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Latinwatch

Economic Research Department

First semester 2007

Growing optimism for 2007

Oil: are current prices sustainable?

Orderly slowdown in credit growth

Signs of "Dutch disease" in remittances

China: solid growth and moderate risks

Index

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Editorial

When one evaluates the evolution of the Latin American economies in the past few years, there are two factors which are particularly relevant. The first refers to the big advances made in the area of macroeconomic stability. The second is that long-term growth continues to be disappointing.

While economic activity in Latin America has seen a significant pick-up in the past three years within a particularly favourable international environment, when one looks at the full economic cycle the performance is hardly impressive.

The region shows trend growth of about 3%, which, with growth in the population of 1.5%, amounts to average annual growth in GDP per capita of slightly above 1%. These figures are well below those recorded in other developing countries, particularly in Asia and Eastern Europe, and represent practically zero convergence in living standards with developed countries.

A study of some of the recent inflationary pressures in the region points generally to the existence of bottlenecks which start to emerge in economies showing rapid recovery paths, the norm being that most of these economies are growing at above potential.

One of the main factors behind low long-term growth is the performance of investment, which has stagnated at levels seen in 1980, with the biggest contribution coming from public investment compared with other components.

Total factor productivity has shaved 0.75 points off growth. In relative terms, compared with the 1950s there has been a deterioration in the productivity ratio compared with the United States, while in Asia there has been a considerable improvement.

GDP per worker as a proxy for the efficiency of the use of the factors shows a drop in its growth rate of 1.9 points in the period 1988-2003, with the average year-on-year growth scarcely 0.3%. Only Chile, with growth of 3.5%, comes close to the performance of the countries in Southeast Asia, where average growth over the same period was 4.5%.

Weak growth in the region has affected both countries which have taken on the pro-market reform agenda in the 1990s as well as those which have not.

While a consensus exists that reforms as a whole are desirable, the impact of these on growth varies between countries according to the existence of bottlenecks and how these affect them. However, there is also a consensus that reforms aimed at enhancing human capital and productivity, together with a favourable institutional environment which guarantees a stable and trustworthy legal framework are key elements in explaining the differences in the growth paths of the countries in the region.

This is perhaps the key issue in the sustainability of macroeconomic advances in Latin America beyond the current commodity-driven cycle; advances which pave the way for a sustained growth path capable of achieving the desired convergence towards standards of living closer to those of developed countries.

I. Economic and financial environment

International outlook

Global expansion in 2007

The year 2007 will be another good year of strong economic growth. Global activity, although slowing slightly, will expand at rates of over 4.5%. This will be the fifth year in a row with global growth over 4%, the strongest upward cycle since the oil crisis in the 1970s.

By region, growth will be strongest in the emerging economies, with Asia at the forefront. As regards the developed countries, the area which threw up the most positive surprises in 2006 was the euro zone. The euro zone will also perform better in 2007 than was forecast a few months ago, with growth rates reaching 2.5%. The bias in the forecast will even be slightly upwards.

The US economy is where there are most doubts in the light of the possible impact the slowdown in the real-estate sector could have on consumption. In addition, growing concern about the problems experienced by some higher-risk segments of the mortgage market (above all the *sub-prime* segment) add a certain degree of downward bias. There are in any case factors which limit the risk for consumption such as the strength of the labour market and income growth.

Non-residential investment will also continue to lend support, while for the first time since the mid-1990s there is no drag on growth from the external sector. We therefore remain optimistic for a soft landing in the US economy over the course of the next few quarters.

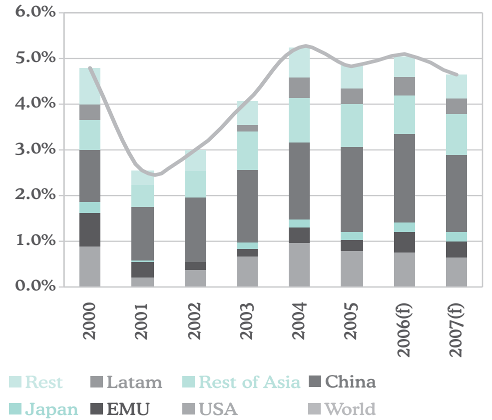
Our synthetic activity indicators for the United States (USA) and the European Economic and Monetary Union (EMU) show these differences in the cycle of the two regions. Whereas the boom in the United States is over, the indicators for Europe continue to point to relatively high growth rates continuing this year.

Renewed investment cycle and stabilization of global imbalances

The favourable evolution of investment is not confined only to the US economy. One of the main features of the current expansion cycle is that the corporate sector globally is very well placed. Corporate earnings will continue to grow at high rates. Forecasts for the US point to growth in earnings of over 10% in 2007. This would represent a slowdown from the 20% growth seen in 2006, a figure that has not been seen since the technology boom in 2002. This situation in turn will feed a continuation of merger and acquisition activity in the coming months, lending support to the performance of the stock markets.

The emerging world has not been left out of the investment boom. The investment/output ratio is at its highest level in the past 20 years. However, this dynamism is very much centred in the Asian economies, which have returned to levels seen prior to the crisis in the 1990s. This is not the case for other emerging areas such as Latin America and the Middle East where the ratios are well below the highs reached in previous expansion cycles. Despite this, the high savings rate of the emerging economies, above all Asia (a rate above that for investment) will continue to generate a pattern of global growth with significant imbalances. The gap in the current account between the group of countries which are net lenders (emerging countries) and net debtors (developed countries) will remain large at around 2.5 points of global output. This trend, however, already started to stabilize in 2006. In fact, the US deficit, currently above 6.5% of GDP, may have already touched its ceiling, and will start to narrow by about one point over the next two years.

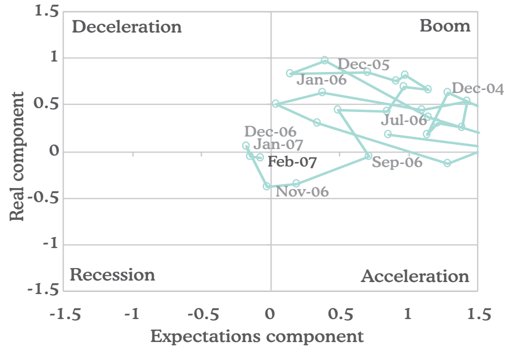
World growth and contribution by region (%)



Source: BBVA

BBVA-AI for USA

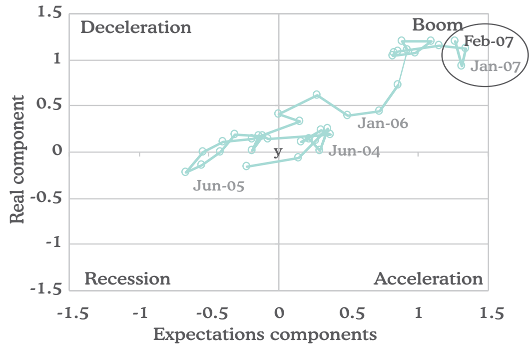
(3 mma)



Source: BBVA

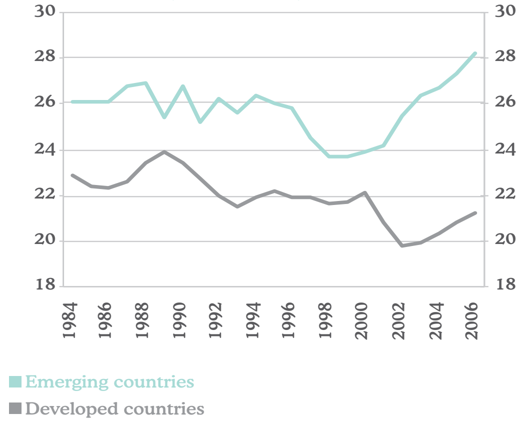
BBVA-AI for EMU

(mm3)



Source: BBVA

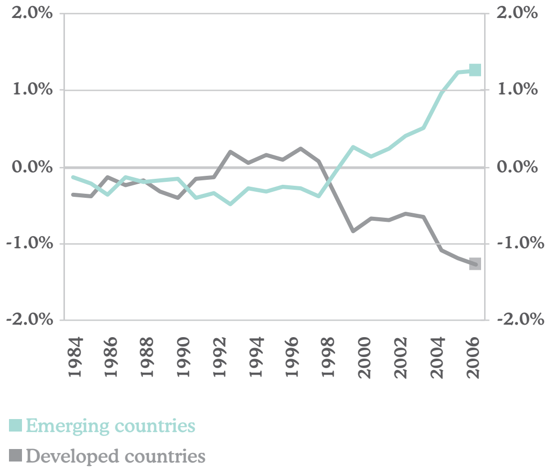
Investment (% of GDP)



Source: BBVA

Current account balance

(% of world GDP)



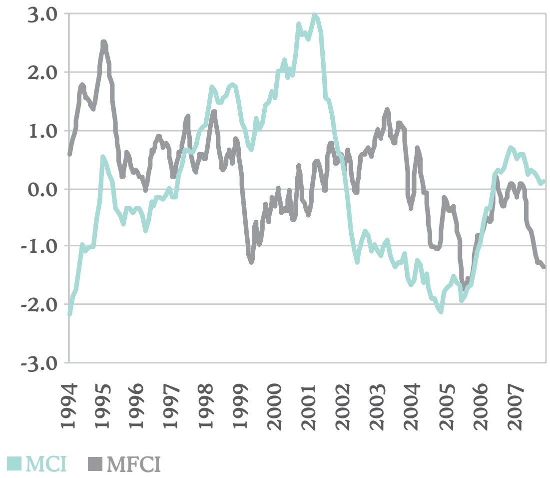
Source: BBVA using IMF data

Financial forecasts (end-year)

	2005	2006	2007e
Official rates			
USA	4,25	5,25	5,25
EMU	2,25	3,50	4,25
10 year rates			
USA	4,5	4,7	4,9
EMU	3,4	3,9	4,3
Dollar-euro	1,19	1,32	1,31

Source: BBVA

USA: MFCI and MCI*



* Using underlying inflation
Source: BBVA

Central Banks: the Fed under greater uncertainty

Monetary policy in areas such as Japan and Europe is returning to normal. In the case of the former, in addition to the pace of activity, forecasts of an upward trend in inflation will pave the way for a gradual increase in official interest rates to levels of around 1%. For its part, the ECB has scope to continue to raise interest rates, even to levels above 4%, given the outlook for stronger growth in the domestic economy.

It is in the US where there are still lingering doubts. The most likely scenario from our point of view is that the Federal Reserve (Fed) will keep interest rates on hold for the next few months in the light of forecasts for a slight slowdown in the economy, and with underlying inflation remaining high at levels above the Fed's comfort zone (2% for the underlying consumption deflator). The market, however, remains concerned about activity, and is once more betting on the Fed easing monetary policy in the final quarter of the year.

However, it should be taken into account that the monetary conditions of the US economy remain very accommodating, and the Fed will exercise a great deal of caution when it comes to considering a relaxation of its monetary policy. In fact, current financial conditions, including, apart from short-term rates, fixed-interest prices, equities and exchange rates, are more relaxed than when interest rates were at 1% in 2003-2004. The situation is similar in Europe where financial conditions are at levels similar to those seen in 2004 when the ECB held the official rate at 2%.

Risks remain local

The central scenario of high global growth, renewal of the investment cycle, inflation under control and neutral monetary policies, is not, however, without uncertainty. The balance of risks in the medium term are on the downside for interest rates and for a depreciation of the dollar.

These risks derive mainly from two sources. The first lies in a new oil-supply shock which sends crude prices soaring again, creating greater inflationary pressure in the short term, and recessionary effects in the medium term. However, although the geopolitical risk remains in place, the likelihood of this developing into a war scenario in Iran is still limited. In addition, medium-term expectations for inflation remain anchored, while energy-saving gains by economies appear permanent.

The main risk at present stems from the US economy. The concern in the next few months is centred on the real-estate and mortgage markets, and their potential impact on consumption. In fact, this has been one of the factors which have led to the current situation of pessimism in the global markets, with a general downturn in the stock markets, and with long-term interest rates at such low levels. The market's fear is that the problems currently isolated to the sub-prime mortgage market could spill over onto other segments in such a way as to put a significant clamp on credit which ends up affecting household consumption. At the moment, with all due caution, there are elements which lead one to the idea that this viewpoint lacks solid foundations. The sub-prime segment represents a very small proportion of the total mortgage market (7%) and households are in a favourable situation of financial solvency.

Situation and outlook for Latin America

Latin America closes 2006 with high growth

The first GDP figures for the fourth quarter of 2006 have been released in Brazil, Peru and Venezuela. These economies grew at an annual rate of 2.9%, 8.0% and 10.3%, respectively. With these data, our estimates for the major economies in Latin America[1] place GDP growth for 2006 at 5.2%, a little over one point higher than was expected at the end of last year. Growth has therefore remained high for the third consecutive year, with an average rate of expansion of over 5%, well above the average figure for the 1980s and 1990s.

