World Economic and Financial Surveys

Regional Economic Outlook

2006 MIDYEAR UPDATE

Western Hemisphere

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I N T E R N A T I O N A L   M O N E T A R Y   F U N D

WESTERN HEMISPHERE REGIONAL ECONOMIC OUTLOOK: 2006 MIDYEAR UPDATE

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Western Hemisphere Regional Economic Outlook: 2006 Midyear Update

Executive Summary

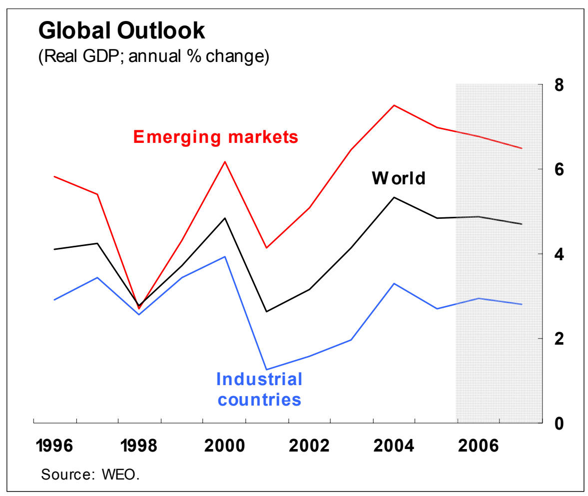
- **The global and regional economic outlooks remain favorable.**
  - In the United States, 2006 growth is projected at 3½ percent, supported by strong business profits and investment, which are expected to help offset the effects of higher oil prices and interest rates on household consumption. Growth in Canada, which is benefiting from the boom in global commodity prices, is expected to be slightly higher in 2006, remaining close to potential.
  - The external environment is expected to continue to provide support to the Latin American and Caribbean (LAC) region, including strong partner country demand, booming global commodity prices, and still easy global liquidity conditions that have pushed sovereign spreads to record lows. As a result, 2006 growth is projected to remain well above the average of the past decade—partly reflecting recoveries from earlier crises—as inflation eases to its lowest rate in recent history, and a third successive year of current account surpluses is also expected.
- **Stronger policies have helped underpin performance of the LAC region.**
  - Significant primary fiscal surpluses helped achieve substantial reductions in public debt/GDP ratios, while external vulnerabilities have been further reduced by debt buybacks and other debt management operations.
  - Monetary policies have continued to emphasize inflation reduction, a growing number in the context of inflation-targeting frameworks and more flexible exchange rate policies.
  - The region's strong recovery is having a significant effect on reducing unemployment and poverty, as indicated—for example—by Argentina and Brazil.
- **The key challenges for the LAC region, then, are to further strengthen macroeconomic and structural policies to manage future risks and entrench faster growth and poverty reduction:**
  - ***Monetary policy and inflation:*** Output gaps are narrowing and, although many central banks have acted pre-emptively to contain the second-round effects of oil price increases, credit growth has accelerated and care will be needed to contain inflation risks, and retain flexibility in exchange rates in order to preserve the credibility of commitments to price stability.
  - ***Fiscal policies:*** Noninterest government outlays have begun to grow rapidly in the last year, but public investment has remained at relatively low levels. The task of fiscal policy in many countries is to make further progress toward debt sustainability while enhancing social and infrastructure support by making tax and expenditure structures more flexible and progressive.
  - ***Improving competitiveness:*** To encourage a much-needed boost in private investment and productivity growth, many countries are considering bolder agendas to improve the business climate, deepen financial sector development to better channel savings to productive investment, and achieve greater openness to trade. Given the region's wealth in natural resources, its efficient management will also be key to the medium-term outlook. Greater flexibility in labor markets will help consolidate recent employment gains.

I. THE GLOBAL ECONOMY AND THE OUTLOOK FOR THE UNITED STATES AND CANADA

A. The Global Context

1. **The global economy retains significant momentum.** Even in the face of still-high oil prices, global growth surprised on the upside in 2005, reaching 4¾ percent. In particular, the second half of 2005 was stronger than expected, particularly among emerging market countries.

2. **The conditions for continuing strong global growth remain favorable.** Despite rising global short-term interest rates, long-term rates are still modest and interest rate spreads in industrial countries and emerging markets remain close to historic lows, implying continued favorable financial market conditions. Inflation remains well anchored. Indicators point to a pick-up in global industrial production and global trade, a strengthening in consumer confidence and labor market conditions, and rising business confidence and investment in major industrial countries.



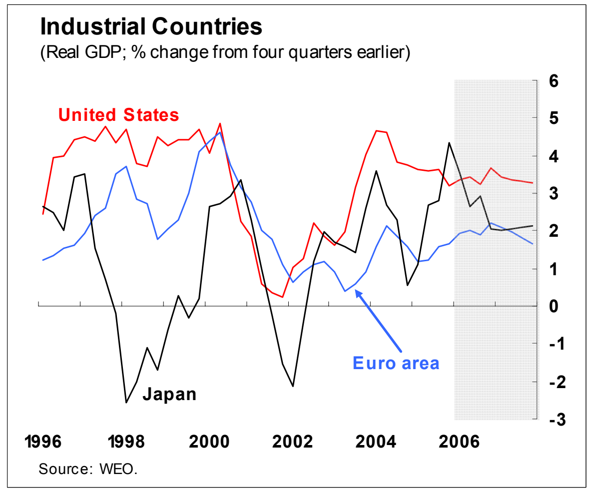
3. **Against this background, global growth is projected to accelerate close to 5 percent in 2006,** about ½ percentage point higher than expected in September, before easing slightly to about 4¾ percent in 2007.

4. **The expansion has become more broad-based.** Recent labor market and confidence indicators point to strengthening expansions in Japan and the Euro area, where growth could surprise on the upside. Growth in most emerging market and developing countries remains solid, with especially buoyant activity in India, China, and Russia. Nevertheless, the U.S. and China are expected to remain the key drivers of the global expansion in the near-term. In China, growth exceeded expectations in 2005, reaching almost 10 percent.

B. The Outlook for the United States and Canada

5. **The U.S. economy has continued to be an engine of global expansion, anchored by low core inflation and strong productivity.** Real GDP growth is projected to remain close to 3½ percent in 2006, still the highest among G-7 economies, as the economy shrugs off a slower-than-expected fourth quarter, high energy prices, and the withdrawal of monetary stimulus. Although consumption and residential investment are projected to slow as the housing market cools, activity is expected to be sustained by the strength of business investment, supported in turn by still very high levels of profits. Recent monthly indicators suggest a strong start to 2006, with industrial production strengthening, and nonfarm payrolls expanding by a monthly average of 218,000 during November–March.

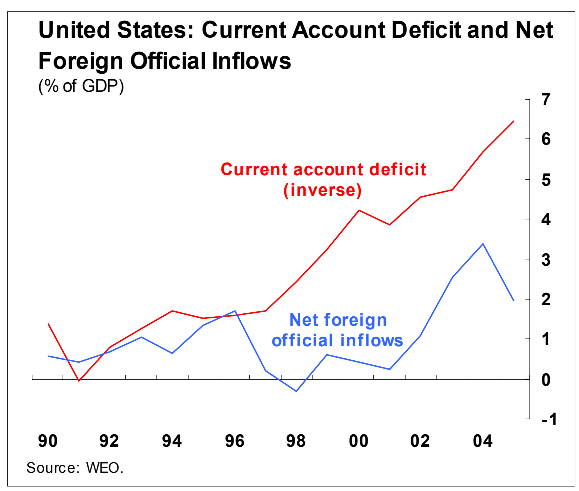
6. **The Canadian economy also continues to perform strongly.** The economy is already operating at close to capacity, but growth is expected to remain near potential, and the second highest in the G-7, as the effects of an appreciated exchange rate are offset by the strengthened commodity terms of trade, private consumption growth and, as in the United States, healthy corporate profits and business investment. Inflation also remains well anchored and the fiscal situation remains very favorable, with surpluses providing room for the new government to introduce tax cuts while still maintaining the commitment to debt reduction.



C. Global Risks

7. **There are some upside risks to the short-term outlook**. In the United States, these arise from the corporate sector running down financial surpluses more rapidly than anticipated, further boosting investment and employment; elsewhere, growth in some emerging markets could continue to exceed expectations.

