuela. In this sense, the most striking result is that of Mexico, a country that is heavily dependent on oil income, but which nevertheless does not show a significant elasticity to changes in the price of oil.

In order to again calculate the structural balance, we have used the elasticities presented in Table 5 (for Argentina and Brazil we use the values of β obtained by Alberola and Montero for both countries and a γ value of 0.15. The results are displayed in Graph 2. If we compare this graph with the previous one, we can see that taking account of movements in the terms of trade has the effect of making the countries' fiscal policies more neutral. Moreover, only two countries, Argentina and Colombia, seem to lie clearly within the pro-cyclical panel in 2005. It is worth repeating again that our definition of expansionary policy takes no account of the levels of the public fiscal balance.

In conclusion, we can say that on the basis of the estimations carried out in this article, it would seem that it has only been in special circumstances that some of these countries have adopted pro-cyclical policies. What is more, the evidence shows that during 2004 and 2005 the changes in fiscal policy of governments in the region have been conservative. This is not to say that they are not bedeviled by past debt or that during 2006 public spending did not expand at above-normal rates.

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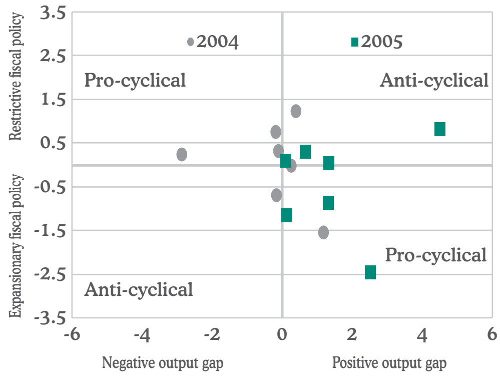
OECD (2006), "Cyclically-adjusted budget balances: a methodological note", available at www.oecd.org/eco.

[7] Although this is considerably higher than the historical average, a more detailed analysis of the fiscal position of these countries should include some type of analysis of the sustainability of debt levels given the current financial situation of governments in the region.

Graph 1.
Fiscal policy in Latin America, Beta=1
(2004-2005 - % of GDP)



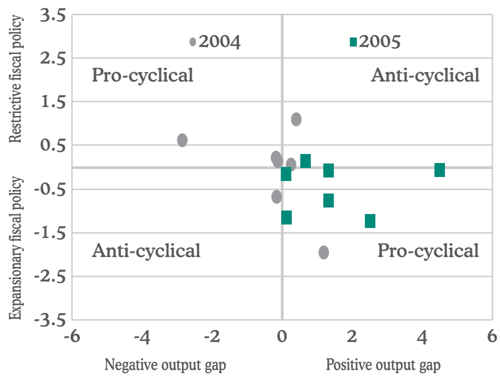
Source: BBVA

Table 5.
Estimations of (2)

	Alpha	Beta	Gamma	R^2
Chile	0.48	0.73***	0.15	0.95
Colombia	-9.14***	1.61***	0.10*	0.96
Mexico	-3.1***	1.14***	0.04	0.95
Peru	-7.21***	1.40***	0.17	0.65
Venezuela	-1.71	0.86***	0.37***	0.47

*, **, ***, correspond to confidence levels of 90, 95 and 99 percent, respectively.

Graph 2.
Fiscal policy in Latin America, Beta and Gamma (2004-2005 - % of GDP)



Source: BBVA

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Do public spending and investment correlate with political and economic cycles?

In both revenue gathering and the use to which those revenues are put, the public sector follows two main tenets: efficiency and fairness. In the case of public spending, the principle of efficiency implies government intervention by means of providing goods of a public nature, or by looking for efficient solutions to situations in which the economic balances achieved turn out to be inefficient because of the existence of imperfections in the market. On the other hand, the idea of fairness requires putting mechanisms in place for the redistribution of income among different social groups and economic agents.

On occasions the fulfilment of the two principles produces a conflict due to the need to apply policies that move in opposite directions. The principle of efficiency is directly related to the concept of economic optimization, the result of which does not necessarily imply fairness. Meanwhile, the principle of fairness is a moral concept related to the equality of individuals under the rule of law. Therefore, intervention by governments in the economy also implies a more or less balanced choice of efficiency and fairness. The greater or lesser extent of interventionism by governments in different countries or in the same country at different moments in time reflects the choice of the different balances between these two principles. In making such choices governments face restrictions of an economic nature such as growth, inflation and income levels, as well as restrictions of a political or social nature, for example demographic shifts in the electorate.