Economic growth in the region has been gathering pace since the summer months of 2006. With data for all of the countries, the rate of GDP growth in the third quarter was 5.2% year-on-year. This was 0.8 points higher than the rate of growth in the April-June period. The countries where growth was strongest were Venezuela, Argentina, Peru and Colombia, with the latter two countries on an upward trend throughout the year. Mexico consolidated an improving performance, Brazil recovered a reasonable pace of advance, at slightly above 3%, and Chile posted somewhat slower growth. These data show, on the one hand, faster (and high) rates of growth in a number of economies and, on the other, the cyclical alignment that has characterised the region since 1994.

Lower inflation has led to easier financial conditions

The behaviour of inflation in Latin America has been equally positive. Apart from isolated episodes due to seasonal factors, there has been a clear downward trend since the middle of 2005. Inflation in consumer prices in the region has fallen from 6.9% in May of 2005 to 5.1% in December of 2006. Particularly noteworthy is the fall in Brazil over the past 12 months, from 6.4% to 3.1%, the result of the positive effects of applying an orthodox monetary policy. Most of the countries in the region today have rates of inflation more typical of the industrial countries, most notably Chile (2.6% in December) and Peru (1.1%).

The low inflation environment has, together with a favourable international financial context, made it possible to maintain or even improve financial conditions. The average interest rate in the major Latin American economies has come down by over 2 percentage points since the summer of 2005. A decisive contribution to the reduction in financing costs came from the loosening of monetary policy in Brazil and Mexico, the two countries that have had the tightest policy bias since 2004.

Lower interest rates in the region have been reflected in an upturn in domestic lending, which has helped to boost the growing contribution of domestic demand to growth in the different economies. The real volume of private lending in the major economies of Latin America has grown by an annual rate of 14% on average since 2004, with rates of increase in 2006 rising to over 25%[2].

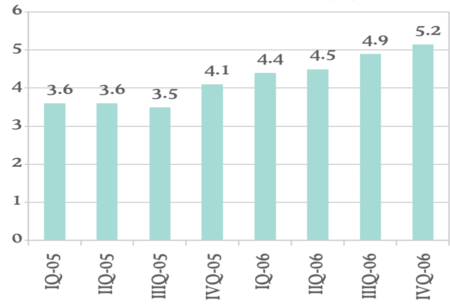
The terms of trade remain favourable

The BBVA-MAP commodity price index posted a rise of 13% in the fourth quarter of 2006 with respect to the same quarter of the previous year. With this advance, the increase for the whole year came in at 22%, accumulating in the 3-year period from 2004 to 2006 a rise of almost 100%. The price of metals (copper, gold, aluminium and silver)

[1] Throughout the text we refer in this way to Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

[2] See Article further along in this report for a more detailed analysis of the evolution of lending in Latin America over recent years.

Growth forecasts for 2006 (%)

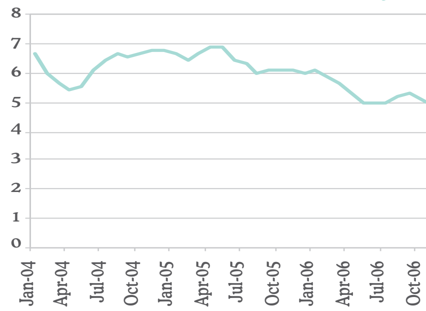


Source: BBVA

GDP growth in Latin America* (% oya)

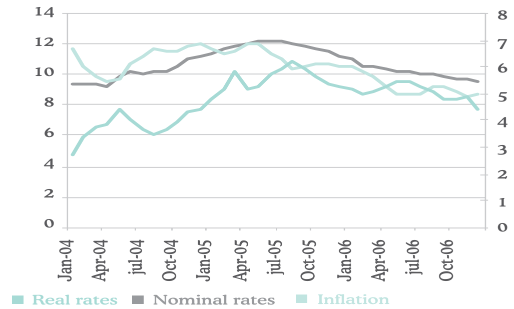
Source: BBVA *Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela

Inflation in Latin America* (% oya)



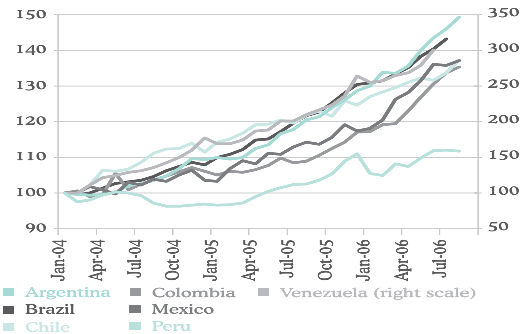
Source: BBVA *Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela

Weighted benchmark rates and inflation in Latin America* (%)



Source: BBVA *Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela

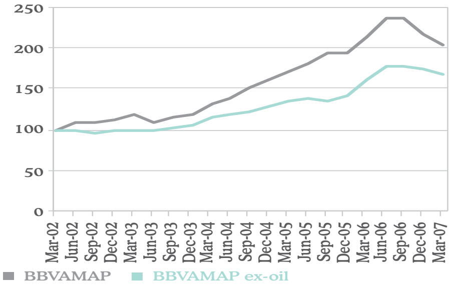
Real private sector lending (index, 100 = Jan-04)



Source: BBVA using IMF data

BBVA-MAP commodity price index

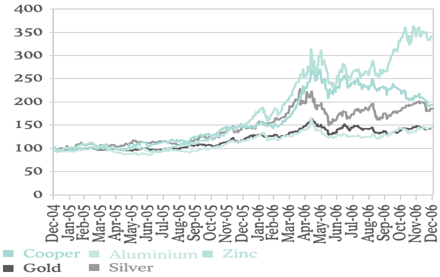
(index, 100 = Q1-02)



Source: BBVA

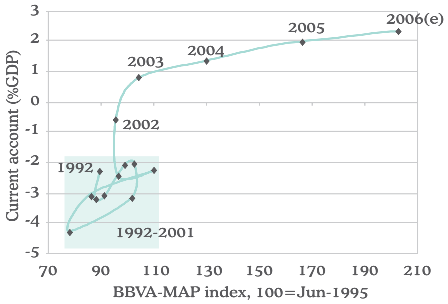
Metal commodity prices

(index100=31/12/04)



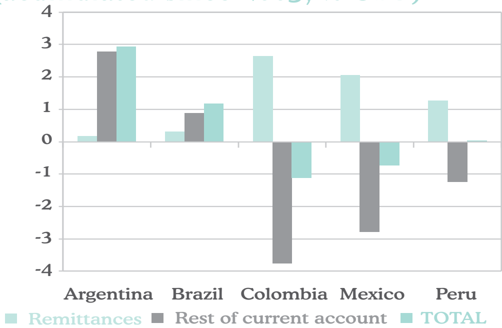
Source: Datastream

Terms of trade and current accounts



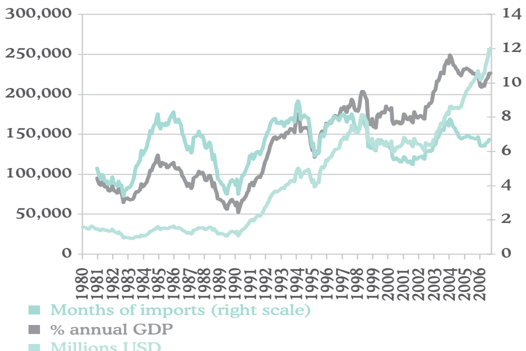
Source: BBVA (e) estimación

Current account balance (acumulated since 2003, % GDP)



Source: BBVA a partir de FMI

International reserves in Latin America*



Source: BBVA a partir de FMI; *Argentina, Brasil, Chile, Colombia, México, Perú, Uruguay y Venezuela

registered very significant increases, which had positive effects on the terms of trade of countries such as Chile and Peru. In the last quarter of 2006, soya and coffee also rose considerably (by around 20%), which benefited countries such as Argentina and Colombia.

For its part, oil has dropped back from the highs reached in August 2006, from close to $80 a barrel to $60 at present. This has helped to contain inflationary pressures in the oil-importing economies, while producer countries have been able to sustain high levels of receipts in the current account and from taxes. The prices of oil and other commodities currently stand much higher than the historical average, which affords Latin America a further cushion in addition to the strong domestic situation[3].

Positive impact on the current account...

High commodity prices have resulted in improvements in extraordinary income (through trade) in the current account of the different Latin American economies. This situation, together with stronger international growth, has made this the first sustained period of current account surpluses in Latin America as a whole, with an average of 1.6% of GDP in 2003-2006. Venezuela is a paradigmatic example of this, since its external accounts have benefited the most from higher oil prices, with surpluses at double-digit levels throughout the period. And also worthy of mention is Brazil, which, although specialising to a lesser extent in raw materials, has seen its traditional current account deficit swing into surplus thanks to exports of competitive manufactured products.

The strong current account performance is not only due to increasing export income; rising remittances from emigrants have also played a significant role in a number of countries. The best examples of this are Mexico, Colombia and Peru, where inflows of such funds over the period 2003-2006 have reduced the current account deficit in the first two cases and reversed the sign in the third. Elsewhere, these flows have been positive in Argentina and Brazil, but irrelevant in Chile and Venezuela[4].

The improvement in the current account has been accompanied by the consolidation of Foreign Direct Investment (FDI), an influx of financial flows into local markets and intervention by some central banks in order to check currency appreciation. The result has been uninterrupted growth in the level of reserves since the beginning of 2003 in the major Latin American economies, from a level of $144 billion in January of that year to $264 billion at the end of 2006. As a result, these assets as a percentage of the region's GDP currently stand at an all-time high and although strong real growth had moderated these figures, the percentage has risen further since the spring of last year, reflecting strong inflows of foreign currency. The situation in terms of the import cover of reserves makes for less positive reading, since this stands at just under 7 months and has been trending downwards since 2004.

...and on the fiscal balance

The positive surprises in GDP growth and commodity prices have led to overshoots in fiscal targets as established by the respective laws of the different Latin American countries. Countries that specialise in raw materials, with export-oriented companies and taxes, have received significant extraordinary revenues in the public coffers. In general, the use of these resources has been restrained, leading

[3] For more information, see Box which follows this article on the oil market situation and oulook.

[4] The Article further along on remittances includes an analysis of the impact on the real exchange rate of inflows of this kind for the recipient countries.

to record levels of fiscal surpluses. The region is estimated to have closed 2006 with a deficit of 0.5% of GDP, the lowest figure since the middle of the 1990s. However, it would be useful to establish fiscal rules similar to the one applied in Chile, taking into consideration cyclical aspects and deviations of commodity prices from long-term levels.

Political normality the norm in the electoral year

During 2006 elections were held in most of the Latin American countries, with the predominant climate being one of political normality and institutional stability. This development was reflected in financial markets in the form of currency appreciation, after the turbulence experienced in May and June, and continuing historically-low levels of risk premia. Investors only reacted to certain one-off events and in most cases in response to international factors, especially regarding interest rate expectations in the United States.

The new governments' economic teams are expected to stick to the more orthodox fiscal and monetary policies that have accompanied the improvement in the macroeconomic environment in the past few years. The international and domestic context today is a propitious moment in which to push ahead with the microeconomic reform agenda in order to consolidate the progress made and tackle the challenges that remain. The existence of an efficient tax system, more competitive goods markets, the elimination of rigidities in the labour market and a competitive education system are necessary aspirations, which will pave the way for stronger growth and greater social welfare in the future[5].

A healthy outlook for 2007

World growth will slow, but remain high, in 2007, while inflation should stay at historically-low levels. Within this context, commodity prices are expected to ease back moderately, and the volume of liquidity and low international interest rates will continue to support good financial conditions. We expect the BBVA-MAP index to move down 9% from its average levels in 2006, while our estimates, as we saw in the section on the international environment, point to an interruption of the Federal Reserve rate hikes and moderate increases in Europe and Japan.

In this environment, our projection for 2007 is for GDP growth of 4.5% in the major Latin American economies, 7 tenths of a point more than forecast at the beginning of 2006. Inflation is expected to remain subdued, and low in historical terms (5.4%), and most of the monetary authorities should meet their inflation targets. Current accounts and fiscal balances will reflect slower economic growth and a slight fall in commodity prices. As a result, the current account surplus is expected to narrow to 1% of GDP, and the forecast fiscal deficit is 1% of GDP. In sum, a macroeconomic environment which is better equipped than in previous periods to withstand whatever risks and uncertainties materialise.

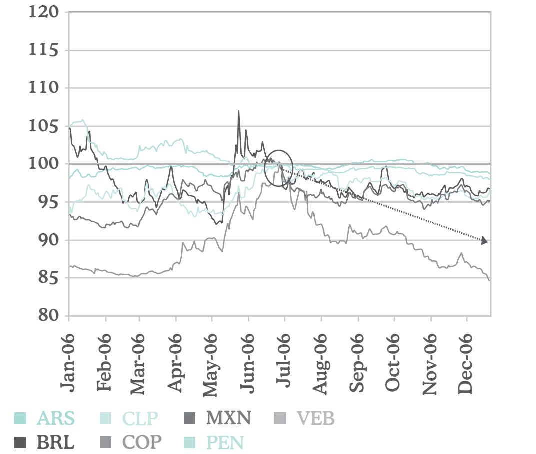
5 In an Article further along in this report, we analyse the alternatives for covering the outstanding social agenda.