8. **However, the balance of risks remains tilted to the downside.** For the United States, the possibility of a sharp deterioration of the housing market or abrupt withdrawal of consumer demand remain concerns. Globally, the continued rise in the U.S. current account deficit—financed by large surpluses in oil exporters, China, Japan, and parts of emerging Asia—has contributed to a further widening of global imbalances. There has been some recent decline in official inflows, but the U.S. current account deficit continues to be financed relatively easily by private inflows. Nonetheless, the possibility of a disorderly adjustment (involving a sharp reduction in the demand for U.S. assets, abrupt movements in interest and exchange rates, and rising protectionist pressures) is a key risk over the medium term. Moreover, capacity constraints in oil markets and the risk of a turnaround in credit conditions also represent vulnerabilities. Finally, there is growing concern about the possibility of an avian flu pandemic and its consequences, which could be especially severe for developing countries.

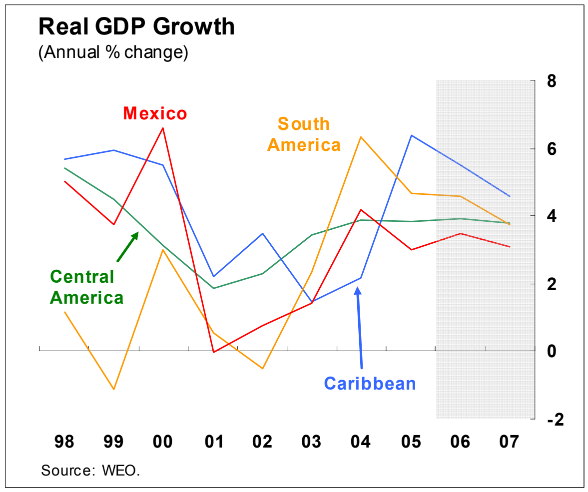


II. LATIN AMERICA AND THE CARIBBEAN (LAC)

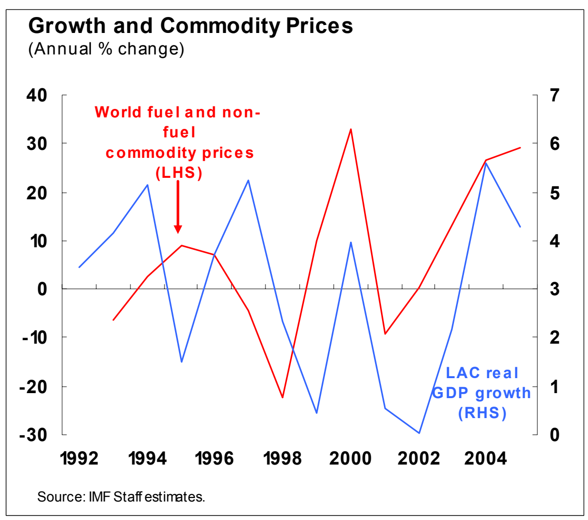
A. Recent Developments

9. **During 2005, Latin America and the Caribbean (LAC) expanded at a robust rate.** Real GDP growth for the region as a whole was 4¼ percent, above trend and about ¼ percentage point higher than projected in the September WEO. Activity in Argentina, Chile, Colombia, Peru, Uruguay, and some oil exporters (Ecuador and Venezuela) surprised on the upside, more than offsetting a soft patch in Brazil during the latter half of the year.

10. **Nonetheless, there were important disparities across the region.** Argentina continued to recover strongly, with 2005 growth again reaching around 9 percent, while Chile, Peru, and Uruguay also expanded at rates of 6-7 percent. Activity in the Caribbean gathered momentum in 2005, accelerating to 6½ percent, with some countries growing briskly as investment surged in preparation for the Cricket World Cup. Growth in Central America, on the other hand, continued to lag the rest of the hemisphere.



11. **LAC countries have continued to benefit from the strong global demand for commodities.** Since the late 1990s, growth has been closely associated with developments in commodity prices. 2005 proved to be no exception, as sustained high fuel and metals prices provided continued support to growth in Chile and countries in the Andean region (Bolivia, Colombia, Ecuador, Peru and Venezuela). Central America and the Caribbean (with the exception of Trinidad and Tobago) were adversely affected by the oil price shock, but Central America gained from increases in agricultural prices, as did Brazil and Uruguay.

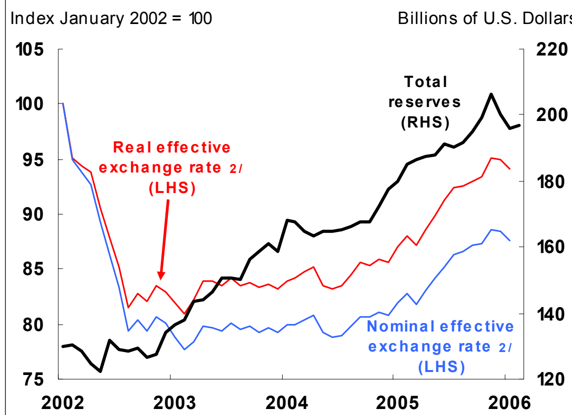


12. **As a result, external positions strengthened further in 2005.** Buoyant export volumes contributed to double-digit increases in export receipts in many countries and yielded a third consecutive year of trade and current account surpluses, which reached about US$70 billion (3 percent of GDP) and about US$30 billion (1¼ percent of GDP), respectively. Private capital inflows also increased, led by a surge in portfolio inflows, and remittances remained buoyant in many countries in Central America and the Caribbean.

13. **These developments put upward pressure on exchange rates and provided further opportunities for countries to rebuild reserves.** How countries made this tradeoff depended upon

individual circumstances and vulnerabilities, including the discipline imposed by inflation targeting regimes. In nominal effective terms, the appreciations during 2005 were especially large in Brazil (28 percent), Chile (15 percent), Colombia (11 percent), Dominican Republic (9 percent), and Uruguay (12 percent), but even after these movements, nominal and real effective exchange rates remain below their levels of early 2002 in some countries in the region. Although external reserves continued to rise throughout the region, many countries have also used the good external conditions to pay down foreign currency debt and improve their debt vulnerabilities (Box 1). At the turn of the year, Brazil and Argentina repaid all outstanding obligations to the IMF (US$15.5 billion and US$9.6 billion, respectively) and, in March, Uruguay advanced US$625 million of 2006 payments.

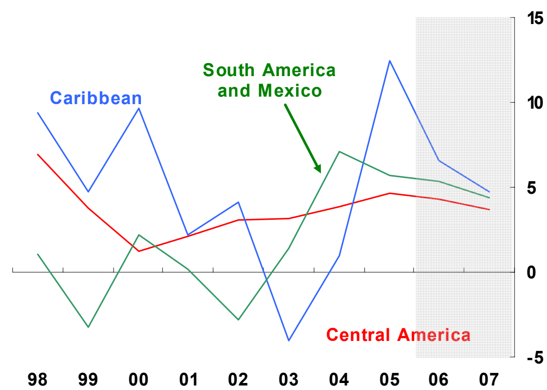
Exchange Rates and Reserves 1/



1/ Argentina, Brazil, Chile, Colombia, Mexico, and Peru.
2/ Six country monthly average. Increase indicates appreciation.

14. **As recoveries in the region have matured, domestic demand has become an increasingly important driver of growth.** This has largely reflected the continued strength of private consumption, which accounted for about three-fourths of economic growth in 2005, as compared with less than two-thirds in 2004. Real consumption grew by about 5 percent for the year, just slightly less than the 5½ percent achieved in 2004; meanwhile, investment growth remained close to the double-digit range, despite slowing slightly from 2004. With the solid growth of investment over the past two years, private investment–to-GDP ratios, at 16 percent of GDP, have recovered to about the average of the late 1990s.

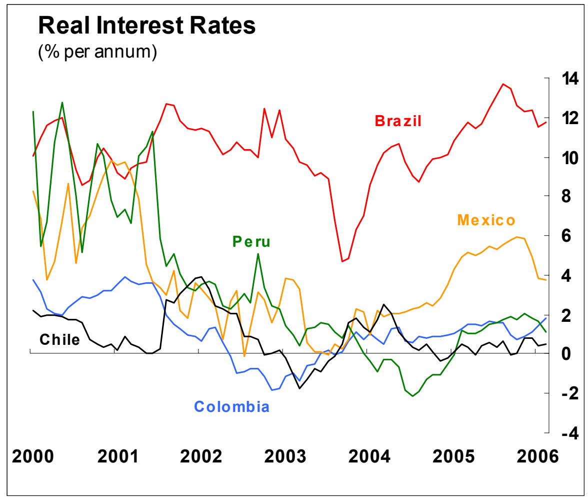
Real Final Domestic Demand
(Annual % change)



Source: WEO.