The different political systems which countries in Latin America have lived through the past few decades have given rise to a number of studies in the area. The shift from authoritarianism to different forms of democracy has sparked studies into how governments draw up their spending plans and the economic and political reasons behind those decisions. Brown and Hunter (1999) suggest that authoritarian governments are more sensitive to economic restrictions than are democratic systems. For example, in situations of low per capita income and negative growth, authoritarian governments cut spending more quickly. On the contrary, democratic systems respond more rapidly to social demands of the electorate.

With the transition from authoritarian regimes to democratic systems, there is evidence of an increase in public social spending to the detriment of public investment[1] . The reasoning behind this is that democratic governments need to satisfy the demands of voters with a view to winning re-election and remaining in power, which is something authoritarian governments do not need to do. Therefore, it has been found that electoral competition increases social spending, particularly on health and education.

On the other hand, there are reasons to believe that the increase in social spending under democracy has been relatively limited. The debt crises of the past few decades and the role played by international organizations impose natural restrictions on governments in their control of public spending.

Up to the end of the 1980s there was a wide body of literature documenting these differences between authoritarian and democratic governments. However, after the consolidation of democracy as the chosen system of government in Latin America, the debate regarding choices governments make with regards to their resources has petered out.

The economic cycle and the political cycle as determinants of spending

During the 1990s, public investment in many countries continued to slow down as a result of the privatization of state-owned companies. Mexico and Colombia are clear examples of this process. However, the figures for most countries show highs and lows that are typical of cycles.

1 See Ames (1987), Sloan and Tedin (1987).

Some authors demonstrate the existence of a political cycle in finding an increase in public transfers (social spending) and the monetary base ahead of elections (McCallum, 1978 and Golden and Poterba, 1980). In the specific case of Latin America, there are a number of studies that highlight the relation between the political cycle and economic variables. For example, Frieden, Guezzi and Stein (2001) identify a relationship between the holding of elections and currency depreciation or devaluation. The months after elections have concurred with average real currency depreciation in Latin America of 4.5%. This took place after governments intervened in the months prior to the elections to prop up their currencies, with this imbalance being corrected after the polls.

As regards economic cycles, in this publication we have not found empirical evidence that allows us to say Latin American governments have implemented pro-cyclical fiscal policies in the past two decades. That is to say, there is no evidence that fiscal deficits can be attributed to the economic cycle in such a way that moments of greater growth produce greater fiscal shortfalls and vice-versa.

The underlying idea in this article is to find out whether not only the economic cycle but also a possible political cycle driven by the periodic holding of elections, affect the level of public spending and its components. Although public investment is relatively more reduced compared with the past, it still remains necessary in the region due to a lack of adequate infrastructure. The instability of public investment may reflect different responses by governments to moments of reduced or negative growth, or to the fact elections are forthcoming, redirecting funds that had been assigned for investment towards increased social spending through direct transfers of income: real increases in unemployment or pension benefits, an increase in the monetary base or an increase in the minimum wage.

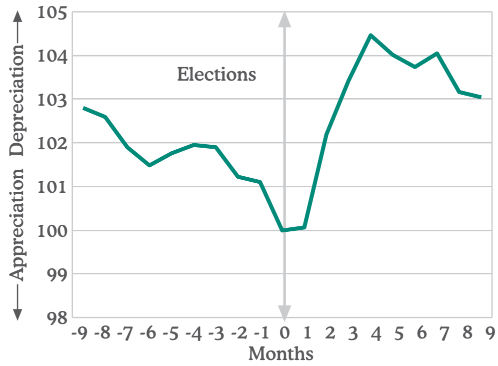
In this article, we have made an initial analysis, necessarily of a simplified nature, and a comparison between different countries in Latin America. In any case, the heterogeneous nature of the data available for each country makes it more difficult to carry out a more in-depth analysis, which is something that is required. We have divided primary public spending (total spending excluding interest payments on debt) into three components: public consumption, transferences and public investments. Public consumption is spending that encompasses the payment of the salaries of state employees, the purchase of goods and services, as well as current spending necessary for the normal functioning of the public apparatus of the country. Public investment includes expenditures on investment projects (in infrastructure, state-owned companies, technology etc) whether this be real or financial. These are outlays that do not give an immediate political pay-off since they involve periods of maturity normally over one year. Lastly, transfers are outlays such as unemployment benefits and state retirement pensions, and in general encompass social expenditures of a more visible nature.