Fiscal balance 2006 (% GDP)

	Deficit	BBVA estimate	Difference
Argentina	1,4	2,1	0,7
Brazil	-3,0	-3,0	0,0
Chile	2,3	7,6	5,3
Colombia	-2,0	-0,4	1,6
Mexico	0,2	0,2	0,0
Peru	-1,0	1,0	2,0
Venezuela	-5,6	1,1	6,7

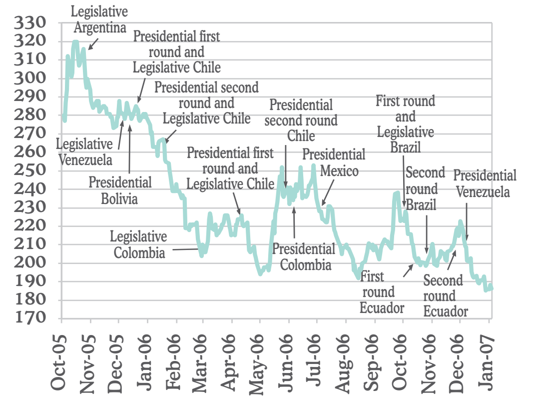
Source: BBVA and national statistics offices

Exchange rate (index, 100 = 28-Jun-06)*



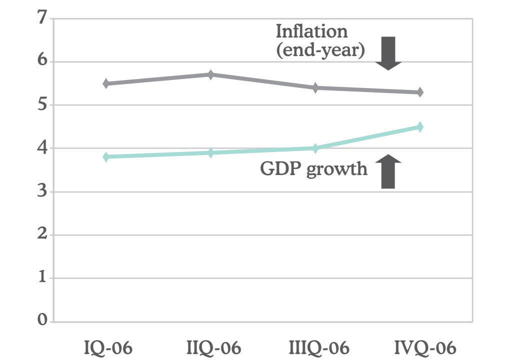
Source: BBVA using Bloomberg data; * A rise (fall) is associated with depreciation (appreciation) of the local currency.

EMBI+ (bp) and elections in Latin America



Source: BBVA, JP Morgan

Forecasts for 2007 (%)



Source: BBVA

Are current oil prices sustainable?

The price of oil has fallen 30% from the highs it posted in July 2006. The key factor behind this development has been the absence of the combination of factors that had impacted on the market, which were more a question of expectations rather than profound changes to fundamentals.

These include an easing of the geopolitical risk surrounding Iran, and strong supply, which has allowed significant inventories to be built up both in the United States as well as the rest of the main oil-consuming countries.

However, we have also experienced strong volatility as a result of one-off weather-linked factors, problems with some refineries and matters of greater depth such as announcements by the Bush administration on doubling the United States' strategic reserves of oil, the comings and goings of OPEC member countries in their views of the market, and the reappearance of potential conflict scenarios in Iran.

However, are these factors sufficient to drive a sustained recovery of the price of a barrel of Brent to average levels around those reached in 2006? According to our estimates, the answer to this question is that the prospect of Brent oil prices reaching $65.6 a barrel or higher has a probability of 25%.

Structural factors

From the point of view of structural factors in the market, we find ourselves in a situation in which supply is growing at 2.0% annually while the rate of growth of demand is 1.6%. Analyzing the factors underpinning the evolution of demand, we find that it is still buoyant growth in the emerging economies which will account for around 75% of the annual increase in demand expected in the next two years.

On the supply side, non-OPEC producers account for around 65% of growth in supply. OPEC countries, meanwhile, are adding around 470,000 barrels a day, which means levels of production of some 29.9 million barrels a day, similar to the average level of production registered in the third quarter of 2006.

The main factors which could cause supply to deviate from its current trend are production cuts by OPEC and tensions in Iran. On the demand side, aggressive policies of building up strategic reserves on the part of the US and China are the main source of potential surprises.

Baseline scenario (75% probability)

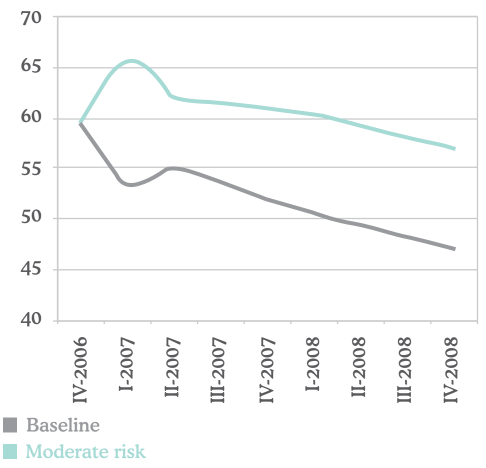
The baseline scenario is for growth in supply and demand to be as described above. On the demand side, an aggressive policy of building up strategic reserves of 11 million barrels by 2007 on the part of the US does not take place. As regards emerging countries, some of the potential increases in demand are beginning to be offset by efficiency gains by countries such as China and India. In the case of China, the policies being adopted by the government point to greater incentives to consolidate the progress already made and to make further improvements basically in the transport and industrial sectors.

On the supply side, the view is that further cuts in output on the part of OPEC will not take place basically due to the role of countries such as Saudi Arabia which are little convinced of the need to continue to cut production. In fact, in February a second cut of a further 500,000 barrels agreed in 2006 came into effect, making a total adjustment of 1.7 million barrels since the final quarter of last year. However, looking at actual production levels, the fact is that only 60% of the first agreed adjustment, some 720,000 barrels, has been put into effect, with Saudi Arabia responsible for 65% of this, while countries which most pushed for the cuts – Nigeria and Venezuela – started off from a situation in which they were producing less than their assigned quotas, so that their contribution to the cutbacks has been low. Recent statements by the Saudi authorities are beginning to ease pressure for compliance with the second round of cuts, and there is little likelihood of further adjustments being approved at the next OPEC meeting in March.

This scenario implies a phase of inventory building which should allow an average level of inventories equivalent to 87 days of demand in OECD countries. This represents a rise of 5% compared with the level at the end of 2006.

On the side of geopolitical risks, tensions remain in Iran, but without these having any impact on oil production in the country. A scenario of lower oil prices for Iran means greater fiscal pressure for the country. Between 2005 and 2006 the country registered a public deficit of 1% of GDP despite high oil prices. Public spending is running at close to 40% of GDP, with transfers in the form of social spending accounting for a fourth of the total. A scenario of lower oil prices in an environment of an increasingly interventionist economic policy would imply an average deficit for 2007

Brent oil price scenarios (USD per barrel)



Source: BBVA

and 2008 of 6% of GDP. Increasing domestic imbalances constitute one element which reduces the likelihood of the situation developing into one of conflict. In this sense, there have been statements by high-ranking Iranian officials blaming Saudi Arabia for bringing about lower prices, which in a situation of public deficits, would put the brakes on the development of the country's nuclear energy programme.

The sum total of all of this implies an average price for a barrel of Brent for 2007 of $53.5, a fall of 22% compared with the previous year.

Risk scenarios (25% probability)

The risk scenario comprises two components, one moderate the other extreme.

The first deviates from the baseline scenario by assuming on the demand side that the US and China build up strategic reserves at a rate of 350,000 barrels per day throughout the rest of the year. On the supply side, it assumes compliance with the cuts agreed by OPEC, which would mean a reduction of 1 million barrels per day over output levels in January. This moderate risk scenario has a probability of 20% of occurring. The average price of a barrel of Brent would be $62.6 for 2007 and $58.6 for 2008.

The extreme risk scenario has a probability of occurring of 5%, and can be divided into two elements. The first implies an escalation of the situation in Iran which ends up with the country stopping output. The average price of a barrel of Brent crude would be $80 for 2007. The probability of this scenario occurring is 4%.

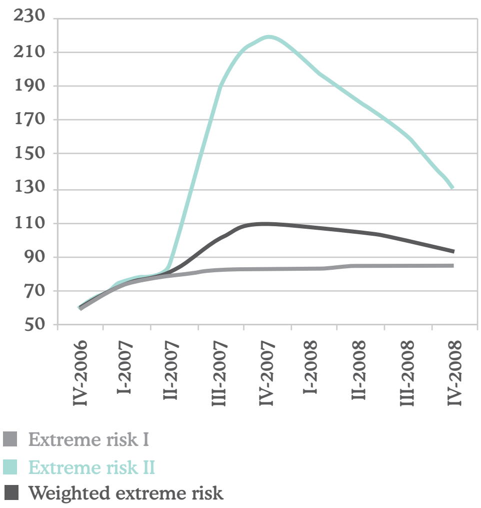
The second also assumes problems in the Strait of Hormuz through which 17 million barrels of oil pass daily. The average price of Brent crude would rise to $142 per barrel in 2007. The probability assigned to this scenario materializing is 1%.

The weighted price of a barrel of oil under the extreme risk scenario would be $92.4 for 2007.

Effects on the region

The changes to the price of oil and derivatives contemplated under the baseline scenario would result in an average fall in the current account balance in Latin America equivalent to 0.6 points of GDP. The countries in the region that are net importers would see an average improvement in their current account position of 0.8 points, while exporters would see an average deterioration of 1.9 points.

Brent oil price scenarios
(USD per barrel)



Source: BBVA

Among the countries where the positive impact of lower oil prices on the current account is greatest, Paraguay, Chile and Brazil stand out with 1.9, 1.5 and 0.4 points of GDP, respectively. In contrast, the biggest negative impact is felt in Venezuela with the equivalent of 7.1% of GDP, and in Mexico with 1.1% and Argentina with 0.5%.

In terms of flows, this would result in an improvement for net importers of $9.7 billion in 2005 dollars, while for exporters it would entail a loss of $24 billion in 2005 dollars. The net effect for the region would be a drop in flows of $14.3 billion, half of which would correspond to Venezuela and Ecuador.

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II. Economic observatory

Credit boom in Latin America. Are there reasons for concern?

Lending to the private sector has grown spectacularly in the major countries in Latin America. Growth in lending measured in real terms over the past two years has averaged between 10% and 15% annually in all of the countries in the region with the exception of Peru where the rate of growth was 4%, and Venezuela where credit expanded in the past two years at an average rate of 40%.

At first sight, it could be argued that this development is a reflection of global factors which are basically affecting all emerging countries. The current point in the global cycle is to a large extent responsible for this broad growth.

With these figures, it can easily be said we find ourselves in a credit boom. However, although the figures seem high, one needs to point out that the increases are below those seen in other boom periods which were followed by busts. During the previous boom in the 1990s, growth in lending was above that seen currently.

Although the real growth rates of lending in a number of countries are above the highest rates observed in previous boom cycles, in many of these countries the levels of lending are still below their peak levels. Measuring the size of the credit portfolio relative to the size of the economy, only Chile and Colombia show all-time high levels of real lending, while only in Chile is the level (73% of GDP) close to that of the industrial countries. In Brazil, the stock of credit is the equivalent of one-third of GDP, while in Colombia it amounts to 24% of GDP. In the other countries in the region, credit is equivalent to less than one-fifth of GDP, well below the levels observed in the other emerging countries in Asia and Europe.

In all of the countries with the exception of Chile, lending is recovering from very low levels. An increase in the ratio of credit to GDP is normal in countries that are experiencing a process of re-intermediation. All of these countries have also gone through a process of financial system restructuring which coincided with significant falls in intermediation and ratios to historically low levels. Moreover, when growth in lending is adjusted for the economic cycle, it is found that the rate of expansion is not exceptionally high in this recovery cycle after a prolonged period of quasi-recession.

Analysis of lending busts in Latin America

The habitual detonators of financial crises in Latin America have derived from external shocks or an interruption of capital flows which have firstly affected liquidity levels linked to potential adjustments to exchange rates, which in turn have caused a run against local currencies with an accompanying undermining of solvency by the transmission of the crisis to the real sector. The Latin American economies have traditionally been exposed to such interruptions in flows in part due to inappropriate management of economic policies. Credit busts in the region have been the result not so much of high credit stock levels but of other imbalances

Traditionally, strongly expansionary fiscal policies led to high levels of public debt increasingly more expensive to finance. The impotency of monetary policy in fixed exchange-rate regimes, which normally maintain overvalued currencies, reduced governments' room for manoeuvre while at the same time creating growing current account deficits.