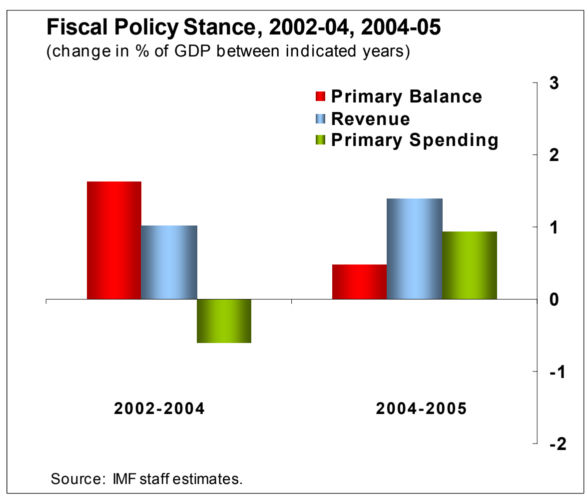
15. **The sources of domestic demand growth have varied across the region.** In Central America, remittances, which have risen to 10–20 percent of GDP, are helping support consumption. In the Caribbean, the strong pick up owes primarily to developments in the Dominican Republic, where consumption grew by double-digits in the wake of improved confidence in the recovery from crisis, exchange rate appreciation, and the easing of interest rates. Domestic demand is also being spurred by significant increases in primary (noninterest) government spending, most notably in Argentina and the oil exporters, after several years of restraint.

16. **Monetary policy has generally been focused on containing inflation pressures.** Real policy interest rates rose substantially in several countries during 2004-2005, notably in Brazil and Mexico. An important exception was Argentina, where real rates have been negative. Steady or rising real policy rates helped signal the credibility of monetary policy and the commitment to low inflation. Brazil and Mexico, in this regard, entered a virtuous cycle of falling inflationary expectations and policy interest rates; in both countries, with inflation expectations converging to the targets, central banks have had room to significantly lower policy interest rates over the past year. Lower interest rates have reinforced the recovery of credit and domestic demand without raising inflationary expectations.



17. **Domestic credit has expanded very sharply, albeit from a very low base in many countries.** Year-on-year growth soared from about 2 percent in 2003 in the seven largest countries to about 29 percent in the third and fourth quarters of 2005. The expansion in credit has been shared by most countries, but has been particularly pronounced in Argentina (about 30 percent) and Venezuela (nearly 70 percent). While sectoral data on the composition of lending are not readily available, national accounts data suggest these loans have supported both higher consumption and investment. More generally, the surge in lending activity also owes to improved credit market infrastructure, including the strengthening of credit information systems and loan recovery frameworks (Brazil, Mexico).

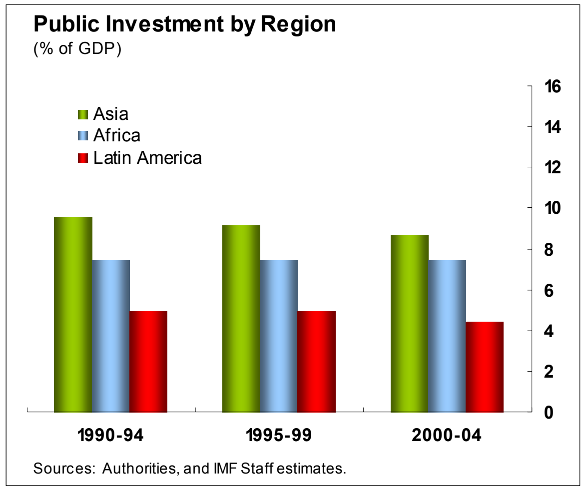
18. **Fiscal primary spending has been on the rise**. Non-interest outlays rose by about 1 percent of GDP in 2005, more than erasing the ½ percent of GDP decline achieved in 2002-04.[1] Spending increases were particularly pronounced in oil exporters (especially in Ecuador and Venezuela), which increased expenditures by about 2 percentage points of GDP, or by an average of 13½ percent in real terms.[2] However, these increases in regional outlays appeared to be largely in current spending, as the capital expenditure-to-GDP ratios fell a further ¼ percentage point to 3¾ percent. As a consequence, public investment (as measured on a national accounts basis) remained well below levels in other developing regions. These expenditure trends have



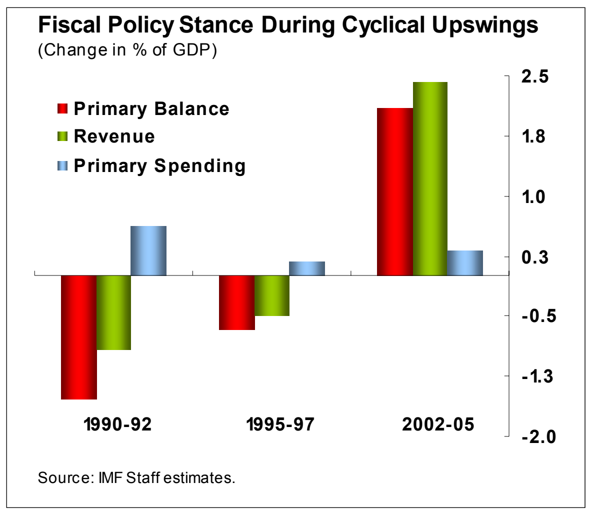
[1] Data on revenues and expenditure refer to Latin American countries only.

[2] In Ecuador, the fiscal responsibility law was modified during 2005 to allow greater spending from the oil windfall.

raised several concerns that bear close monitoring: first, that countries may not be taking full advantage of the revenue windfalls to support a more pro-growth composition of spending; second, that spending may be ratcheting up too quickly on the basis of cyclical revenue increases; and, third, that not enough of the oil-related windfalls are being saved.



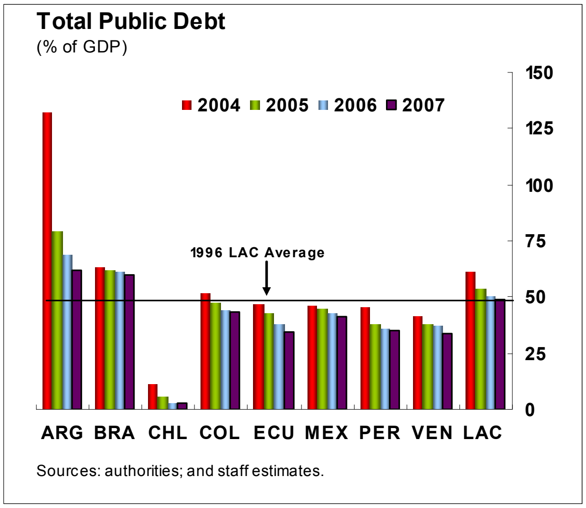
19. **Nevertheless, thus far, fiscal positions in the LAC region have generally retained their overall strength.** Against the background of rising spending in many countries, buoyant revenues have kept primary fiscal balances in significant surplus. Both oil and other commodity prices have contributed to rising government revenues. At one extreme is Venezuela, where revenues surged by a remarkable 14 percent points of GDP between 2002 and 2005. Other countries have benefited from more modest, but still very significant increases. Non-oil producers have been able to increase receipts by an average of about 2 percentage points of GDP.



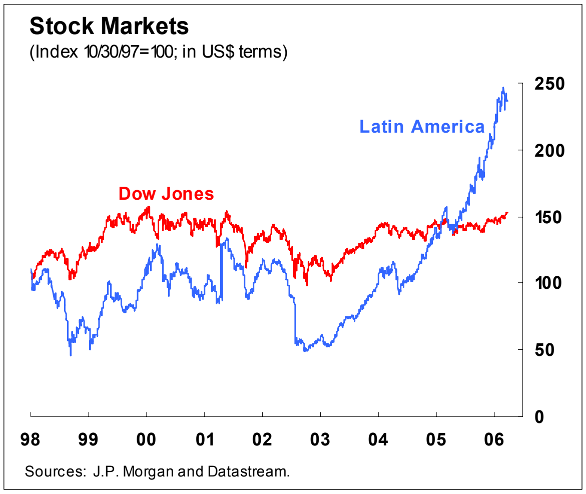
20. **As a result, primary fiscal surpluses rose, on a weighted average basis, to 3¾ percent of GDP in 2005**, and averaged about 3 percent of GDP in 2003-2005, suggesting a shift from the pro-cyclical tendencies of the past. The improvement was especially marked in Chile and Colombia, which benefited from the discipline imposed by fiscal rules and responsibility laws. Fiscal balances also improved in oil-producing countries, especially Venezuela, although by significantly less than the surge in oil-related revenues. By running primary fiscal surpluses, countries have been able to continue to lower debt and reduce the burden on monetary policy for aggregate demand management.