Although social spending can include both direct transfers of income as well as investment expenditure, the impossibility of obtaining a detailed breakdown of spending that is sufficiently homogeneous for all of the countries in Latin America makes the distinction we have used in this article a reasonable one, given that the purpose of this exercise is to see if economic and political cycles affect the amount and make-up of public spending, and in particular investment spending. Our starting hypothesis is that electoral cycles cause governments to increase public spending in general, and in particular, leave to one side spending on possible investment projects in favour of increased transfers or spending of a social nature directed at certain groups of the population in order to gain as many votes as possible[2].

Using annual figures on the public sector for the period 1990-2004 obtained from CEPAL, and our own estimates for economic cycles, we have drawn up panel data for 16 countries in Latin America. The variable that needs to be explained in the first instance is primary public spending. We next try to explain the evolution of the ratio of public investment to total spending. Following the recommendations of Beck and Katz (1996) on using panel data, we have included among the

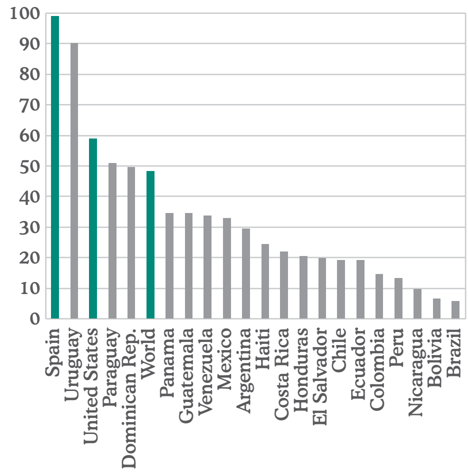
[2] A further widely-studied indication of the existence of a political cycle affecting public sector policies is the reduction of taxes before elections.

Real exchange rate



Source: Frieden, Guezzi and Stein (2001)

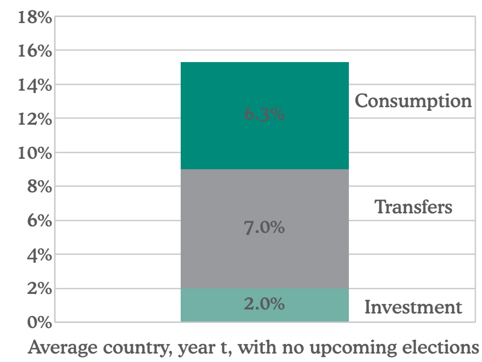
Paved roads (%)



Source: World Bank

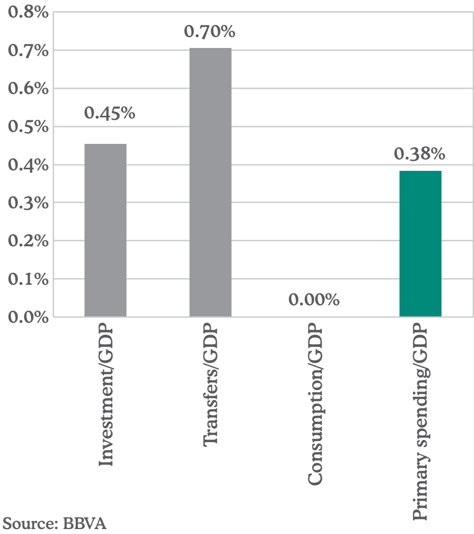
Primary public spending in Latin America

(as % of GDP)