On the other hand, low factor productivity (during a large part of the 1980s and the first half of the 1990s), and the low savings rate of these economies swelled levels of public debt and worsened financial conditions. In economies little open to trade, the unsustainability of the exchange-rate regime given the need for devaluations in order to gain

Average annual real growth rate in private lending in last 2 years

Argentina	15.1%
Brazil	13.2%
Chile	14.8%
Colombia	14.9%
Mexico	10.2%
Peru	3.7%
Venezuela	40.0%
China	9.0%
Croatia	12.4%
Czech Republic	14.6%
Hungary	14.2%
India	20.0%
Indonesia	10.4%
South Korea	1.5%
Lithuania	44.4%
Malaysia	4.5%
Russia	25.9%
Slovenia	14.7%
Thailand	3.3%
Turkey	34.5%
Ukranie	27.5%

Source: BBVA

Real private lending growth
(previous boom)

	% annual	Years
Argentina	13.4%	96-98
Brasil	9.3%	92-94
Chile	21.0%	80-82
Colombia	12.6%	96-98
México	21.9%	92-94
Perú	17.5%	96-98
Venezuela	22.0%	95-97

Source: BBVA

Stock of private sector credit
(% of GDP)

	2006	Max	Year of Max
Argentina	11.7%	0.0%	1999
Brazil	34.5%	82.2%	1993
Chile	72.8%	72.8%	2006
Colombia	23.7%	23.7%	2006
Mexico	16.9%	38.7%	1994
Peru	18.1%	28.3%	1999
Venezuela	12.3%	33.4%	1978
China	114.9%	141.7%	2003
Croatia	60.8%	60.8%	2005
Czech Republic	36.7%	76.5%	1994
Hungary	51.7%	51.7%	2005
India	41.2%	41.2%	2005
Indonesia	26.0%	60.8%	1997
South Korea	92.3%	94.4%	2003
Lithuania	34.9%	34.9%	2005
Malaysia	116.7%	154.9%	1997
Russia	25.7%	25.7%	2005
Slovenia	53.8%	53.8%	2005
Thailand	93.1%	165.7%	1997
Turkey	25.4%	25.4%	2005
Ukranie	33.4%	33.4%	2005

* In grey, historical highs
Source: BBVA

competitiveness intensified the scale of the exchange rate adjustments, and the balance-sheet effect on foreign debt from depreciation brought on recession.

In previous crises there was a consensus that these had been proceeded by a period of strong expansion in lending along with a weak regulatory framework and financial supervision, as well as the existence of protection authorities which increased risk-taking on the part of depositors, lenders and financial institutions.

When the growth in lending began to lose support in the real sector, this created a situation of over-indebtedness which normally ended up with an increase in interest rates and non-performing loans.

This time around, however, and although countries are not exempt from risk, greater macroeconomic stability and an improvement in macroeconomic fundamentals have reduced fears of a sharp fall in lending.

Based on the evidence linking the wealth of an economy, as measured by its GDP per capita, with the stock of private credit, the natural tendency would, therefore, be one in which lending continues to increase over the next few years as part of a catching-up process with other emerging economies and above all developed ones.

Economic growth, the absence of macroeconomic imbalances, macro stability as a whole, the development of an adequate regulatory framework (Basel), the depth of the financial market (reaching a greater percentage of the population) and the development of private-sector banks at the expense of public banks are factors which have a positive impact on "healthy" growth in lending in contrast to the volatility seen in previous periods of boom followed by bust. Let us examine which of these factors have seen an improvement compared with previous cycles, and which still have room for improvement.

Similarities with previous boom periods

In the first place, the current situation is one of an upward cycle in commodity prices on which to a large extent the Latin American economies are dependent. Volatility in commodity prices has historically impacted activity in the region. Some of the lending booms have coincided with the wealth effect created by high commodity prices. Given that the dependence on commodities has not diminished over time, in this sense part of the current boom is due to the strong growth in the prices of these.

As on previous occasions, while the wealth effect has an impact on lending in general, growth in consumer credit has been greater than that of credit to companies and mortgage lending. As such, resources are not channelled towards investment projects guaranteeing the future growth of the economy (in general, investment as a percentage of GDP in the region has failed to increase in the past few years). As a result, the economies in the region remain exposed to a certain degree of instability given the greater volatility of consumer credit.

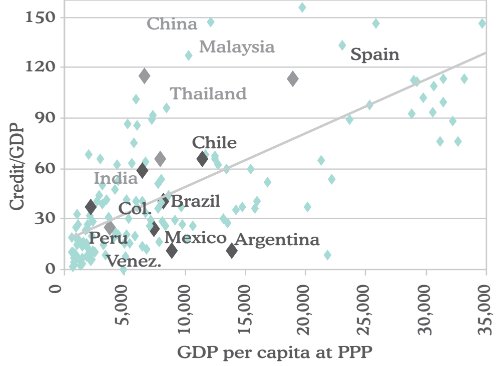
As in previous years, another notable feature is that a large part of the lending to the private sector in some countries still comes from the public sector. This type of lending tends to go to sectors or companies, which because of their characteristics, are little efficient or add little value, such as the case of agriculture. In some countries, such as Brazil, such lending represents 40% of total private credit.

As a result of this, credit in Latin America is, as on previous occasions, vulnerable to the end of the wealth effect generated by the price of the commodities the region exports.

Differences with other periods of booms in lending

Many of the countries in the region, however, have made a lot of progress in the area of macroeconomic stability in the past few years. As mentioned above, the imbalances created by excessive and

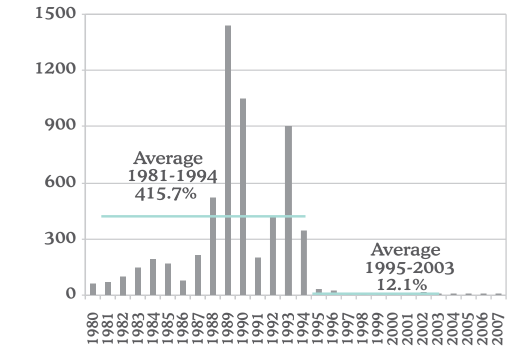
Ratio of credit to GDP and per capita income in 2005



Source: BBVA using World Bank data

Inflation in Latin America

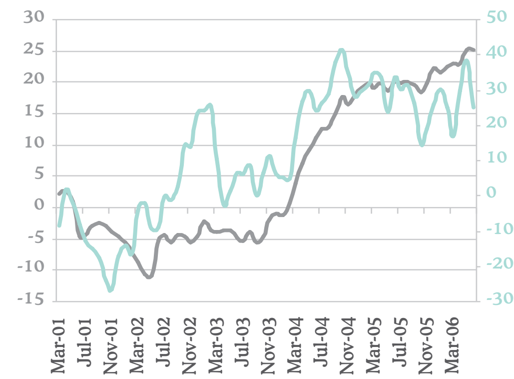
(annual % change in CPI)



Source: BBVA

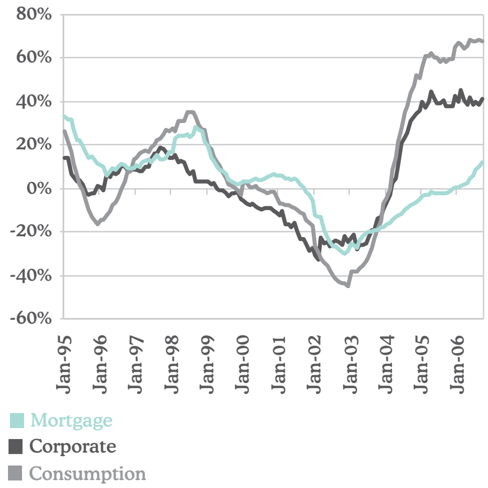
Latam: private lending and commodity prices

(annual growth)



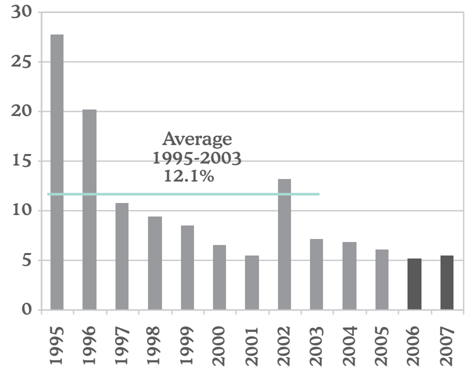
Source: BBVA

Argentina: growth in lending



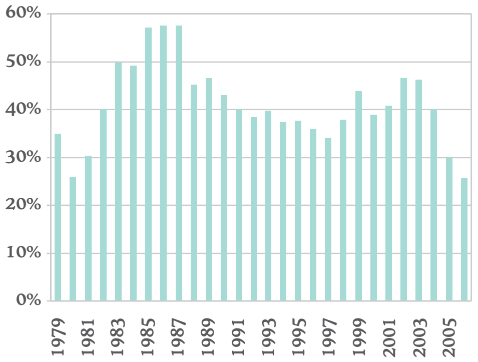
Source: BBVA using BCRA data

Inflation in Latin America
(annual % change in CPI)



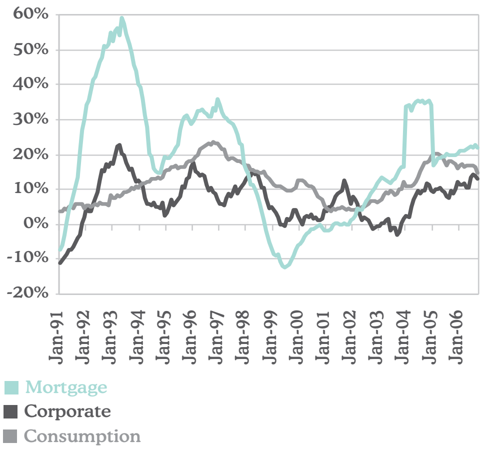
Source: BBVA

Latin America: foreign debt
(% of GDP)



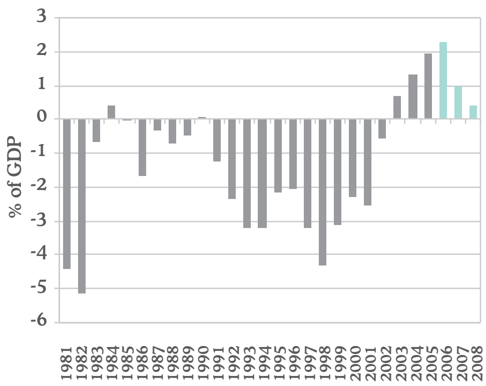
Source: BBVA using IIF data

Chile: growth in private lending



Source: BBVA using BCCH data

Latin America: current account balance



Source: BBVA

inadequately directed public debt, which did not result in greater economic growth, have traditionally been the cause of foreign debt and balance of payments crises.

High levels of debt which required prohibitively high interest rates have been reduced in the past few years. The total debt of the region is about half of what it was only four years ago as a percentage not only of GDP but also regional exports. Two points stand out here: firstly, the effort governments have made taking advantage of the current situation to restructure their debt, making early repayments and increasing maturities. Secondly, the region's opening up to trade, with trade flows doubling in the past decade.

As a result, the external solvency of the region has improved notably. From a situation of current account deficits of 4%, Latin America now enjoys sustained surpluses, reducing the possibility of repeating the balance of payments crises of the past in the medium term. The building up of foreign reserves also is a reassuring factor.

The absence of such crises and the implementation of mechanisms to avoid them in future, such as imposing limits to the levels of public debt through fiscal rules that guarantee fiscal responsibility, and the independence of central banks in carrying out monetary policy have had the effect of reducing volatility in economic growth, and with this the danger of a lending bust.

In addition, the region's financial markets have deepened in the past few years. The degree of banking penetration in Latin American countries is now greater, and this carries with it a natural increase in demand for credit.

From the point of view of the supply side, the existence of an efficient private banking sector, in large part foreign, at the expense of public banks, and the progress made in the area of banking and financial regulation (Basel I and II) guarantees a more secure banking system. In this area, the Latin American banking system is well ahead of other emerging countries.

The main risk in the short term to continued growth in lending lies in the appearance of inflationary pressures in those countries which are currently growing above potential, thereby requiring higher real interest rates which hold back the growth trend in lending. However, there is no reason to expect a sudden fall as in the past.

Could a financial and banking crisis as seen in Asia in 1997 develop?

The Asia crisis went down in history as the first big financial crisis in the era of globalized markets. It was a purely financial crisis, with most of the economies it hit enjoying solid macroeconomic fundamentals.

In particular, the restoration of financial health to the public accounts, with public deficits under control (or even surpluses) during the years of strong growth, brought with it relatively low levels of public debt, and contained and stable rates of inflation, all within an environment of controlled exchange rates (fixed or semi-fixed regimes).

Also, all of the countries opted for export-led growth policies based on the comparative advantage of cheap labour. High domestic savings rates allowed spectacular growth in investment, which eventually led to some sectors of the economic being over-dimensioned. In this way, growth was largely due to the accumulation of capital, with growth in productivity falling. In an environment with free capital flows and fixed exchange rates, dollar-denominated debt rose rapidly. In addition, the impossibility of putting appropriate monetary policies in place led to money supply growth, and with this an increase in domestic bank credit. When added to this you also have inadequate banking regulation and poor quality bank assets, the loss of confidence on the part of the markets is understandable.