21. **Public debt management has improved.** Latin American countries have nearly completed their 2006 financing plans and a few countries have begun to pre-finance for 2007. Moreover, several countries—including Brazil, Colombia, Ecuador, Mexico, Panama, Peru, Uruguay, and Venezuela—have actively sought to improve debt structures (through debt buy-backs, exchanges, and pre-payments) and develop local currency markets (see Box 1). These operations—coupled with the drop in debt ratios—have significantly reduced countries' vulnerability to external shocks. In the Caribbean, Grenada successfully restructured its commercial public debt last November, helping improve its repayment profile for the next several years.

22. **Public debt ratios have continued to fall.** The ratio of debt-to-GDP for the region as a whole fell from its recent peak of 73 percent in 2002 to 53 percent in 2005, reflecting the effects of strong primary surpluses, faster growth, and appreciating exchange rates. Looking ahead, debt/GDP ratios are projected to decrease further to 50 percent of GDP in 2006.



23. **Supported by increasing investor interest from abroad, equity markets in the region boomed in 2005.** On average, market indices climbed by some 45 percent in 2005, and have more than tripled since 2002. Equity issuance, at US$5 billion, was at its highest level since 2000, led by about US$3½ billion in issuance in Brazil. Higher prices have been supported by earnings growth, and the price-earnings ratio is presently only 14:1 (compared with an average of 13:1 over 2000-04). Moreover, stock market capitalization at end-2005 stood at about 50 percent of GDP, compared with about 75 percent of GDP in 2004 in emerging Asia.



24. **Thus far, rapid credit growth has not led to deterioration in banking sector balance sheets.** Non-performing loan ratios and other indicators of financial sector soundness continued to strengthen in 2005, as the region's banking system recovered further from the tensions in many countries earlier in the decade. Nonetheless, financial sector supervisors will need to be particularly vigilant in those countries where credit growth or the issuance of new financial products has been especially high to ensure that regulation and oversight keeps pace.

Financial Soundness Indicators for Latin America 1/
(in percent)

	2002	2003	2004	2005
NPL ratio 2/	10.9	8.8	6.2	5.1
Provisioning of NPLs	93.1	98.3	115.1	120.0
Return on assets	-0.5	1.4	1.8	1.9
Return on equity	-17.2	11.6	16.2	18.6
Capital adequacy ratio 3/	15.1	15.2	15.1	14.3

1/ Fixed sample of countries over time for each indicator. The number of countries varies by indicator.
2/ Non-performing loans (NPLs) as a share of total loans.
3/ Regulatory capital/risk weighted assets.

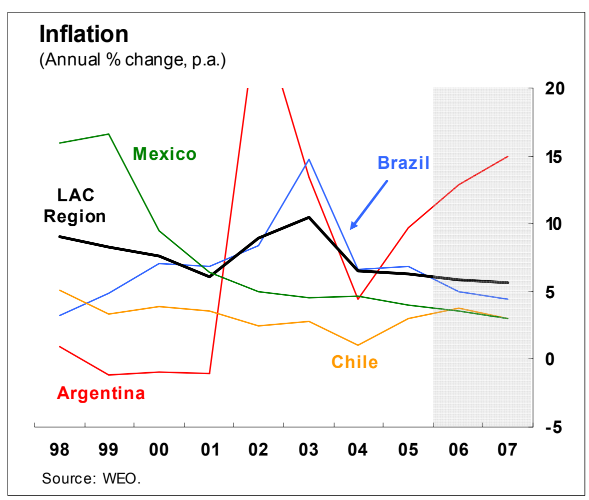
25. **The region's recovery in recent years—together with improved targeting of social programs in some countries—has had a significant effect on reducing poverty, and inequality.** In Argentina, the share of the population in poverty has fallen from a peak of 58 percent shortly after the financial crisis to 33¾ percent at end-2005. In Brazil, the poverty rate has declined significantly since 2002, to about 25 percent of the population in 2004, its lowest level since the data were first collected in 1992, while the share of those in extreme poverty has also declined to historic lows. At the same time, income inequality has also fallen, with Brazil's Gini coefficient declining from

55½ percent in 2003 to 53½ percent in 2004, well below the 58⅓ percent level in 1981. More effective social spending and safety nets have contributed to these outcomes. For example, in Brazil, the *Bolsa Familia* program has combined cash transfers with specific requirements ensuring enrollments of children in school and child vaccination programs; its coverage has been expanded to over 8 million families, about two-thirds of the households in poverty or extreme poverty, and is on target to achieving full coverage of the estimated 11.2 million families under the poverty line by end-2006. In Argentina, the "Heads of Households" program is being reoriented from emergency income support to a system that combines social assistance with greater opportunities for education and training. Mexico's conditional cash-transfer program, *Oportunidades*, is another example of improved targeting of anti-poverty spending programs in the region; *Oportunidades* has targeted children from families in the lower income deciles, reaching about 5 million families by early 2006.

B. The Outlook

26. **Looking ahead, growth momentum is expected to be sustained in 2006 and average 4¼ percent for the LAC region as a whole.** This reflects continued recoveries in many countries, which still appear to be operating somewhat below their potential, as well as the effects of strong demand in LAC trading partners, favorable conditions in both financial and commodity markets, and well-anchored inflation expectations. Export receipts are projected to grow again at double digit rates, including in Argentina and Brazil, where data over the first few months of the year are suggestive of continued strong performance. Moreover, the expansion across the region is being supported by the increased geographic diversity of exports, and improvements in balance of payments positions that have significantly reduced the region's dependence on external capital inflows. This contrasts with earlier upswings when capital inflows and domestic demand (particularly expansionary fiscal policies) fueled the expansion, leading to widening current account deficits and overvalued currencies. Continuing strong growth is sustaining increases in employment; in Ecuador, for example, unemployment fell to 10½ percent in March, its lowest rate in two years, and in Peru, to 7¾ percent, its lowest level since 2000.