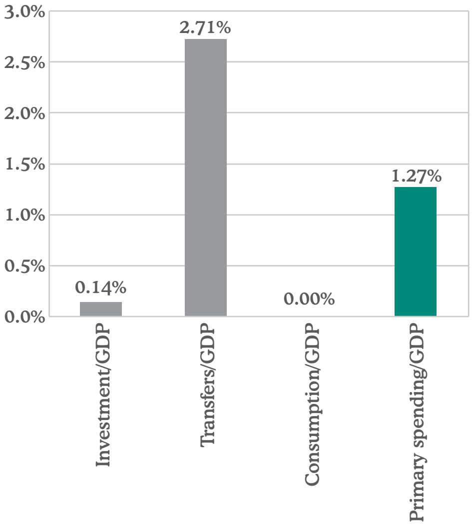
Source: BBVA using ECLAC data

Impact in year t of a 1-point fall in output gap in t-1



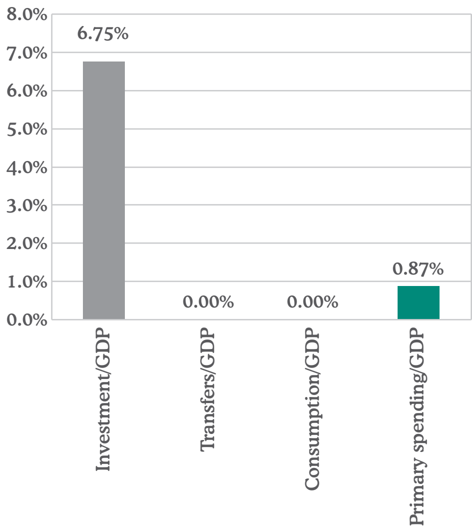
Source: BBVA

Impact in year t of elections the same year



Source: BBVA

Impact in yeat t of elections in t+1



Source: BBVA

regressors the dependent variable lagged for one period in order to offset the existence of autocorrelation. The results point to this measure being sufficient, there being no need to differentiate the variable.

In any case, the regressors are set one period ahead of the data for the variable to be explained, it also being logical that the public sector takes time to make decisions, and that the figures that are known today affect spending decisions that are taken for the following period.

The estimates of panel data with fixed effects show that total public spending in Latin America is impacted by the economic cycle, while there is also evidence of a political cycle[3]. On the one hand, public spending is pro-cyclical. For the average country in Latin America, a 1% closure in the output gap, all other things being equal, brings about an increase in public spending of 1.4%, 0.4 points bigger than the increase in GDP. On the other hand, the closeness of elections has an even bigger impact on this variable, with growth in spending outpacing growth in GDP by 0.9 points during the year prior to holding elections and by 1.3 points in the year in which they take place. If the situation occurs, as is the case of a large number of countries in 2006, that the electoral year coincides with a favourable cyclical situation, expected increases in spending could outpace growth in GDP by over 2 points.

How are these variations in spending allocated according to its components? No significant estimates were found that showed public consumption is affected by cycles. This conclusion makes sense within the context of how we have defined consumption. That is, as current spending on personnel, goods and services, which should, as is the case, be independent of cycles, since this is expenditure necessary for the normal functioning of the public sector.

More interesting are the results obtained in the area of investment and public transfers. In the first place, both variables correlate positively with the period of the economic cycle, with governments increasing both of these components of spending during periods of stronger economic growth, and reducing them during recessions. However, public investment shows itself to be less volatile, with transfers suffering most from cyclical fluctuations.

The proximity of elections also causes these two components of spending to increase. However, the increase in spending in the year prior to elections applies only to public investment. There is no evidence that increases in transfers take place so far ahead of elections. The situation is the other way around during an election year, with most of the increase in spending accounted for by public transfers.

By way of conclusion, it can be said that economic cycles affect both the level of public spending and its composition, with the correlation being positive. However, when faced with cyclical fluctuations, governments adjust spending through the transfers component, maintaining a higher level of commitment to investment spending, which although relatively lower tends to be more stable.

The study also showed evidence of the existence of political cycles as a result of the periodic holding of elections[4]. In addition, it was not found that in the course of political cycles governments decide to substitute public investment for spending in the form of transfers. On the contrary, during the 1990s and up to the present, it appears governments in Latin America sought votes not only by means of highly visible spending, but also increased outlays in other areas, which although not so visible in the short term, were over the longer term more productive by helping to boost economic growth and making national accounts more sustainable. Precisely, the greater period required for the effects of investment spending to show through offers an explanation for why governments decide to increase this type of investment a year before elections are due to be held. Increases in transfers of income as part of efforts to redistribute wealth are left for the following year in order to attract the votes of groups which most benefit from these increases.

[3] For the sake of simplicity, we have chosen to report only the effects on the dependent variable of changes in the regressors. The estimations are available from the author on request.

[4] From the point of view of reputation games, it is argued that after successive elections, political cycles cease to exist. However, the continuing existence of such cycles may be due to information asymmetries. See Rogoff and Silbert (1987) and Rogoff (1990).

Polarisation of trade policies

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The processes of trade integration of the countries in Latin America have taken very different routes over the course of the past few decades (See Table). There has also been diversity in the initial reach of the process, with agreements stretching from Free Trade Treaties (FTT) to the establishment of a Common Market (CM). However, the outcome in the vast majority of cases has been hardly satisfactory. Intra-regional trade volumes continue to be low compared with other integrated areas such as the European Union (EU) (See Graph). The pattern of productive (and exporting) specialization may be one of the elements that explains this situation. While it is true that manufactured goods have accounted for an increasing share of total exports, this growth has been insufficient. The importance of farm, energy and mining product exports is very high in a large number of countries, which means there are few areas in which complementary trade exists[1].