With the growing dependence on short-term financial flows, currencies eventually suffered a sharp depreciation which had a very pronounced effect on real activity. Thus, gross fixed capital formation, the main economic engine, registered real contractions of between 20% and 50% in a single year, accompanied by slumps in consumption and credit as well as rising bad debt ratios. Over-investment was an imbalance that needed to be corrected, given the lack of any appreciable gains in productivity. And the poor regulation of the banking system aggravated the correction in investment, consumption and credit.

There are certainly some similarities between the current situation in Latin American countries and Asian countries in 1997 prior to the crisis. Firstly, macroeconomic discipline is the norm in the region, where, with some exceptions, inflation remains under control and public balances carry slight deficits or even surpluses. In the past few years, foreign debt has fallen to levels even below those seen in Asia in 1997. The relatively free flow of capital is also something they have in common. The current account surpluses in the region are proof of a lack of imbalances also in this area. However, one of the characteristics shared with pre-crisis Asia is the low contribution of productivity to economic growth.

On the other hand, there is a whole gamut of features which make the current situation in Latin America different from that in Asia in 1997.

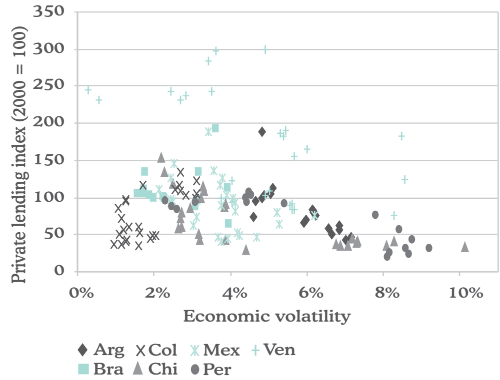
Beginning with the levels of private lending reached. With the exception of Chile, credit levels in the rest of the countries in the region are well below those seen in Malaysia, Thailand, Indonesia and the Philippines prior to the crisis. In addition, while in those countries credit levels were at maximums in 1997, in Latin America, only Chile and Colombia have credit levels at historical highs, and in the case of the latter lending does not represent even a quarter of output.

In addition, rates of saving and investment in Latin America are substantially below those in Asia in 1997. It is difficult to argue that there are signs of over-investment in some sectors. Also, the injection of flexibility in foreign exchange markets in the 1990s, together with the application of monetary policies that pursue compliance with explicit inflation targets in most countries, means that market exchange rates assume a large part of the burden of adjustment instead of all of it falling on interest rates. Even if a particular currency did become overvalued, the reduction in external debt and the accumulation of reserves over recent years should help to cushion the effects of a potential correction of this imbalance.

Lastly, the banking markets in the region are more solvent than they were in Asia in 1997. The regulatory mechanisms in place in the Latin America economies put them at the forefront of emerging markets in terms of regulatory quality. In addition, the quality of credit in Latin America is higher than in Asia. As a result, the highest non-performing loan ratios reached in periods of crisis in Latin America are lower than those seen in Asian countries. To a large extent, the privatization of a large part of the Latin American public banking sector in the 1990s has helped lead to the appearance of better risk-management techniques.

In short, the adjustments to the rate of growth in lending which could exist, and which could cause an increase in non-performing loans, would be linked more to the natural slowdown in the economy as one of the strongest expansion cycles enjoyed by the region runs its course. A financial crisis along the lines seen in Asia is not on the cards in the short term, and neither is one along the lines seen in Latin America in the past with accompanying huge imbalances.

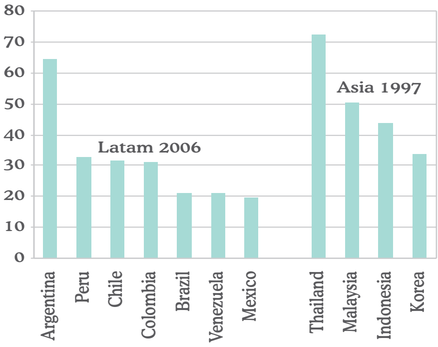
Lending and macroeconomic stability



Source: BBVA using IMF data

External debt

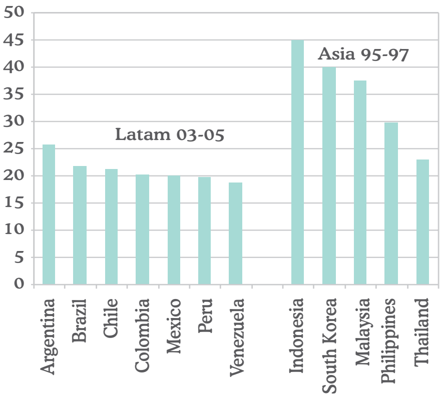
(% of GDP)



Source: BBVA using IIF data

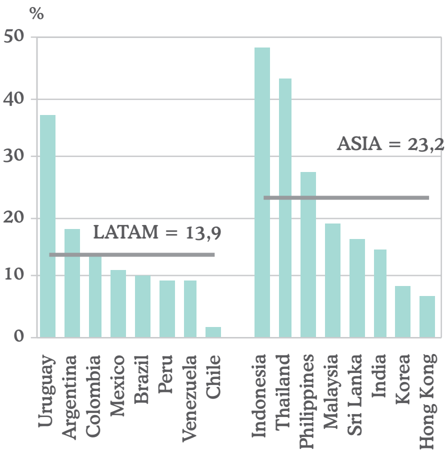
Investment

(% of GDP)



Source: BBVA en base a IIF

Highest non-performing loan ratio in crisis (98-06)



Source: GFSR - IMF

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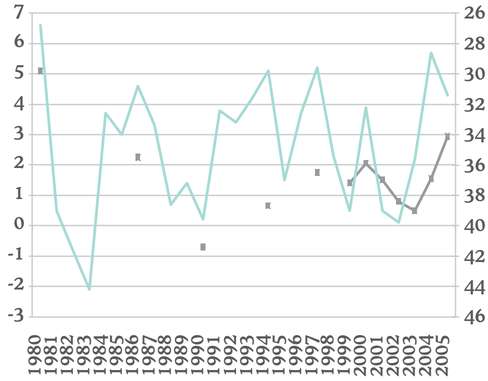
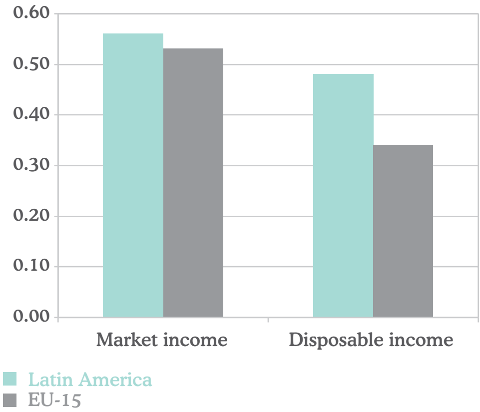
Growth and poverty in Latin America



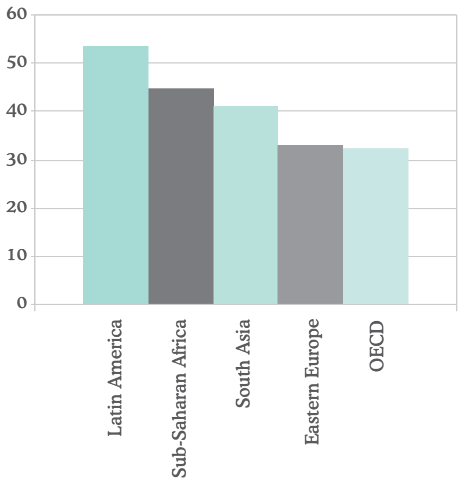
Source: FMI and Cepal

GINI index before and after public spending



Source: World Bank

GINI index
(regional average*)



* Several years
Source: BBVA using World Bank data

Growth: The real antidote to poverty

The current state of the economy has had considerable sway on the political debate in the region. This debate has also been marked in the past year by a heavy election agenda in which 12 presidential elections have been held since November 2005. In general, the results of the elections have thrown up a picture in which there are two clear visions of the issue of poverty in the region.

The first argues that in order to tackle the problem, income redistribution policies need to be put in place. The second school of thought contends that this is not enough, and that the priority should be on policies to promote growth, and thereby income.

An efficient economic policy strategy directed at reducing poverty should assign priority both to policies aimed directly at promoting economic growth as well as policies to address poverty which indirectly stimulate growth.

The evidence indicates that policies directed at overcoming poverty have the potential to generate a virtuous cycle of less poverty and more growth. On the other hand, policies in the struggle against poverty which have the potential to produce a net positive effect on long-term economic growth are in essence those which contribute to the accumulation of human capital on the part of the poor (such as transfers conditioned to school attendance and other incentives to promote education, improvement in heath care facilities made available to the poor etc.).

This is a key factor, given that poor households are exposed to lower-quality schools and liquidity restrictions, and as a result do not invest enough in the education of their children, thereby in turn limiting growth in human capital in society as a whole. Individuals with inadequate nutrition and poor health learn less and produce less than those who have access to quality health services..

Macroeconomic policies aimed at reducing volatility in growth are also key, since swings in growth are particularly harmful for the poor given their limited access to financial and insurance facilities.

From the point of view of supply, when one analyses the factors which make a country more or less attractive for investment, one finds that low quality institutions, deficient infrastructure and low health and educational levels are detracting elements.

These elements must be at the core of policies aimed at combating poverty in order to guarantee that progress in this struggle is sustained in the medium-to-long term. Policies directed only at income distribution have left these issues to one side, and this has been the main reason behind their failure to reduce poverty in a sustained manner.

In order for these lessons to translate into viable policy initiatives, one needs to arrive at an understanding of the political-institutional reasons behind the failure of Latin American governments to adopt growth-centred policies aimed at fighting poverty. There are two examples which illustrate this point:

(i) It is not out of ignorance or ineptitude that a number of Latin American governments persist with massive and indiscriminate subsidies for energy and higher education. This is more the result of a resistance on the part of society for their removal which is capable on many occasions of putting democratic stability at risk.

(ii) In Latin America, where democratic government is the norm, the poor are not necessarily passive elements in economic policies. On the contrary, through their participation in the electoral process, they tend to mark the characteristics of the government and its policies. In this context, the question that poses itself, therefore, is how to persuade poor voters, who constitute the majority, to vote for conditioned transfer and subsidy policies as opposed to non-conditioned ones.

The results of recent elections in the region provide a few clear answers to this question. The bulk of the governments which were elected or re-elected can be described as moderate progressive. While they assume goals of equality or the improvement of the living standards of the less well-off sectors of society, they also seem to be committed to prudent fiscal policies, sound macroeconomic governance, openness to trade and foreign investment as the pillars of sustained long-term economic growth.

With few exceptions, the conviction exists in the region that the best policy to tackle poverty is to promote stability and growth.

Remittances and poverty

One of the new developments in the past few decades has been the emergence of remittances to the region. These have doubled in terms of their contribution to GDP, compared with the levels seen in the 1990s. For many analysts, this should have been a driving factor in the reduction of poverty and inequality.

While this is true, the impact, however, has been limited. The latest World Bank report for Latin America on this subject[1] indicates that for every additional point of increase in the contribution of remittances to GDP, the percentage of the population living in poverty falls on average by 0.4 points, while the impact on indicators of income distribution is scant.

A key factor to consider is that these modest results could end up being a source of contention in the long run if we take into account the impact on growth of the loss of part of the most qualified human capital from these economies. A loss (gain) of one year of schooling produces a loss (gain) in average productivity per worker in the range of 5-15%[2]. Apart from this first-round impact, one would have to examine the final impact of remittances on the increase in the number of years of schooling as in itself an incentive to spend more years at school.

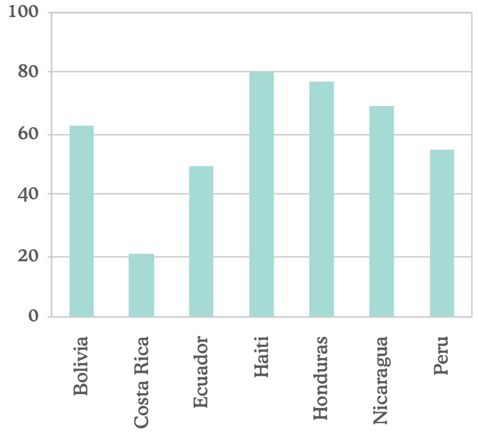
Given the inconclusive evidence of the impact of remittances, growth once again becomes the factor which has the biggest impact on reducing poverty. As an example of this is China, whose long period of growth of rates above 6% has allowed 200 million people to emerge from poverty.

1 "Close to Home: The Development Impact of Remittances in Latin America": http://siteresources.worldbank.org/INTLACOFFICEOFCE/Resources/ClosetoHome_FINAL.pdf

2 Barro, Robert J. "Economic Growth in a Cross Section of Countries." Quarterly Journal of Economics 106 (May 1991). pp. 407-43.