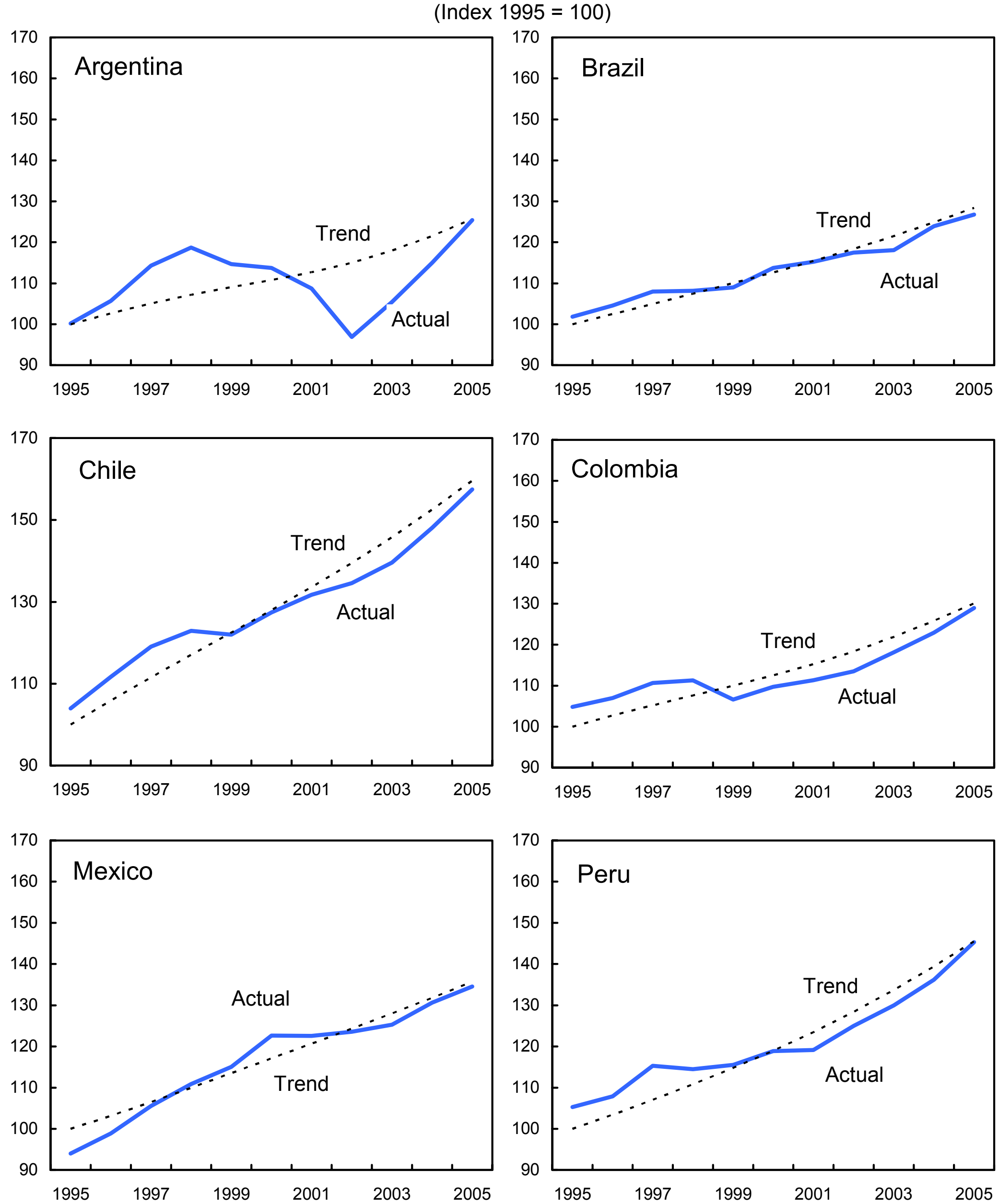
27. **Inflation is expected to be contained despite high world oil prices and narrowing output gaps.** In many cases, countries have taken the welcome step of passing through higher world prices to domestic consumers, and monetary policy has been careful to limit the second-round effects. However, this has generally not been the case for the region's oil producers (for example, the domestic subsidy on energy use has risen to 5 percent of GDP in Ecuador). Nonetheless, inflation-targeting frameworks and the more general shift towards greater macroeconomic policy transparency in the region have been effective in anchoring inflation expectations. As a result, end-year inflation for the region is expected to ease from 6 percent in 2005 (end-of-period basis) to 5¾ percent in 2006 at end period.



28. **Over the medium term, growth will ease toward longer-term trend rates as expansions mature and economies return to potential.** Despite strong growth in the region, output in many countries still appeared to be below potential in 2005. These output gaps would be virtually closed during 2006 and, by 2007, growth is expected to slow to 3½ percent—still above the longer run trend—as the external stimulus from the boom in fuel and non-fuel commodity prices slowly recedes.

Latin America: Trend and Actual Real GDP, 1995–2005 1/

(Index 1995 = 100)



Source: IMF staff estimates, based on WEO database.

1/ Trend output is calculated using an HP-filter.

C. Risks

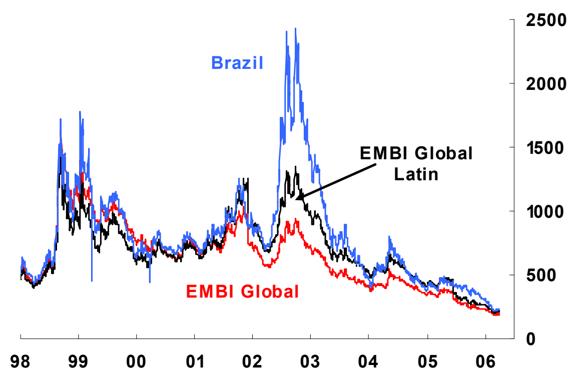
29. **Downside risks remain significant.** These include:

- **Global financial market conditions**: Bond spreads have fallen sharply in the region, coupled with steady improvements in credit ratings. (see also Boxes 1 and 2). As the credit cycle turns, the region will be affected, but less than in the past because of the gains that have been secured in debt management, pre-financing, and reserves.

- **Commodities prices:** Thus far, the LAC region as a whole has benefited from higher global energy prices, reflecting its position as a net exporter, and from the boom in non-oil commodity prices. However, the oil market is now expected to remain very tight, which could weigh on partner country growth and spill over to the region (Box 3). Moreover, the projected gradual decline in non-fuel commodities prices beginning in 2007 could pose a challenge for some countries, especially where structural impediments to labor and product market flexibility are severe.

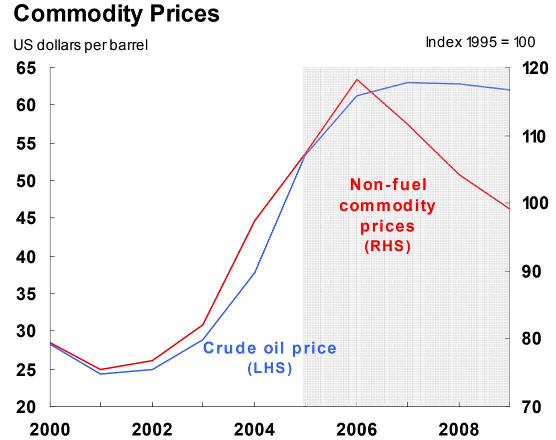
- **Political developments:** The election calendar in 2006-07 remains heavy and has raised concerns about a possible weakening of policy discipline and reform momentum. Encouragingly, inflation has generally not risen in the region in the run-up to elections or during election years in the recent past, a testimony to the increased social consensus for macroeconomic stability in the region (Box 4).

Emerging Market Debt Spreads
(Basis points)



Sources: J.P. Morgan and Datastream.

Commodity Prices



Source: WEO.

D. Policy Challenges and Priorities

30. **The region is at an important historical juncture.** The recent strong performance of the regional and global economy, and the continuing generally favorable outlook, provide a rare opportunity for policymakers in the region to move decisively further in addressing growth, poverty, and inequality vulnerabilities. This would pave the way for raising productivity and the growth potential in the region over the medium-term, and better meeting the increasingly urgent social aspirations of the population.

31. **Among the most important macroeconomic policy priorities are**:

- **Maintaining fiscal discipline and the commitment to reducing public debt/GDP ratios:** With the notable exceptions of Chile and Guatemala, the core challenge everywhere is to make further steady progress in reducing the public debt burden, especially short-term and foreign currency-linked debt. The rapid rise in primary spending in many countries in 2005 suggests the need for a firmer commitment in a number of countries to effective fiscal responsibility laws and expenditure rules, as well as improvements in budget formulation and fiscal reporting. Encouragingly, the Brazilian authorities—earlier this month—reaffirmed their intention to maintain the primary surplus target of 4¼ percent of GDP over the period through 2009.

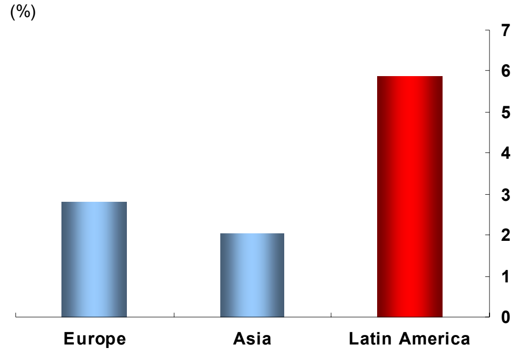
- **Improving the composition of spending to bolster growth and poverty reduction**: Reorienting government spending toward investment and efficient, well-targeted social programs—following the positive experience thus far, for example, in Brazil—would provide a welcome fillip to growth and poverty reduction. Improvements in the tax effort (and lower earmarking of revenues) will also be needed, especially in Central America, to support higher social spending in a fiscally sustainable manner.

- **Entrenching exchange rate flexibility and low inflation:** The region has been well served by the greater exchange rate flexibility of recent years, and the adoption of explicit inflation objectives. Care will be needed to maintain and deepen these commitments in the period ahead, even in the face of increases in global interest rates and shifts in investor sentiment. For countries that still face a high degree of external vulnerability, and a need for a further accumulation of reserves, the implied tradeoffs should not compromise exchange rate flexibility. This will help ensure that inflation remains well anchored and avoid the quasi-fiscal costs of sterilized intervention.