Recent developments

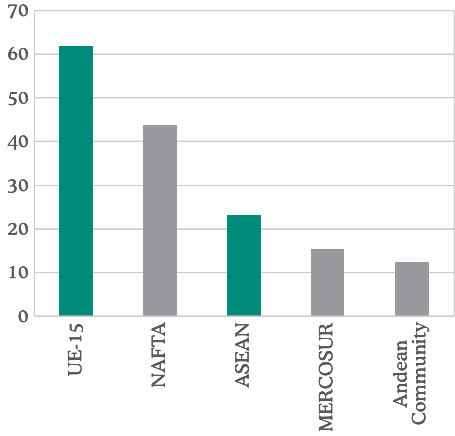
In the above context, the different countries that make up the region have begun the new century looking for trade policies that allow better results in terms of economic growth. Colombia signed a FTT with the United States on February 27 which is pending ratification by the parliaments of both countries, while Peru did likewise on April 12. The current government in Ecuador is seeking a similar deal ahead of the presidential elections in October, but local opposition towards this is strong as is also the case in Bolivia. In doing so, they would follow the path taken by Mexico in 1994 and by Chile, whose FTT with the United States came into effect on January 1, 2004. Central America and the Dominican Republic signed a similar deal at the end of the same year in the shape of the Central American Free Trade Agreement (CAFTA), which is due to take effect in the different countries in the pact during this year[2].

The signing of FTTs forms part of the Bush administration's "Plan B" in response to the opposition shown to the US Free Trade Area of the Americas (FTAA) project. There is a clear logic to this in that a priori it is always easier to reach an agreement with a single party rather than with several with different interests. The 4th Summit of the Americas held in Buenos Aires November 4-5, 2005 exposed the different strategies of the governments in the continent with respect to the FTAA project. The bulk of these, 29 out of 34 countries led by the United States and Mexico, expressed themselves in favour of the FTAA. But there were also dissenting opinions that were far from encouraging. The opposition group formed by MERCOSUR and Venezuela[3], showed itself, for different reasons, of being capable of blocking the proposed deal. Differences over the treatment of the farm sector, especially in the case of Brazil[4], as a spillover from the dispute within the WTO, is also an obstacle. There is also the issue of Hugo Chávez's ideological pull, with the Venezuelan president already having won the governments of Bolivia and Argentina over to his way of thinking, while maintaining his influence over Ecuador and Peru.

From bilateralism to regionalism

In the light of the developments mentioned above, there are two clearly divergent currents in trade policy in Latin America. The first one opts for signing FTTs with the United States, which has a large market with lots of purchasing power, and which opens the door to domestic products by taking advantage of the dismantling of tariff barriers, as well as the possibilities of achieving economies of scale on the production side. In this sense, the figures relative to the longest-standing FTTs in the region show that the country that most benefits in terms of growth in exports is always the smaller of the two trading partners (See Table). A clear proponent of this policy is Chile, which without belonging to any of the large regional blocks, has even managed to extend this bilateral approach outside the continent, signing free trade agreements in the past few years with Canada, Mexico, Central America, the EU, South Korea, the European Free Trade Association (EFTA) and China.

Share of intra-regional trade (in %)



Source: BBVA using WTO data

Main trade agreements in Latin America

Type of agreements	Countries involved	Year
Customs union	Central American Common Market (CACM)	1960
	Andean Community (CAN): Bolivia, Colombia, Ecuador, Peru and Venezuela	1969
	Caribbean Community (CARICOM)	1973
	Southern Common Market (MERCOSUR): Argentina, Brazil, Paraguay and Uruguay	1991
Free trade	Bolivia-Mexico	1994
	Canada-USA-Mexico (NAFTA)	1994
	Colombia-Mexico-Venezuela	1994
	Costa Rica-Mexico	1994
	Canadá-Chile	1996
	Mexico-Nicaragua	1997
	Chile-Mexico	1998
	Central America-Chile	1999
	Mexico-European Free Trade Association	2000
	Mexico-Israel	2000
	Mexico-Honduras-Guatemala-El Salvador	2000
	Mexico-European Union	2000
	Chile-European Union	2002
	Chile-USA	2003
	Chile-European Free Trade Association	2003
	Chile-South Korea	2003
	Mexico Uruguay	2003
	Central America-Dominican Republic-USA	2004
	Mexico-Japan	2004
	Peru-Thailand	2005
	Chile-China	2005

Source: BBVA

[1] The World Bank (2000) indicates that, in general terms, the benefits of North-South agreements are greater than those for South-South accords, among other reasons because of the existence of complementary production.
[2] The agreement has been ratified by El Salvador, the United States, Honduras, Guatemala and Nicaragua. It is pending ratification in Costa Rica.
[3] Venezuela is in the process of joining MERCOSUR and has announced it is pulling out of the Andean Community (CAN).
[4] Hilaire and Yang (2003) indicate that when major sectors are left out of free trade talks, the gains derived from these are substantially less.