Countries with policy continuity*: Level of poverty

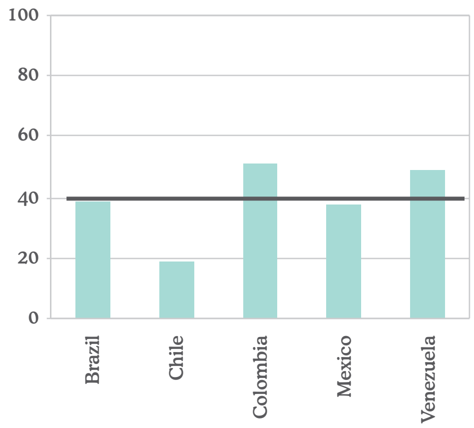
(% of total population)



* Countries in which the president or party in power wins another term in office.
Source: Cepal

Countries with a new executive: Level of poverty Average

(% of total population)



Source: Cepal y CIA World Factbook. Varios años

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Dutch disease in remittances?

Holland's discovery of natural gas in the North Sea in the 1960s gave rise to large increases in foreign currency income which led to a real appreciation of the exchange rate, a factor which may have contributed to the industrial decline of the country. This phenomenon, later labelled as the *Dutch disease*[1], has historically been linked to commodities, with examples as old as the massive inflows of gold to Spain in the 16th century to finance its wars. However, and despite the existence of current examples of this (such as Russia with its oil and natural gas), research has also focused on other flows which can end up producing negative effects on the economic structure of a country. This is the case of official development aid and private transfers by emigrants. This article focuses on the latter, and attempts to answer the following question: Do remittances bring about an appreciation of the real exchange rate?

Remittances and competitiveness

The growing importance of remittances in the current account of a large number of countries in Latin America has already been highlighted on a number of occasions in this publication and is not the focus of this current article. Our purpose here is to focus on the macroeconomic effects of these flows, following up on what we merely noted in "The process of Latin American emigration", the article published in the Third Quarter of 2006 *Latinwatch* edition. That article referred to the impact of this process on the countries of origin, highlighting among other things greater stability in flows of foreign currency, the loss of human capital, and inflationary pressures deriving from higher spending per capita. In addition to all of the above, which amount to theoretical hypotheses which need to be backed up with empirical study, one needs to add the potential negative consequences of a significant appreciation of the real exchange rate (RER)[2] on the exporting industry, and if the level of openness to trade is high, on the economy as a whole.

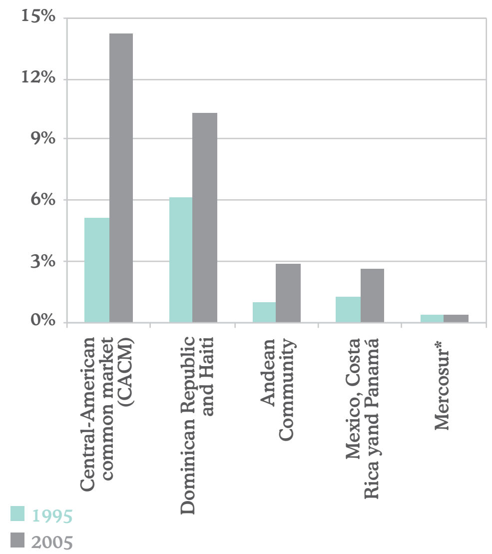
A significant inflow of remittances, besides increasing demand for the local currency (an appreciation of the nominal exchange rate), also entails an injection of disposable income for households, and thereby impacts on their spending and saving decisions. If the bulk of this goes to final spending on goods and services (as opposed to investment), this puts upward pressure on domestic prices and salaries, undermining the competitiveness of the economy. The ultimate impact on the RER will depend to a large extent on imports driven by the additional spending deriving from remittances. A greater preference for foreign goods will have a negative impact on the trade balance (through outflows of foreign currency), which could wipe out the impact of remittance inflows.

Figures on the use of flows sent by emigrants have been produced in *ad hoc* studies on individual countries, but these are not published regularly. A homogeneous base for comparison is, therefore, not available. Despite this, it can be said that most of the additional income generated by remittances goes to current spending on food, clothing, and other basic goods, with the tendency to save being limited. As regards the offsetting effect of imports, a simple correlation analysis shows that this is indeed the case to varying degrees in a number of countries in Latin America. That said, there are other factors that weigh on the volume of imports in an economy, such as the signing of bilateral trade agreements. This invites caution when it comes to making generalizations about the observed results, with these requiring more careful analysis.

Methodology: determinants of the real exchange rate

The aim is to gauge whether remittance flows cause an appreciation of the real exchange rate, taking the deterioration of the competitiveness of the export sector of the economy as a proxy. The focus of this section is to establish the main factors impacting on the RER. This will allow us to control for the impact of variables other than the foreign currency created by emigrant fund transfers. There are a number of varied approximations in the literature, but by way of compilation, the following factors, along with

Gross remittances as a % of GDP



Source: BBVA; the 1995 data only include Argentina, Brazil and Paraguay. NOTE: The CACM comprises El Salvador, Guatemala, Honduras and Nicaragua; the Andean Community comprises Bolivia, Colombia, Ecuador and Peru; and Mercosur Argentina, Brazil, Paraguay, Uruguay and Venezuela.

Correlation coefficient between growth in gross remittances and imports (1980-2005*)

Dominican Republic	0.90
Paraguay	0.69
Haiti	0.68
Peru	0.64
Brasil	0.35
Mexico	0.22
Ecuador	0.21
Bolivia	0.21
Guatemala	0.04
Argentina	-0.14
El Salvador	-0.15
Nicaragua	-0.16
Honduras	-0.18
Panama	-0.22
Costa Rica	-0.29
Colombia	-0.34

Source: BBVA using IMF data
*For the years available

[1] In the article "The Dutch Disease" in the November 26, 1977 issue of the *The Economist* magazine.

[2] Referring always to an effective exchange rate. That is to say, one drawn up on the basis of bilateral exchange rates and the consumer price indexes of the main trading partners of the country in question.

the chain of effects they induce, can be identified[3] :

- Productivity: Greater technological development can lead to an increase in the relative price of services over goods for export (the Balassa-Samuelson effect).
- Terms of trade: Increases in prices of exported products, in general, commodities whose prices are set by international markets, improve the current account balance and may boost domestic liquidity.
- Fiscal policy: A significant increase in public spending normally leads to an increase in the level of domestic inflation.
- International aversion to risk: A fall in the risk premium has a positive effect on the financing costs of emerging economies and on capital flows.

In order to carry out the estimates, we have chosen variables which gauge the factors identified above and for which historical series of figures are available for our time sample (annual observations) and geographical scope (Latin America).

The explanatory variable is defined by the real effective exchange rate index produced by BBVA[4] . Inflows of remittances obtained from the IMF are shown as a percentage of GDP in order to relativize the size of the flows. For productivity, we have used GDP per capita adjusted for purchasing power parity, given the difficulty, on the one hand, of finding homogeneous figures for employment, and on the other, because of the need to eliminate the price effect that comes with using nominal variables. In relative terms, we have used the trading partners of the countries in question to show the impact of changes in their levels of competitiveness, and with a lag to avoid problems of endogeneity. The fiscal variable is public consumption as a percentage of GDP in the National Accounts, since this reflects the element of spending with most impact on the evolution of domestic prices. The source in the above two cases is the IMF. The terms of trade index is the BBVA-MAP[5] , while international aversion to risk is represented by the risk premium of high-yield corporate bonds and US 10-year bonds, using the available figures compiled by Datastream.

Results: an evaluation of the Dutch disease

The estimates were made using panel data for the period 1990-2005 covering 15 countries: Argentina, Bolivia, Brazil, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay and Peru.

The results of the estimation[6] are in line with the expected sign for each of the variables included along with remittances:

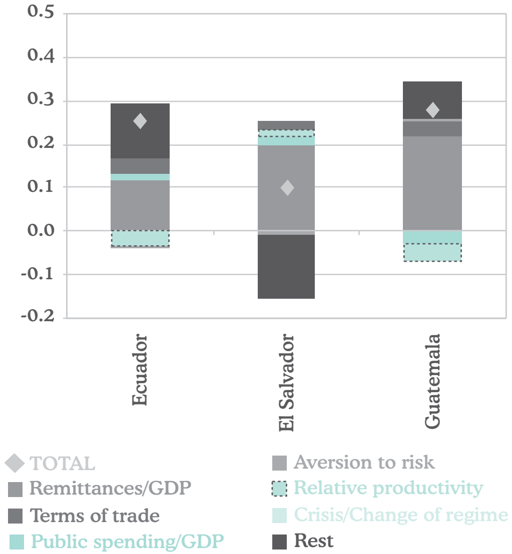
- A one-point increase in public consumption as a percentage of GDP generates an appreciation of the RER of between 2.2% and 4.0%.
- A relative increase in productivity of 1 percentage point brings about an appreciation in the RER the following year of between 0.1% and 0.5%.
- An improvement in the terms of trade of 10% generates an appreciation of the RER of between 0.6% and 2.2%[7] .
- A fall of 100 basis points in the risk premium of high-yielding US corporate bonds causes an appreciation of the RER of between 0.2% and 3.2%[8] .

As regards the variable which is the focus of this study – remittances – the aggregate estimate is not significant, and we, therefore, have differentiated between different groups:

- Countries where remittances have reached significant levels (more than 3% of GDP in a sustained manner) and where flows have increased by one point of GDP produce…

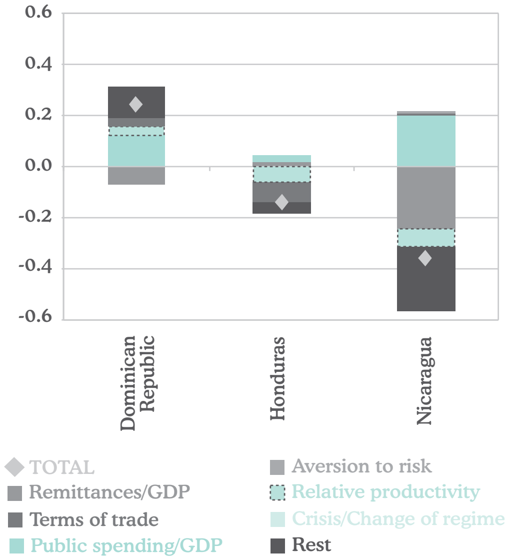
3 All of the cases described involve an appreciation of the RER.
4 Except in the cases of Costa Rica (IMF), Dominican Republic (IMF) and Panama (IIF).
5 Except in the cases of Bolivia, Costa Rica, Dominican Republic, Ecuador and Panama (IIF).
6 For least squares with fixed effects. Dummy variables have been used to correct for major crises and changes to exchange-rate regimes. The results are shown using intervals covering 95% probability (two standard deviations around the central value).
7 Noteworthy higher coefficients are found in the case of Colombia and Ecuador, and in Honduras, where the sign is the opposite.
8 At the 80% probability level. The estimates for this variable are not robust at other specifications, and therefore, the results should be treated with caution.

Breakdown of the change in the real effective exchange rate 1990-2005 (in logarithms): Group I



Source: BBVA

Breakdown of the change in the real effective exchange rate 1990-2005 (in logarithms): Groups II and III



Source: BBVA

- o …an appreciation of the RER of between 1.5% and 3.1%: Ecuador, El Salvador and Guatemala (Group 1).
- o …a depreciation of the RER of between 1.0% and 3.2%: Dominican Republic and Nicaragua (Group 2).
- o …practically no effect on the RER: Honduras (Group 3).

- Countries where remittances have not reached or have not stayed for long periods of time above 3% (Group 4): the rest of the countries. The results for this group show a distinctly significant depreciation effect, although the levels as well as the annual changes in remittances as a ratio of PIB are slight.

The interpretation of the results for Group 1 leads to the view that one has to differentiate one country from another when it comes to determine whether remittances lead to the existence of the *Dutch disease*. In the case of these countries, we can see that the entry of foreign currency through such flows causes the RER to appreciate as a proxy of the deterioration of the competitiveness of the export sector. In the case of the countries included in Group 2, the effect of the depreciation of the RER could be due to two different reasons (or a combination of both elements): the positive effect of the increase in disposable income on imports, and the effect of the attraction of flows due to the appreciation of the RER (greater value in the currency of the recipient country). We already commented at the start on the first effect with its accompanying provisos, while the second is a factor identified as a stabilizing element in the cycle. The entry of foreign currency in the form of remittances when the RER has depreciated offsets the appearance of poverty deriving from economic recessions. Honduras (Group 3) stands as a case apart within the above. The above elements offset the appreciation effect generated by greater demand for local currency and the increase in domestic inflation due to the increase in disposable income. Lastly, it is difficult to speak of results in the case of Group 4 since the levels of remittances are lower. It would be appropriate, therefore, to wait to see how the situation evolves in the coming years to see if some of the countries in this group, particularly Bolivia, Colombia and Mexico, and to a lesser extent Costa Rica, Paraguay and Peru, could be included in one of the other groups.