32. **Key structural policy priorities aimed at improving competitiveness include:**

- **Financial sector reform**: Following continuing reforms (e.g., Brazil and Mexico), prudential indicators point to an overall strengthening of financial sectors and financial sector institutions in recent years. Nevertheless, LAC financial markets are relatively shallow and real interest rates relatively high, in part owing to large spreads between deposit and lending rates.[3] Priorities in this area include further strengthening of regulatory and prudential frameworks, building systems for consolidated supervision, reducing taxation on the sector, raising access to credit, and improving the "credit culture," including by upgrading bankruptcy laws.

Net Interest Margins 1/
(%)

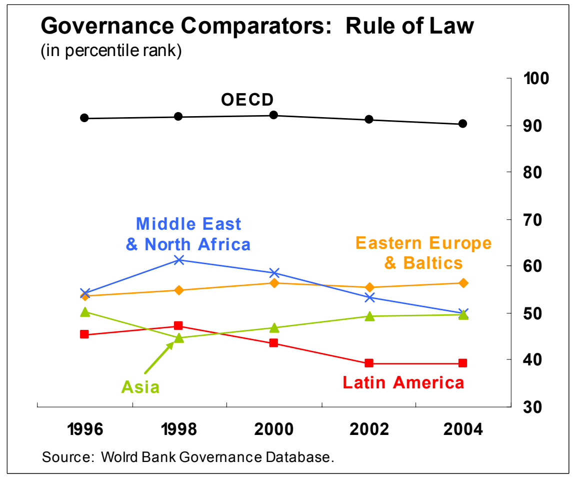


Source: Bankscope.
1/ Averages for 1995-2004 for selected countries in each region.
Latin American includes Bolivia, Brazil, Colombia, Mexico, Peru, and Uruguay.

[3] For additional assessment of the determinants of high intermediation spreads in Latin America, see Gelos (2006).

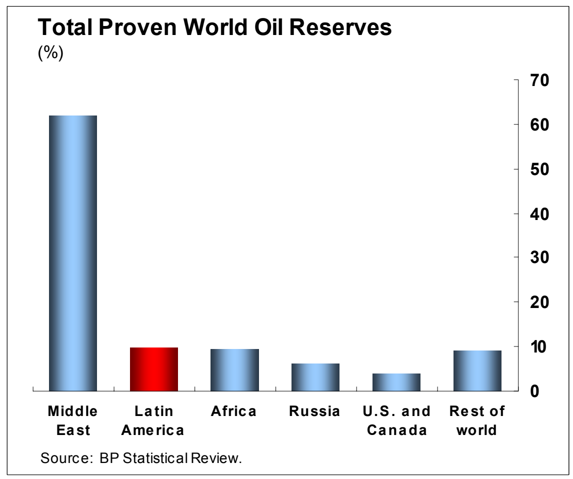
- **Improving the business climate:**

Encouragingly, there is a growing consensus within the region on the need to reduce corruption, improve governance, and meet the needs of the poor, especially since indicators of the quality of governance and the business environment compare unfavorably to other regions. Priorities include strengthening property rights, fortifying the judiciary and allowing the speedy enforcement of contractual obligations, providing greater transparency and stability in rules and regulations governing private investment, and reducing costly distortions, especially in the labor market.



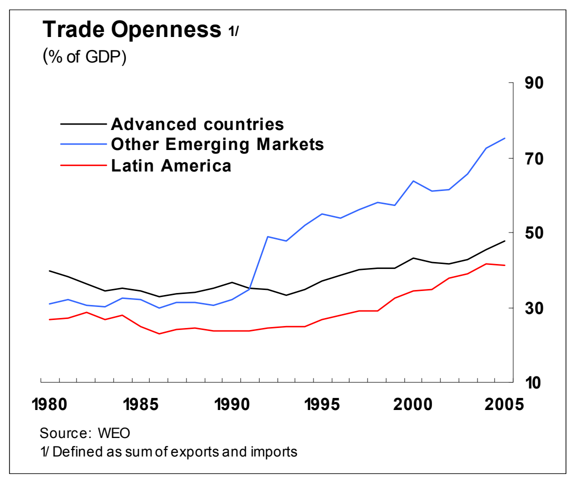
- **Efficient management of natural resources:**

Despite vast oil reserves, the region has been unable to take full advantage of the boom in oil prices. This reflects short-term factors—sporadic work stoppages—as well as deeper, underlying constraints that have inhibited investment (see Box 3). These constraints stem, in part, from the performance and governance structure of national oil companies, weak public finances that limit the ability of these enterprises to reinvest their surpluses, and an unpredictable policy environment in some cases that has discouraged private sector investment.



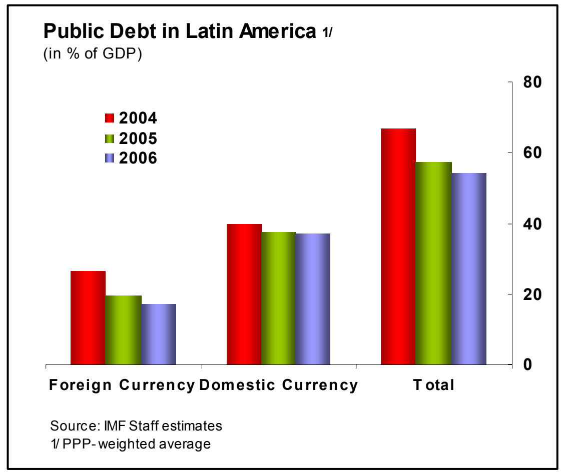
- **Enhancing openness and trade liberalization:**

Latin America is still relatively closed to international trade compared with other dynamic regions, and the region has an important stake in seeing a successful and ambitious conclusion of the Doha Round. Key areas that would be of particular benefit to the LAC region include the phasing out of export subsidies and restrictions on market access for agricultural imports, and tariff reductions on other goods by middle income countries. It will also be important to manage well the large number of integration initiatives in the region, including bilateral and regional agreements with the United States and other countries, to limit trade diversion and undue administrative burdens and inefficiencies that can result from multiple and often inconsistent rules of origin. There has been significant progress in moving these latter initiatives forward; CAFTA-DR, for example, has been ratified by all but one country, and has been implemented in El Salvador (March) and Honduras and Nicaragua (April). Bilateral free trade negotiations between the United States and four Andean countries (Colombia, Ecuador, Panama, and Peru) have also advanced. In the Caribbean, managing the transition following the erosion of trade preferences for bananas and sugar will be a key challenge.



Box 1. Recent Debt Management Operations in Latin America 1/

Earlier this year, a number of Latin American sovereigns undertook debt management operations to reduce their exposure to shifts in international investor sentiment. Brazil, Colombia, Ecuador, Mexico, Panama, and Venezuela announced buy-backs or exchanges of their foreign currency bonds. This is part of a broader trend in emerging market countries to pre-pay foreign currency obligations to IFIs, the Paris Club, and other creditors, and to exchange foreign for local-currency denominated debt. While the trend is taking place in many emerging market countries, these operations are concentrated largely in Latin America.



This debt management strategy has been facilitated by foreign investor inflows into emerging markets. These inflows have been from an increasingly diverse investor base, including pension funds, central bank/state agency allocations, wealthy individual investors, and Asian retail investors. In many countries, central banks have purchased part of these inflows to stem the upward pressure on currencies, and then sold international reserves to the government to help finance these operations.

Reflecting the effects of this debt strategy, as well as the appreciation of many currencies in the region, foreign currency debt of Latin American governments has fallen sharply in relation to GDP. This trend is likely to continue in 2006, as the recently announced buy-backs are expected to reduce the stock of external bonded debt of Latin America by $25-$30 billion (about 10 percent of the face value of bonds of the countries in the Emerging Market Bond Index (EMBI)). In early 2006, for example, the Brazilian government announced a program to buy back up to US$20 billion of external public debt through end-2006. With the recent decision to buy back US$6.6 billion in Brady bonds, the government has already carried out over half of this program. Debt swaps have lowered interest costs, extended maturities, and smoothed amortization profiles.

Governments have relied increasingly on local currency financing. Besides tapping resident investors, Brazil and Colombia have floated global bonds in local currency with features that attracted strong interest by international investors. Mexico and Peru already allow non-residents to transact in their local market for government securities free of withholding taxes and other impediments; and Brazil has recently eliminated its withholding taxes for foreign investors. By extending local market financing to foreign investors, these countries are enhancing the liquidity of their domestic financial markets and diversifying their investor base, lowering the cost of domestic debt.