Bilateral trade developments after FTT

Large country (L)	Small country (S)	GDP ratio 2005	GDP per capita ratio 2005	Year FTT Came into effect TLC	Average export growth S > L	Average export growth L > S
Canada	Chile	11	5	1997	24%	-1%
USA	Mexico	17	6	1994	20%	12%
Mexico	Bolivia	73	6	1995	8%	3%
Mexico	Chile	7	1	1999	39%	-4%
Mexico	Costa Rica	37	1,5	1995	23%	15%

Source: BBVA using UN and IMF data

Share of US-Mexican trade (2004)

Large country (L)	Small country (S)	Group of products*	% exports S > L	% imports L < S
USA	Mexico	1. Food and beverages	86.9	13.0
		2. Intermediate goods	80.6	7.2
		3. Fuel and lubricants	80.9	9.5
		4. Capital goods	93.1	11.5
		5. Transport equipment	92.7	14.5
		6. Consumer goods	89.3	8.1
		7. Others	76.7	12.5

Source: BBVA using UN; *BEC

The second current has opted to seek greater regional integration, with greater clout in multilateral trade negotiations and with less external vulnerability. To a certain extent, this approach is in opposition to the criticized (and apparent) desire by the United States to create a relation of dependence with the countries in Latin America, pushing out other global competitors through the signing of bilateral trade treaties. The main proponent and spokesman for this initiative is Hugo Chávez, who will have to bring Brazil over to his side, since without the participation of the largest market in the continent south of the Río Grande, this project is doomed to failure even before it gets off the ground. This current would encompass initiatives such as the construction of the Southern Gas Pipeline, which would supply natural gas to seven countries, stretching 8,000 kilometres from Venezuela to Argentina and Uruguay.

Reconcilable stances?

The current globalized economy, with strong competition on a world scale, demands high degrees of innovation and competitiveness. If these qualities cannot be developed in the short term, alternative policies are frequently sought which allow more immediate results than those obtained from rolling out a solid industrial strategy. Looking for bilateral agreements comes within this model, given that on the one hand a small country seeks the scope given by a large market (and generally a richer one), while on the other hand the latter tries to secure for itself the supply of basic goods at lower prices, allowing it to better position itself in terms of costs in world markets. The risk for a small country with this strategy lies in its vulnerability to the economic cycle of the market of its bigger trading partner and a possible change in the latter's suppliers (for example, through signing a FTT with another small country), which would generate economic and financial instability. The large country, for its part, could have reason – independently of protectionist or geopolitical issues – to oppose global trade liberalization initiatives as this would involve losing markets which are almost captive (see the example of Mexico-United States in the Table)[5] . Finally, in aggregate terms, Bagwell and Staiger (1998) show that it is not possible to reach a situation of efficiency in global trade liberalization movements when there are countries which enjoy preferential agreements, such as FTTs, in which the most favoured nation clause is not applied.

As opposed to bilateralism, there are broader liberalization movements such as the multilateralism defended within the WTO. As the trajectory taken since the end of the Second World war reaches its culmination, in the long term the biggest challenge facing producers in different countries will be how to make what they have to supply competitive, not national policies of a discretional natural or bilateral/regional trade agreements. Applied to Latin America, although the productive and exporting network is not complementary, the region could seek to establish a position of strength for itself within WTO negotiations, forge joint strategies in industrial and business policy[6] , and bring integration further along in other, such as financial assistance, the fight against poverty and the energy sector. With MERCOSUR[7] and FTAA having suffered serious setbacks, there is scope to focus on initiatives which make Latin America's role as an international supplier of raw materials compatible with the implantation of the region in a more competitive and higher value environment for its manufactured products, whilst at the same time achieving greater geographical diversification of its export markets.

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[5] For other countries with which the United States has signed FTTs see Hilaire and Yang (2003). For example, US exports to El Salvador, Guatemala, Honduras and Nicaragua represented in 2002 between 0.1% and 0.4% of total exports, while shipments by these countries to the United States represented between 58.7% and 69.5% of their exports.