Conclusions: areas of interest

This empirical study throws up some interesting conclusions, and what is more important, new lines of research, which we will try to cover in the next few editions of this publication. On the one hand, it confirms our view that remittances might be playing a significant role in Latin America beyond their micro effects by impacting on macroeconomic variables such as inflation, growth and the real exchange rate. On the other hand, we can see the effects are not easily identifiable, and that it is appropriate to focus on the workings of individual countries and areas, given that the results are not absolute since they are conditioned by the phenomenon of migration whose importance varies greatly among the economies under study.

Among the points that merit more careful examination are the nature and measurement of the effects of the *Dutch disease* some of the countries might be "suffering" from because of the entry of remittances. It would be of great interest to see how monetary policy is impacted by the developments brought about by high inflows of foreign currency from this source, or more simply, to quantify the impact of higher disposable income resulting from higher remittances on domestic inflation.

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Asia in growth: China

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Keys to growth in China in 2007

Last year China's economy once again posted stronger than expected growth, with a real GDP growth rate of 10.7%, the fastest rate of expansion in the past 11 years. Growth was driven by investment, which has an estimated share of nominal GDP of almost 50%, and by the external sector, where net positive flows amount to close to 10%. The Government aims to achieve a gradual deceleration of the economy by lowering investment and the external surplus, while maintaining high rates of growth, at over 8%, supported by consumption. The Government and international analysts have been predicting a slight slowdown since 2004, but we seem closer to this becoming a reality this year. However, this would be a temporary jolt along the way rather than a standstill. In 2007, a slight deceleration is expected as a result of the restrictive measures on investment, a less accommodating monetary policy and the fall-off in external demand. Growth will nevertheless pick up again in 2008 on the back of the positive impact of the Olympic Games on private consumption, a strengthening external environment and a recovery in investment underpinned by the political cycle.

The main risks in 2007 derive from domestic factors related to monetary policy, inflation, the exchange rate, the financial system and the political climate, while among external risks the most acute would be a crisis brought on by the spread of bird flu rather than a sudden slowdown in the United States (US) or a pick-up in the price of oil.

In this article we analyse the economic prospects for China in four key areas: real activity, the external sector, monetary policy and the risks to growth.

Real activity

Investment will continue to play a decisive role in growth, while the contribution of consumption to GDP will gradually increase. But we will have to wait until the end of the current five-year plan or a new revision of the figures, as has been common, in order for both to be at the same comparable level.

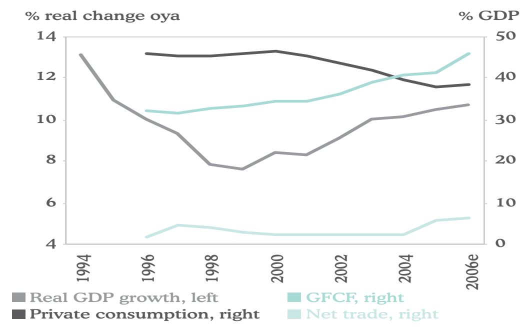
The main concern does not lie in a slight slowdown in the short term but in the sustainability of growth over the longer term. This year should see a continuation of the slowdown seen in the past few months as the central government continues with its restrictive policy, and as a result of reforms of the distribution of dividends by state companies, which will reduce their investment resources, and an evaluation of the contribution of local governments to growth on the basis of qualitative development criteria rather than merely quantitative. However, the goal in the medium term will be to accelerate investment in infrastructure, which has stagnated since 2003, and which next year will be will given an added push by the debut of new government teams at all levels of the administration. The five-year plan for the period 2006-2010 includes investments of 3.8 trillion *renminbis* (about 380 billion euros) on roads, ports, the railway system, and 140 billion *renminbis* (about 14 billion euros) on airports. In total, we estimate at least 50% more will be invested than in the five previous years.

Foreign sector

A large trade surplus and, as a consequence, the accumulation of international reserves are set to continue. The contraction in domestic demand, in particular investment, makes growth even more dependent on the external sector. However, an appreciation of the exchange rate, the easing of certain controls on capital outflows and increasing direct investment overseas, as well as a rise in production costs, will slow the increase in the trade surplus. The key factors for 2007 will be:

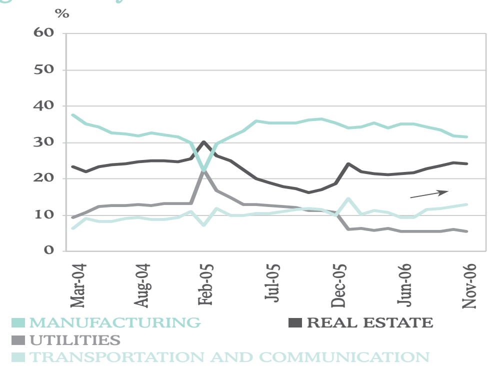
1. A growing protectionist mood on the part of the Chinese business class, which has become more evident because of foreign investment in Chinese banks, and which is putting pressure on Beijing to intro-

GDP: main components
(share in %, nominal, 2006 estimate)



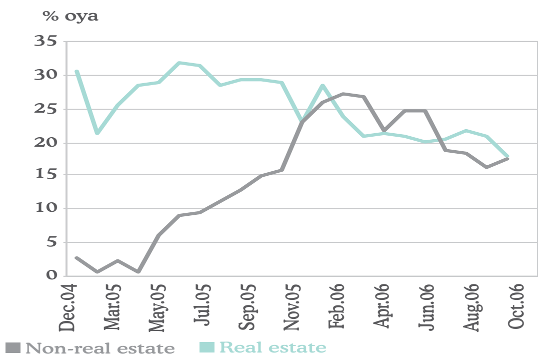
Source: BBVA Datastream

Urban fixed investment: contribution to growth by sector



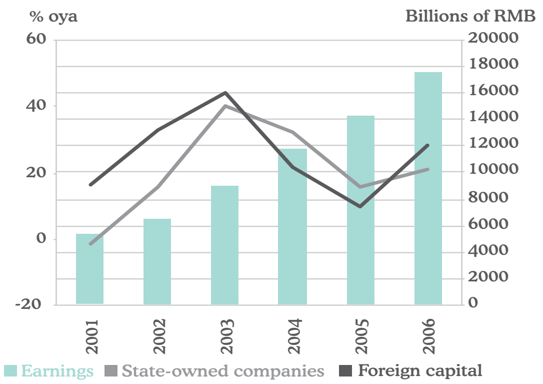
Source: BBVA

New investment projects
(number of projects initiated in period)



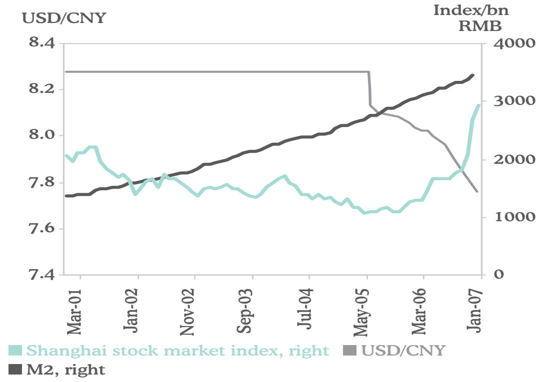
Source: BBVA, Datastream

Corporate earnings*
(end of period; 2000 prices)



* Industrial companies with annual turnover > 5bn RMB
Source: BBVA, Datastream

Monetary liquidity conditions and exchange rate appreciation



Source: BBVA, Datastream

Official 12-month deposit rate

Source: BBVA, Datastream

Consensus Chinese forecasts for USD/CNY

Agency	USD/CNY	Annual appreciation	Affiliation
Ministry of Trade	n.a.	3%	Gabinet
NDRC	n.a.	2-3%	Gabinet
Prof.Fan Gang	n.a.	5%	Central Bank
CAITEC	7.10-7.50	3.10%-4.10%	Ministry of Trade
CICC	7.44	5%	Central Huijin Investment
China Jianyin Investment Securities	7.5	4.10%	Private
China Galaxy Securities	7.46	4.70%	Private

Source: BBVA and Chinese press

Asia: political calendar for 2007

Date	Country	Leader	Event
May-07	Filipinas	Gloria M. Arroyo	Legislative elections; in 2010, for Presidency
Jul-07	Hong Kong	Donald Tsang	Elections for Governor
Jul-07	India	Manmohan Singh	Elections for Presidency
Jul-07	Corea del Sur	Roh Moo-Hyun	Elections for Presidency; in 2008, for Parliament
Oct-07	China	Hu Jintao	17th Congress of Chinese Communist Party
Oct-07	Tailandia	Surayud Chulanot	Elections for Presidency
Dec-07	Taiwan	Chen Shui-bian	Legislative elections; in 2008, for Presidency

Source: BBVA, Merrill Lynch, press

duce protectionist measures. The national consensus is that China does not need to continue to attract foreign investment through preferential schemes, and that foreign companies, therefore, should compete on an equal footing with domestic companies. On the one hand, foreign investment companies which use China as an export platform are responsible for more than 50% of the trade surplus, and according to our estimates, up to two thirds of Chinese exports on aggregate are made up of imported items. On the other hand, their profits in 2006 grew more than those for state-owned companies after slowing the previous two years. A review of the export tax breaks (VAT rebates), which have been in place since 1996, and tax treatment homogenization is expected in March, which could mean an increase in the corporate tax rate imposed on foreign investment companies to over 25% (estimate) from 15% at present.

2. Increased intra-regional competition in the export market, particularly in the event of a slowdown in foreign demand, could put pressure on other central banks in the region to intervene to maintain competitive exchange rates.

3. The creation of a special agency with more aggressive return criteria than the Central Bank to invest part of China's foreign reserves. The Central Bank, however, will continue to manage the bulk of the reserves. However, the creation of the agency will accelerate the process of diversification and will eventually help reduce upward pressure on the *renminbi*.

Monetary policy

Monetary policy will be tightened in 2007, continuing the trend observed in 2006. The Central Bank is concerned about the rapid increase in liquidity in the financial system and, as a result, asset inflation in general and the formation of a speculative bubble in the stock and real estate markets, in particular.

The options open to the Central Bank for withdrawing liquidity are, among others, the following: a) increase the return on the deposits of financial institutions held with the Central Bank and introduce further hikes in reserve requirements.; b) remove the current 20% tax rate on bank deposits, and further raise official interest rates; c) establish a tax on stock market capital gains of a similar nature to the one on the profits of real-estate developers[1]; d) more aggressive appreciation of the exchange rate with the US dollar.

Conditions are in place for further hikes in interest rates in 2007: a) Beijing's backing for the target of reducing liquidity; b) more inflation with increased disposable income and rises in production costs; c) real interest rates at historically low levels; and d) reduced probability of cuts in US rates.

Risks

Domestic factors

1. More restrictive monetary policy than expected: a renewed pick-up in investment could lead to higher interest-rate hikes, although this would be subject to exchange-rate policy. Excessively high interest rates could lead to a sharp fall in investment and massive inflows of capital of a speculative nature, attracted by the narrowing of differentials and expectations of an appreciation of the *renminbi*.

2. Inflation surprises: a) if the Government allows significant increases in farm prices and, as on previous occasions, the improvement in rural income reduces migration and labour supply in the cities; b) if the fuel tax and a reform of fuel prices in line with changes in international markets are approved[2], as well as the upward revision of other administered prices, mainly in energy supplies and natural resources.

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1 Effective from February 1, 2007. See original statement in: http://www.chinatax.gov.cn/n480462/n480498/n575817/4933245.html

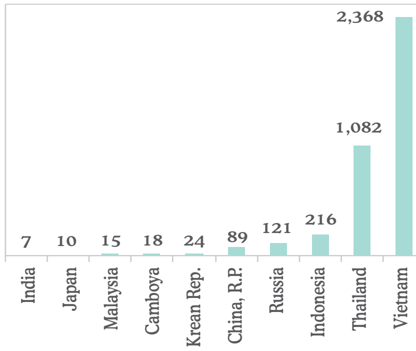
3. A more aggressive appreciation of the exchange rate than expected: the appreciation of the *renminbi* could gather pace ahead of the second US-China bilateral summit in May. However, the consensus in China is for the maintenance of an annual increase of around 5%, and a surprise on the upside could lead to heavy losses for companies with uncovered foreign positions.
4. Financial crisis: the solidness of the banking sector in the face of a sudden slowdown in activity and a rapid increase in loan defaults remains to be seen. In the capital markets, expectations of a gradual appreciation of the *renminbi* and a forecast increase in investment in equities by insurance companies, among other institutional investors, explain the buoyancy of stock prices. But there is also a risk of a more restrictive monetary policy, and the creation of a bubble similar to that seen in Japan in the 1980s.
5. Political environment: the Government started an anti-corruption campaign[3] in 2006 which could lead to the start of large projects and investments being delayed out of fear of investigations being launched into these. The uncertainty surrounding the renewal of mandates within the Chinese Communist Party (CCP) in October and the formation of a new government team committed to the economic reform process will be key in the next five-year plan. Around two thirds of the officials allied to the binomial Hu-Wen have had their positions renewed so far, strengthening their hand against the more conservative wing of the CCP. Separately, the region is going through a year of controversial elections (Thailand, Taiwan), which could be a source of greater volatility and instability in the markets.