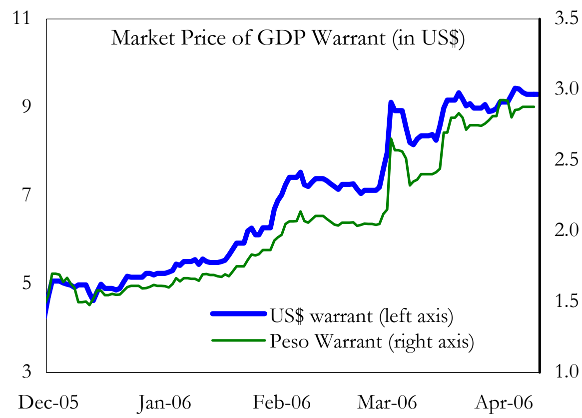
These operations are transforming the market for Latin American sovereign debt securities. Emerging market foreign currency debt is becoming scarcer, further lowering spreads and pushing investors into higher yielding, local currency instruments. According to market analysts, 80 cents of every new dollar in strategic inflows into emerging market debt this year is going into local currency instruments, and industry surveys show that about half of the volume of trade in emerging market debt last year was in local-currency instruments. Moreover, rising investor appetite for higher-yielding credits is opening up room for emerging market corporates and low-income countries to tap international markets.

Rating agencies are already rewarding these debt management strategies by ratings and outlook upgrades. Brazil recently received a credit rating upgrade by Standard and Poor's to its highest level ever, in part due to the strength of its debt management operations. Similarly, Moody's raised Colombia's rating outlook for foreign currency obligations to stable (from negative) after the announcement of debt buy-backs. In their comments, the ratings agencies praised the continued reduction of foreign currency debt and signaled the importance of the development of the domestic debt market.

1/ Prepared by G. Bannister, M. Papaioannou, M. Cerisola, and R. Rennhack.

Box 2. Declining Spreads and the Improving Valuation of Argentina's GDP Warrants 1/

In June 2005, Argentina issued a notional value of US$62 billion in GDP-linked warrants that were attached to the par, quasi-par, and discount bonds issued in the debt exchange. These warrants pay each year 5 percent of the amount that actual GDP in the previous year exceeds a base level of GDP (which was pre-specified in the prospectus for the debt exchange) but only as long as *both* the growth rate and the level of GDP are higher than in the base scenario. In addition, lifetime payments on the instruments are capped at 48 percent of the notional value.



On November 30 these warrants detached from the underlying bonds issued in the exchange and began to trade independently on financial markets. Since then, the market price of these instruments has virtually doubled due to the greatly improved near-term growth outlook and declining market spreads.

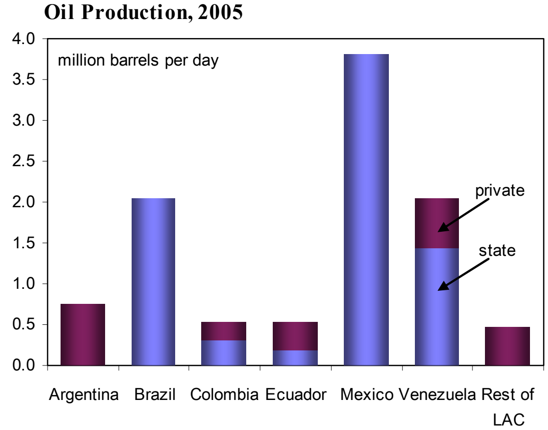
As a result, the ex-post value of Argentina's debt exchange offer has increased significantly. At the time the exchange closed, the haircut implied by the government's offer was estimated at around 75 percent of principal and past due interest. Given the current macroeconomic outlook, market spreads and price of the GDP warrant, this haircut has now fallen to around 59 percent of principal and past due interest. Around one-third of this improvement has been a result of the increased value of the GDP warrant.

1/ Prepared by Nigel Chalk.

Box 3. Oil Sector Developments and Challenges in the LAC Region 1/

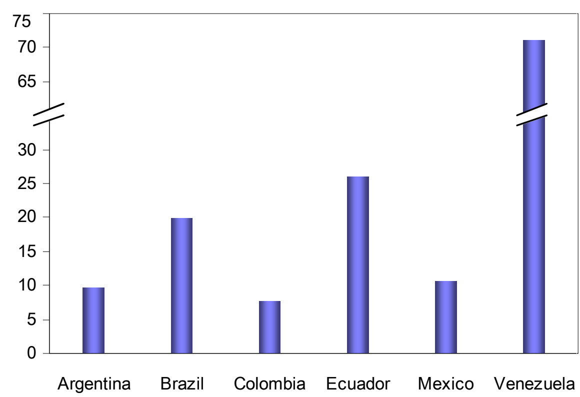
The petroleum sector plays an important role in the regional economy. LAC contributes nearly 14 percent of global oil output (around twice its share of world GDP), and has nearly 10 percent of world oil reserves. However, despite the sharp jump in oil prices, oil output has risen relatively modestly—by 4 percent over the past three years—while world output grew by 9 percent and OPEC production by 18 percent. This partly reflects a slow recovery from the 2002/03 slowdown in Venezuela's production, which lowered regional output, but output has also been weak or declining in other countries, with the exception of Brazil.

Oil Production, 2005



Source: IEA database, 2005

Oil Proved Reserves/Production Ratio, 2004



Source: BP Statistical Review, 2005

Most countries have run into capacity constraints that have limited their output response. As in the rest of the world, this is due to low investment rates, largely attributable to two decades of low oil prices. In some countries, where oil fields have matured and proven reserves have declined, significant new investment will be required to maintain production levels. Incentives to invest in LAC, however, have been particularly weak for several reasons: (1) the physical characteristics of the regional oil industry (relatively low oil reserves with discovery not keeping pace with extraction and the high proportion of heavy crude in the region's reserves—which are costly to refine and less attractive to develop); (2) the predominance of national oil companies (NOCs), which may face fiscal/borrowing constraints (see below); and (3) in some cases, uncertainties in the policy environment. Nonetheless, there are signs that investment is beginning to respond to the price increase—for instance, in Brazil, Colombia, and Mexico.

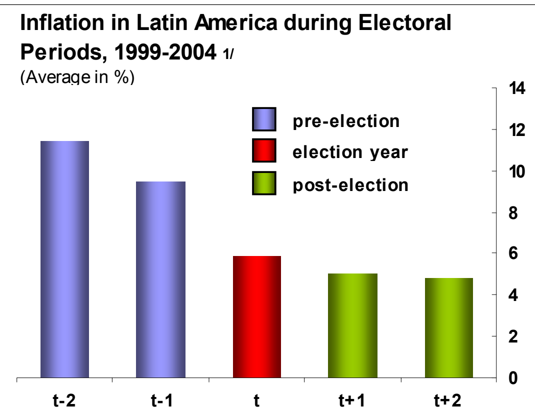
Oil producing countries have been looking to reform their NOCs and upgrade their access to technology to spur a greater supply response. Their investment capacities may be limited by fiscal constraints, in some cases from the need to subsidize domestic fuels or transfer surpluses to the government budget. The preferential position that some NOCs enjoy can also create inefficiencies and undermine governance.

Reform needs vary by country. Common elements are to promote greater investment and competition (e.g., by allowing oil companies to compete for contracts) under predictable regulatory and tax frameworks, and ensuring that NOCs operate under appropriate governance structures, including requirements that they are operated on a commercial basis and at arms-length from government. Brazil's Petrobras illustrates one approach in this direction: in practical terms, the company remains under the strategic control of the government, but with an important degree of private ownership, Petrobras has been able to significantly expand oil production over the last decade.

1/ Prepared by A. Cheasty and S. Phillips.