[6] Understood not from an interventionist point of view, but as creators of incentives to carry out investments and innovative processes.

[7] This assertion is backed up on the one hand by Uruguay holding talks with the United States on a bilateral investment treaty, and on the other by the long-standing conflict between Uruguay and Argentina over the decision by the former to allow paper manufacturers to set up in an area close to the border between the two countries.

International Context

	Real GDP (%)				Consumer prices (%. average)			
	2004	2005	2006	2007	2004	2005	2006	2007
USA	4.2	3.5	3.3	3.2	2.7	3.4	2.8	2.1
EMU	1.8	1.4	2.0	2.2	2.1	2.2	2.0	1.9
Japan	2.7	2.7	3.0	3.0	0.0	-0.3	0.4	0.5
China	10.1	9.8	9.0	8.5	3.9	1.8	2.5	2.0

	Official interest rate (%. end of period)				Exchange rate (vs $. end of period)			
	31/03/06	Jun-06	Dec-06	Jun-07	06/01/06	Jun-06	Dec-06	Jun-07
USA	4.75	5.00	5.00	5.00				
EMU ($/€)	2.50	2.75	3.00	3.25	1.21	1.20	1.23	1.26
Japan (yens/$)	0.10	0.10	0.50	1.25	118	113	110	105
China (cny/$)	5.58	5.58	5.58	5.80	8.00	7.90	7.75	7.50

Latin America

	Real GDP (%)				Consumer prices (%. end of year)			
	2004	2005	2006	2007	2004	2005	2006	2007
Argentina	9.0	9.2	7.8	6.2	6.1	12.3	12.0	10.0
Brazil	4.9	2.3	3.6	3.0	7.6	5.7	5.5	4.5
Chile	6.2	6.3	5.8	5.7	2.4	3.7	3.5	3.3
Colombia	4.8	5.1	4.4	3.6	5.5	4.9	3.9	4.0
Mexico	4.2	3.0	3.6	3.2	5.2	3.3	3.3	3.5
Peru	4.8	6.7	4.7	4.7	3.5	1.5	2.5	2.5
Venezuela	17.9	9.4	4.1	2.9	19.2	14.4	15.3	18.1
LATAM [1]	**6.0**	**4.4**	**4.4**	**3.8**	**6.8**	**6.0**	**5.9**	**5.5**
LATAM Ex-Mexico	6.6	4.9	4.6	3.9	7.3	6.9	6.8	6.2

	Fiscal balance (% GDP)				Current account balance (% GDP)			
	2004	2005	2006	2007	2004	2005	2006	2007
Argentina [2]	2.6	1.8	1.9	1.8	2.2	3.0	2.4	1.7
Brazil	-2.5	-3.0	-3.0	-2.0	1.9	1.8	1.0	1.0
Chile [2]	2.4	4.9	4.6	1.4	1.7	0.6	0.4	-1.8
Colombia	-1.3	0.0	-2.0	-1.7	-1.0	-0.2	-0.7	-1.6
Mexico	-0.3	-0.1	0.0	0.0	-1.1	-0.7	-0.9	-1.3
Peru	-1.1	-0.4	-0.6	-1.0	0.0	1.3	0.4	-0.8
Venezuela [2]	-1.9	1.6	-2.3	-3.1	14.1	17.7	10.7	10.4
LATAM [1]	**-0.9**	**-0.7**	**-1.0**	**-0.8**	**1.3**	**2.0**	**1.0**	**0.4**
LATAM Ex-Mexico	-1.2	-1.0	-1.5	-1.2	2.7	3.4	2.0	1.3

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

	Exchange rate (vs $. end of year)				Interest rates (%. end of year)[3]			
	2004	2005	2006	2007	2004	2005	2006	2007
Argentina	2.99	3.01	3.15	3.25	3.1	5.0	8.0	10.0
Brazil	2.72	2.28	2.40	2.50	17.8	18.0	15.5	14.0
Chile	576	514	530	550	2.3	4.5	5.5	5.5
Colombia	2404	2279	2373	2453	7.8	6.3	6.4	6.7
Mexico	11.15	10.63	11.30	11.70	8.7	8.0	7.0	7.0
Peru	3.28	3.42	3.28	3.40	3.0	3.3	4.5	5.0
Venezuela	1920	2150	2150	2580	12.4	10.9	10.3	10.5