External factors

1. Evolution of bird flu: an unexpected development in the bird flu epidemic is the greatest risk currently. The epidemic is out of control in Indonesia, Vietnam and Thailand, and alarm bells were set off recently in Japan. Although the authorities were to react immediately, there is a risk of a possible mutation of the virus, and its possible spread to humans, leading to a human epidemic. In the worst scenario, this could shave 2% off the region's GDP, that is, more than 90 billion dollars, and an unpredictable number of deaths[4] .
2. A hard landing in the United States or a rise in oil prices: in both scenarios, the Chinese economy is better equipped than in the past to withstand the possible negative impact. A more conservative fiscal policy has placed it in a solid position to implement more expansionary policies if this became necessary. In addition, the external sector is increasingly tied with other geographical areas, mainly Europe and other emerging countries in Asia and Latin America, reducing its dependence on the United States.
3. Trade protectionism: if China does not allow the *renminbi* to appreciate significantly against the dollar, the US could end up carrying out protectionist threats, which would seriously harm bilateral ties. However, the focus of attention could turn instead to Japan and the weakness of the yen.

To sum up, the risks will remain limited, with solid growth in 2007 extending the longest and most stable period of growth in China.

Bird flu: number of cases in birds reported in Asia (data up to 31 January, 2007)



Source: BBVA, OIE

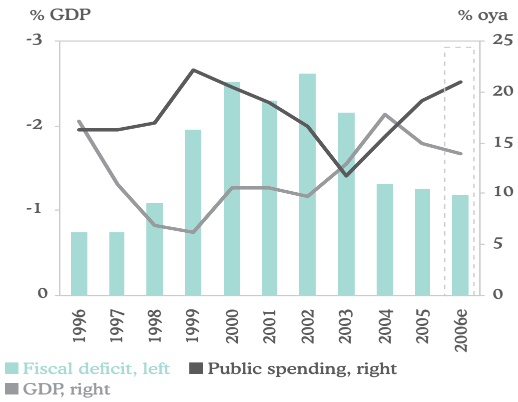
Number of cases of people affected by bird flu reported to WHO (29 January, 2007)

Country	2003		2004		2005		2006		2007		Total	
	cases	deaths	cases	deaths	cases	deaths	cases	deaths	cases	deaths	cases	deaths
Azerbaijan	0	0	0	0	0	0	8	5	0	0	8	5
Cambodia	0	0	0	0	4	4	2	2	0	0	6	6
China	1	1	0	0	8	5	13	8	0	0	22	14
Egypt	0	0	0	0	0	0	18	10	1	1	19	11
Indonesia	0	0	0	0	19	12	56	46	6	5	81	63
Iraq	0	0	0	0	0	0	3	2	0	0	3	2
Thailand	0	0	17	12	5	2	3	3	0	0	25	17
Turkey	0	0	0	0	0	0	12	4	0	0	12	4
Vietnam	3	3	29	20	61	19	0	0	0	0	93	42
Total	4	4	46	32	97	42	116	80	7	6	270	164

* The number of cases includes deaths. The WHO only reports laboratory-confirmed cases.
Source: World Health Organisation

Public spending and fiscal deficit/GDP

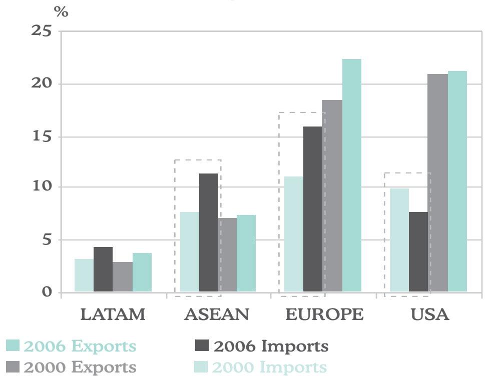
(at current prices, 2006 estimate)



Source: BBVA, Datastream

Foreign trade by region

(as % of total, at current prices)



Source: BBVA and China's Ministry of Trade

[2] http://english.gov.cn/2007-01/30/content_512996.htm
[3] In Shanghai 11 high-ranking officials and 9 other people were charged with crimes for a total 475 million dollars, and in the banking sector 164 employees for a total 3.3 million dollars.
[4] Milan Brahmbhatt of the World Bank (November 2005).

International Context

	Real GDP (%)				Consumer prices (%. average)			
	2005	2006	2007	2008	2005	2006	2007	2008
USA	3.2	3.3	2.8	2.5	3.4	3.2	2.1	2.0
EMU	1.5	2.7	2.5	2.3	2.2	2.2	1.8	1.8
Japan	1.9	2.2	2.0	2.3	-0.3	0.3	0.5	1.0
China	10.4	10.7	9.8	10.2	1.8	1.5	2.0	3.0

	Official interest rate (%. end of period)				Exchange rate (vs $. end of period)			
	31/12/06	Jun-07	Dec-07	Dec-08	31/12/06	Jun-07	Dec-07	Dec-08
USA	5.25	5.25	5.25	4.50				
EMU ($/€)	3.50	4.00	4.25	4.25	1.32	1.31	1.30	1.30
Japan (yens/$)	0.25	0.50	1.00	2.25	117	117	112	109
China (cny/$)	6.12	6.39	6.66	6.93	7.81	7.55	7.30	6.80

Latin America

	Real GDP (%)				Consumer prices (%. end of year)			
	2005	2006	2007	2008	2005	2006	2007	2008
Argentina	9.2	8.5	7.9	6.3	12.3	9.8	10.0	10.0
Brazil	2.3	2.9	3.3	3.2	5.7	3.1	4.0	3.8
Chile	6.3	4.1	5.2	5.3	3.7	2.6	3.3	2.8
Colombia	5.2	7.1	6.2	5.0	4.9	4.5	4.2	3.7
Mexico	3.0	4.7	3.6	3.8	3.3	4.1	3.5	3.5
Peru	6.4	8.0	6.3	6.0	1.5	1.1	1.9	2.5
Venezuela	10.3	10.3	4.3	2.8	14.4	17.0	17.3	18.2
LATAM [1]	**4.4**	**5.2**	**4.5**	**4.2**	**6.0**	**5.1**	**5.4**	**5.2**
LATAM Ex-Mexico	5.0	5.3	4.8	4.3	6.9	5.5	6.0	5.8

	Fiscal balance (% GDP)				Current account balance (% GDP)			
	2005	2006	2007	2008	2005	2006	2007	2008
Argentina [2]	1.8	2.1	1.7	2.1	3.2	3.6	2.5	1.9
Brazil	-3.1	-3.0	-3.0	-3.0	1.8	1.6	1.4	0.9
Chile [2]	4.8	7.6	5.0	3.8	0.6	4.8	2.4	2.7
Colombia	0.0	-0.4	-1.3	-1.2	-1.6	-1.8	-1.9	-2.4
Mexico	-0.1	0.2	0.0	0.0	-0.6	-0.3	-1.7	-2.2
Peru	-3.0	1.0	-0.5	-0.8	1.4	1.9	0.7	-0.7
Venezuela [2]	1.7	1.1	-1.8	-3.0	17.7	16.3	11.8	11.2
LATAM [1]	**-0.8**	**-0.5**	**-1.0**	**-1.0**	**2.0**	**2.3**	**1.0**	**0.4**
LATAM Ex-Mexico	-1.2	-0.8	-1.4	-1.5	3.3	3.5	2.4	1.8

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

	Exchange rate (vs $. end of year)				Interest rates (%. end of year)[3]			
	2005	2006	2007	2008	2005	2006	2007	2008
Argentina	3.05	3.06	3.20	3.40	6.4	8.9	12.6	12.6
Brazil	2.28	2.15	2.30	2.45	18.00	13.25	12.50	12.00
Chile	514	533	550	550	4.50	5.25	5.00	5.00
Colombia	2279	2240	2328	2361	6.3	6.8	8.0	7.5
Mexico	10.63	10.81	10.80	11.30	8.0	7.0	6.5	5.8
Peru	3.42	3.20	3.22	3.30	3.25	5.00	5.00	5.00
Venezuela	2150	2147	2408	2800	10.9	10.5	10.4	10.0

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

Argentina / Brazil

	Argentina 2005	2006e	2007f	2008f	Brazil 2005	2006e	2007f	2008f
GDP (%)	9.2	8.5	7.9	6.3	2.3	2.9	3.3	3.2
Consumer prices (% end of year)	12.3	9.8	10.0	10.0	5.7	3.1	4.0	3.8
Trade balance ($bn)	11.4	11.8	10.8	9.1	44.8	46.1	45.3	35.0
Current account (% GDP)	3.2	3.6	2.5	1.9	1.8	1.6	1.4	0.9
Reserves ($bn. end of year)	28.1	31.5	43.1	56.0	53.8	85.8	90.0	93.0
Exchange rate (end of year vs US$)	3.05	3.06	3.20	3.40	2.28	2.15	2.30	2.45
Fiscal balance (% GDP) [1]	1.8	2.1	1.7	2.1	-3.1	-3.0	-3.0	-3.0
Interest rate (end of year) [2]	6.4	8.9	12.6	12.6	18.00	13.25	12.50	12.00
Real effective exchange rate (end of year. dec-97=100)	52	52	55	55	81	83	76	76
BBVA-MAP (end of year, Jun-95=100)	131	155	148	145	77	80	83	84

[1] Argentina: Central Government Balance. Excluding privatisation receipts

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

Chile / Colombia

	Chile 2005	2006e	2007f	2008f	Colombia 2005	2006e	2007f	2008f
GDP (%)	6.3	4.1	5.2	5.3	5.2	7.1	6.2	5.0
Consumer prices (% end of year)	3.7	2.6	3.3	2.8	4.9	4.5	4.2	3.7
Trade balance ($bn)	10.2	24.8	15.8	9.8	1.4	0.2	-0.4	-1.1
Current account (% GDP)	0.6	4.8	2.4	2.7	-1.6	-1.8	-1.9	-2.4
Reserves ($bn. end of year)	17.0	16.8	16.8	16.8	15.0	15.5	16.2	17.0
Exchange rate (end of year vs US$)	514	533	550	550	2279	2240	2328	2361
Fiscal balance (% GDP) [1]	4.8	7.6	5.0	3.8	0.0	-0.4	-1.3	-1.2
Interest rate (end of year) [2]	4.50	5.25	5.00	5.00	6.3	6.8	8.0	7.5
Real effective exchange rate (end of year. dec-97=100)	97	90	87	87	92	91	90	90
BBVA-MAP (end of year, Jun-95=100)	107	134	120	107	151	157	147	140

[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	2006e	2007f	2008f	Peru 2005	2006e	2007f	2008f
GDP (%)	3.0	4.7	3.6	3.8	6.4	8.0	6.3	6.0
Consumer prices (% end of year)	3.3	4.1	3.5	3.5	1.5	1.1	1.9	2.5
Trade balance ($bn)	-7.6	-6.5	-20.0	-26.0	5.3	8.5	7.0	6.0
Current account (% GDP)	-0.6	-0.3	-1.7	-2.2	1.4	1.9	0.7	-0.7
Reserves ($bn. end of year)	73.0	67.5	65.0	65.0	14.1	17.3	18.0	18.5
Exchange rate (end of year vs US$)	10.63	10.81	10.80	11.30	3.42	3.20	3.22	3.30
Fiscal balance (% GDP) [1]	-0.1	0.2	0.0	0.0	-3.0	1.0	-0.5	-0.8
Interest rate (end of year) [2]	8.0	7.0	6.5	5.8	3.25	5.00	5.00	5.00
Real effective exchange rate (end of year. dec-97=100)	114	112	115	112	87	88	87	85
BBVA-MAP (end of year, Jun-95=100)	193	204	183	172	113	133	129	124

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

Uruguay / Venezuela

	Uruguay 2005	2006e	2007f	2008f	Venezuela 2005	2006e	2007f	2008f
GDP (%)	-11.0	2.2	11.8	6.6	10.3	10.3	4.3	2.8
Consumer prices (% end of year)	25.9	10.2	7.6	4.9	14.4	17.0	17.3	18.2
Trade balance ($bn)	0.0	0.2	0.0	0.0	30.4	33.2	25.1	15.9
Current account (% GDP)	3.1	-0.5	-0.8	0.6	17.7	16.3	11.8	11.2
Reserves ($bn. end of year) [3]	0.8	1.9	2.3	3.1	29.6	37.3	29.2	29.2
Exchange rate (end of year vs US$)	27.1	29.2	26.6	23.5	2150	2147	2408	2800
Fiscal balance (% GDP) [1]	-4.1	-3.2	-1.8	-2.5	1.7	1.1	-1.8	-3.0
Interest rate (end of year) [2]	69.9	7.5	5.7	4.6	10.9	10.5	10.4	10.0
Real effective exchange rate (end of year. dec-97=100)	90	75	81	87	90	101	104	105
BBVA-MAP (end of year, Jun-95=100)	85	86	89	81	286	307	263	242

[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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