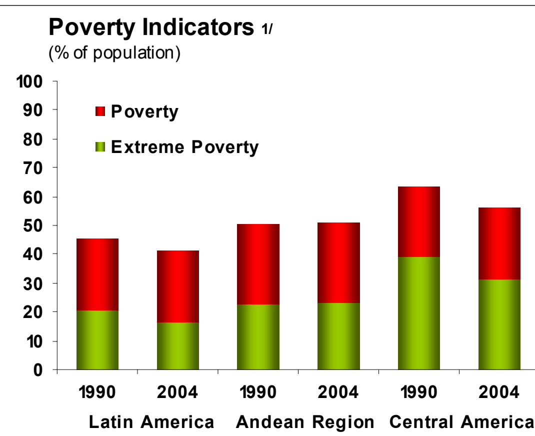
Box 4. Macroeconomic Stability and the Electoral Calendar 1/

The electoral timetable in the region is intense. Fifteen countries in Latin America, including the largest countries in the region, are set to hold Presidential, Congressional, or local elections in 2006 and 2007 that will have an impact on the lives of more than 500 million people. While these elections represent an opportunity for countries to strengthen mandates for policy frameworks and reform agendas that are beginning to bear fruit, there are clearly risks that campaigns and outcomes might weaken policy discipline, stall structural reform, and renew macroeconomic volatility—thereby reintroducing the costly boom-bust cycles of the past.



1/ Sample includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, and Uruguay.

Thus far, recent political transitions have been achieved while maintaining macroeconomic stability. Since 1999, inflation—which can be seen as a rough proxy for macroeconomic stability—has generally not risen in the run-up to and during election years. This suggests that the consensus for macroeconomic stability is becoming more deeply entrenched, with much greater political and social awareness of the debilitating effects of the region's past history of financial instability on investment, growth, poverty, and income inequality. Recent polls also suggest that popular support for democracy and the essential elements of a market economy remain strong. Perhaps most importantly, in a number of countries in the region, center/left governments have advanced policies to meet social priorities without sacrificing macroeconomic prudence.



Source: ECLAC.
1/ Based on 2004 or latest available data.

Nevertheless, the region confronts important challenges and rising frustrations with social outcomes. These problems could prompt a return to populist policies if they are not tackled decisively. Growth in Latin America has lagged other emerging market regions, and poverty, as well as income inequality, remain high. This makes only more urgent the need to develop and press forward with a strengthened structural reform agenda that not only raises growth but also strengthens institutions to ensure that the benefits of this growth are shared widely.

1/ Prepared by C. Faircloth.

Latin America and the Caribbean
Main Economic Indicators
Latest WEO Projections

	Output Growth (annual rate in percent)					Inflation (period average)					Ext. Current Account (in percent of GDP)				
	95-03 Avg.	2004	2005	2006 Proj.	2007 Proj.	95-03 Avg.	2004	2005	2006 Proj.	2007 Proj.	95-03 Avg.	2004	2005	2006 Proj.	2007 Proj.
Latin America and the Caribbean 1/	**2.2**	**5.6**	**4.3**	**4.3**	**3.6**	**13.1**	**6.5**	**6.3**	**5.8**	**5.6**	**-2.3**	**0.9**	**1.2**	**0.8**	**0.2**
South America and Mexico	**1.9**	**6.4**	**4.7**	**4.6**	**3.8**	**12.7**	**6.3**	**7.0**	**6.4**	**6.5**	**-2.0**	**2.5**	**2.7**	**1.9**	**1.0**
Argentina	0.4	9.0	9.2	7.3	4.0	4.6	4.4	9.6	12.9	15.0	-0.8	2.2	1.8	1.2	0.5
Bolivia	3.2	3.6	3.9	4.1	3.9	5.3	4.4	5.4	3.4	3.1	-4.7	3.2	2.6	1.7	1.0
Brazil	2.1	4.9	2.3	3.5	3.5	14.9	6.6	6.9	4.9	4.4	-3.1	1.9	1.8	1.0	0.2
Chile	4.5	6.1	6.3	5.5	5.2	4.8	1.1	3.1	3.8	3.0	-2.3	1.5	-0.4	0.5	-1.2
Colombia	1.9	4.8	5.1	4.5	4.0	13.4	5.9	5.0	4.7	4.2	-2.5	-1.0	-1.7	-1.6	-2.7
Ecuador	2.0	6.9	3.3	3.0	2.2	35.6	2.7	2.4	3.4	3.0	-1.9	-1.1	-0.9	0.2	0.4
Mexico	2.6	4.2	3.0	3.5	3.1	16.4	4.7	4.0	3.5	3.0	-2.2	-1.1	-0.7	-0.6	-0.8
Paraguay	1.2	4.1	3.0	3.5	4.0	9.9	4.3	6.8	7.4	4.4	-2.1	0.2	-2.7	-1.7	-1.8
Peru	3.3	4.8	6.7	5.0	4.5	5.6	3.7	1.6	2.7	2.2	-4.2	0.0	1.3	1.4	0.3
Uruguay	-0.3	12.3	6.0	4.0	3.5	16.9	7.6	5.9	5.5	4.9	-1.2	-0.7	-2.4	-5.8	-2.5
Venezuela	-0.6	17.9	9.3	6.0	3.0	39.1	21.7	15.9	11.7	17.3	5.6	12.5	19.1	14.1	13.4
Central America 1/	**3.7**	**3.9**	**3.8**	**3.9**	**3.8**	**8.2**	**7.4**	**8.6**	**7.4**	**5.8**	**-5.1**	**-5.7**	**-4.9**	**-4.9**	**-4.8**
Costa Rica	4.4	4.1	4.1	3.6	3.0	12.9	11.5	13.6	13.1	11.0	-4.0	-4.3	-4.8	-4.6	-4.2
El Salvador	3.1	1.5	2.8	3.5	3.5	4.1	5.4	4.0	4.0	2.5	-2.0	-4.4	-4.0	-4.0	-4.0
Guatemala	3.5	2.7	3.2	4.1	4.0	7.5	7.6	9.1	6.9	5.4	-4.7	-4.4	-4.5	-4.2	-4.3
Honduras	3.1	4.6	4.2	4.3	4.5	15.0	8.1	8.8	6.8	5.7	-3.8	-5.6	-0.5	-3.4	-3.3
Nicaragua	4.1	5.1	4.0	3.7	4.3	8.9	8.5	9.6	8.8	6.1	-23.3	-16.9	-16.9	-16.7	-16.0
Panama	4.1	7.6	5.5	4.5	4.0	1.0	0.5	2.9	2.2	1.5	-4.9	-7.9	-5.4	-4.7	-4.6
The Caribbean 1/ 2/	**4.2**	**2.3**	**5.9**	**5.3**	**4.5**	**9.3**	**27.2**	**6.9**	**8.3**	**5.8**	**-3.8**	**1.3**	**-1.1**	**-1.0**	**-1.4**
The Bahamas	3.4	3.0	3.4	3.6	4.0	1.7	0.8	2.0	1.2	2.0	-10.4	-5.3	-12.3	-14.6	-14.2
Barbados	2.1	4.8	4.2	4.2	4.5	2.1	1.4	5.9	6.2	4.7	-2.9	-11.9	-12.2	-11.7	-10.4
Belize	5.5	4.6	2.2	2.7	4.0	1.6	3.1	3.5	1.9	3.6	-11.2	-17.7	-13.1	-8.6	-8.1
Dominican Republic	5.5	2.0	9.0	5.4	5.0	9.6	51.5	4.2	8.5	5.0	-1.7	5.8	-1.0	-2.4	-3.0
ECCU economies 1/	2.6	3.2	3.7	4.8	3.9	1.9	2.0	2.8	2.8	2.3	-16.6	-16.0	-20.5	-21.2	-16.2
Guyana	2.4	1.6	-2.8	4.2	3.8	6.1	4.7	7.1	6.9	4.4	-14.0	-9.5	-24.2	-27.9	-20.8
Haiti	2.4	-3.8	1.5	2.5	4.0	17.1	28.3	16.8	13.1	8.9	-0.3	0.4	0.4	-0.6	-0.4
Jamaica	0.5	2.5	0.7	3.7	3.0	11.3	12.8	16.5	11.3	10.2	-5.7	-6.1	-8.2	-12.8	-10.8
Trinidad & Tobago	7.4	6.6	7.0	10.4	4.9	4.3	3.8	6.9	7.8	7.5	0.9	13.5	16.6	21.0	16.0
Memorandum items:															
United States	3.1	4.2	3.5	3.4	3.3	2.4	2.7	3.4	3.2	2.5	-3.1	-5.7	-6.4	-6.5	-6.5
Canada	3.4	2.9	2.9	3.1	3.0	2.0	1.8	2.2	1.8	2.0	0.7	2.2	2.2	3.1	2.9

Source: Fund staff estimates.
1/ Weighted average. For output and inflation, weighted by ppp GDP; for external current account, dollar-weighted GDP.
2/ Average includes the Netherlands Antilles.

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