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

Argentina / Brazil

	Argentina 2005	Argentina 2006f	Argentina 2007f	Brazil 2005	Brazil 2006f	Brazil 2007f
GDP (%)	9.2	7.8	6.2	2.3	3.6	3.0
Consumer prices (%, end of year)	12.3	12.0	10.0	5.7	5.5	4.5
Trade balance ($bn)	11.3	9.1	7.8	44.8	35.0	30.0
Current account (% GDP)	3.0	2.4	1.7	1.8	1.0	1.0
Reserves ($bn. end of year)	28.1	27.6	33.6	53.8	49.5	52.0
Exchange rate (end of year vs US$)	3.01	3.15	3.25	2.28	2.40	2.50
Fiscal balance (% GDP) [1]	1.8	1.9	1.8	-3.0	-3.0	-2.0
Interest rate (end of year) [2]	5.0	8.0	10.0	18.0	15.5	14.0
Real effective exchange rate (end of year, dic-97=100)	52	54	56	81	78	75
BBVA-MAP (end of year, jun-95=100)	131	133	130	77	82	83

1/ Argentina: Central Government Balance. Excluding privatisation receipts

2/ Argentina: 30-d deposits interest rate in pesos; Brazil: SELIC rate

Chile / Colombia

	Chile 2005	Chile 2006f	Chile 2007f	Colombia 2005	Colombia 2006f	Colombia 2007f
GDP (%)	6.3	5.8	5.7	5.1	4.4	3.6
Consumer prices (%, end of year)	3.7	3.5	3.3	4.9	3.9	4.0
Trade balance ($bn)	10.2	12.0	3.8	1.4	0.6	-0.8
Current account (% GDP)	0.6	0.4	-1.8	-0.2	-0.7	-1.6
Reserves ($bn. end of year)	16.0	16.0	16.0	15.0	16.1	17.2
Exchange rate (end of year vs US$)	514	530	550	2279	2373	2453
Fiscal balance (% GDP) [1]	4.9	4.6	1.4	0.0	-2.0	-1.7
Interest rate (end of year) [2]	4.5	5.5	5.5	6.3	6.4	6.7
Real effective exchange rate (end of year, dic-97=100)	97	93	90	92	87	86
BBVA-MAP (end of year, jun-95=100)	107	92	75	151	158	155

1/ Chile: Central Government

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

Mexico / Peru

	Mexico 2005	Mexico 2006f	Mexico 2007f	Peru 2005	Peru 2006f	Peru 2007f
GDP (%)	3.0	3.6	3.2	6.7	4.7	4.7
Consumer prices (%, end of year)	3.3	3.3	3.5	1.5	2.5	2.5
Trade balance ($bn)	-7.6	-6.7	-12.4	5.2	4.0	3.0
Current account (% GDP)	-0.7	-0.9	-1.3	1.3	0.4	-0.8
Reserves ($bn. end of year)	68.7	73.0	75.0	14.1	14.5	14.0
Exchange rate (end of year vs US$)	10.63	11.30	11.70	3.42	3.28	3.40
Fiscal balance (% GDP) [1]	-0.1	0.0	0.0	-0.4	-0.6	-1.0
Interest rate (end of year) [2]	8.0	7.0	7.0	3.3	4.5	5.0
Real effective exchange rate (end of year, dic-97=100)	114	107	105	87	89	86
BBVA-MAP (end of year, jun-95=100)	193	203	194	113	110	102

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

Uruguay / Venezuela

	Uruguay 2003	Uruguay 2004	Uruguay 2005	Venezuela 2005	Venezuela 2006f	Venezuela 2007f
GDP (%)	2.2	12.3	6.2	9.4	4.1	2.9
Consumer prices (%, end of year)	10.2	7.6	4.9	14.4	15.3	18.1
Trade balance ($bn)	0.2	0.0	0.0	30.4	23.8	19.7
Current account (% GDP)	-0.5	-0.8	0.6	17.7	10.7	10.4
Reserves ($bn. end of year)	1.9	2.3	3.1	29.6	24.8	23.5
Exchange rate (end of year vs US$)	29.19	26.56	23.51	2150	2150	2580
Fiscal balance (% GDP) [1]	-3.2	-1.8	-2.5	1.6	-2.3	-3.1
Interest rate (end of year) [2]	7.5	5.7	n.d.	10.9	10.3	10.5
Real effective exchange rate (end of year, dic-97=100)	75	81	87	90	101	97
BBVA-MAP (end of year, jun-95=100)	86	89	81	286	296	278

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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