Latin American Weekly Spotlight

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Dresdner Bank Lateinamerika AG
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Andean Region: Free-trade negotiations with the US this week
Argentina: Interventionist energy policy
Brazil: Industrial production growth by 6% in first quarter
Chile: Central bank leaves key interest rate unchanged
Colombia: Important agreement with paramilitary groups
Dominican Republic: No second ballot necessary – Fernández elected president
Ecuador: : IMF mission starts visit in the country
Mexico: Slight deception with Q1 GDP figures possible
Peru: Largest trade union announces general strike
Venezuela: Alleged conspiracy against President Chávez detected

Research Note on Brazil: How high is the probability of a new balance-of-payments crisis?

Andean Region

Free-trade negotiations between the US and Colombia, Ecuador and Peru are due to start tomorrow. The Andean region already receives trade preferences on their exports to the US as part of the Andean Trade Preference Act, amended by the Andean Trade Promotion and Drug Eradication Act. By means of a Free-Trade Agreement the Andean countries hope to secure the trade benefits granted up to now unilaterally by the US, which absorb around 40 % (Colombia and Ecuador) and around 30 % (Peru) of their exports. A possible FTA would also increase the countries' attractiveness for foreign investments. As the overall FTAA negotiations seem stucked at the moment, bilateral deals may be viewed by the US as an alternative means to further their intentions in Latin America. We therefore expect negotiations to advance quickly, although a conclusion cannot be expected before US presidential elections in November.

Argentina

The government announced a long-term investment program (US$ 3.7 bn) for the energy sector. It will be financed in part by a hike of taxes on exports of oil and gas. Furthermore, a state-owned energy company (oil, gas and electricity) will be set up to function in the otherwise largely privatized energy sector. ---- The UDTD consumer confidence index rose somewhat in May to 50.64. Apparently the energy crisis has not affected consumer confidence as strongly as expected.

Outlook: According to IMF sources the third revision of the current program, which was about to start this week, has been postponed to June at the request of the Argentine government. The reason for the delay is Argentina's wish to concentrate on the debt rescheduling proposal and reforms (e.g. the tax-sharing system between the central government and the provinces). We continue to expect the third revision to be difficult, especially as future primary surplus targets have to be agreed upon. ---- Due to the the effects of the energy crisis we expect growth of industrial production to have weakened in April (March: +1.3%, mom, s.a.; +15.7% yoy). Preliminary figures for April will be published on Tuesday. ---- The monthly GDP indicator EMA (Wednesday) is likely to show slight growth again in March. In February it had been flat (mom, s.a.).

Brazil

Excellent economic activity data: The industrial production (IBGE) increased by 2.1% mom (s.a.) and by 11.9% yoy in March. Thus industrial production rose by 5.8% in the first quarter. Industrial sales (CNI), at 3.45% mom (sa.) and 22.3% yoy, were even stronger. These extraordinary increases are only in part due to the higher numbers of working days in comparison with March 2003; above all, they are a sign of a robust economic upturn. This is confirmed by the April data of the automotive sector, where the production increased by 11.6%. ----- Unlike production figures the consumer confidence index of the Getulio Vargas foundation shows a negative trend. Only 66.8% of the interviewed think that the economic situation is as good as or better than 6 months ago (against 70.1% in January). ----- The latest CNT/Sensus poll from the beginning of May shows that the approval rate of the president increased marginally, in spite of recent weeks' political tensions. ----- The international image of President Lula may have been damaged after the quasi-expulsion of an American journalist who wrote a populist article about Lula (suggesting that he has problems with alcohol). Meanwhile, a national court has revoked the decision. ----- The central government's tax collection increased in April (3% yoy in real terms), mainly due to the recent acceleration in growth.

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Outlook: On Wednesday the central bank will probably cut the key interest by another 25 basispoints (to 15.75%), thus signaling to the markets that it keeps calm amid the market turbulence. However, the change in the global interest rate environment (we expect some interest rate hikes by the fed this year) will make it more difficult to cut the Selic to 14% (our year-end forecast up to now). ------ In April, the current account might show a deficit of US$ 850 mn. This could be explained with high interest rate payments in this month. For the whole year we expect a surplus of US$ 4 bn (Thursday). ----- Foreign direct investment should reach US$ 450 mn in April. For the whole year we expect an inflow of US$ 11.5 bn, only slightly more than in 2003 (Thursday). ----- Along with employment in the industrial sector of Sao Paulo (according to FIESP), the consumer confidence index IIC (Sao Paulo) should have decreased in May in comparison with April.

Chile

As expected, the central bank left the monetary policy interest rate unchanged at 1.75%. According to a statement, both inflation, which is expected to return into the CB's target range (2-4%) over the next 24 months, and economic activity behave as forecasted. We do not expect a monetary policy action until the end of Q3, when a new monetary tightening cycle should start.

Outlook: As economic activity is accelerating, we expect the central government's budget to post a sizeable surplus in April (today).

Colombia

Exports surprisingly receded in February (-4% yoy), partly due to disappointing coal exports (-2% yoy). We expect February figures to be influenced by one-time effects and stick to our forecasts of a small trade surplus (US$ 0.9 bn) and a reduced current account deficit (-US$ 1.2 bn) in 2004. ----- As expected the central bank left the repo rate at 6.75%. While inflation in April came in at the CB's target of 5.5%, prices should climb higher in the coming months. We expect the CB to hike rates in H2-04, driven by a monetary policy tightening in the US.

Outlook: In negotiations with ten heads of the AUC (biggest paramilitary organization in Colombia), the government granted a special area in which temporary immunity is given to AUC members in order to facilitate the negotiations concerning a demobilization of the AUC. The area will remain under state control, however. Negotiations seemed to get stucked after the disappearance of Carlos Castaño, an important AUC leader. Castaños' brother is among the signatories of the new agreement

Dominican Republic

Leonel Fernández, who already governed the country from 1996-2000, won yesterday's presidential elections with 51.2% of votes (preliminary). Incumbent president Mejia gained only 39% of votes and already accepted his defeat. We view this outcome, if confirmed, as market-positive, as there is no need for a second ballot and no prolongation of the current unstable situation. Also with regard to a probable public debt restructuring and the co-operation with the IMF the election of Fernández should be positive.

Ecuador

President Gutiérrez faces mounting criticism also in his own lines. His (separated) wife, which is also a member of his party in congress (one out of five) declared a change in economic policy vital for Gutiérrez to remain in office. ------ Tax collection increased by 24% yoy in April, driven by higher VAT and income tax revenues. Between January and April, tax collection increased by 14% yoy, 3 percentage points more than expected. ----- The IESS social security institute decided to invest no more than 50% of its portfolio in public debt paper. This is in line with the current legislation, but there had been moves in recent weeks which argued for a hike in the level the IESS is allowed to invest in public debt. On the one hand, this decision is market positive as it takes pressure from FinMin Pozo, who had been criticized for his support for a hike; on the other, the decision takes the public financing gap to around US$ 0.5 bn (2% of GDP). The remaining alternative source of financing, international capital markets, do not seem very receptive for Ecuadorian debt at the moment.

Outlook: An IMF mission arrived in Quito over the weekend. According to local press reports the government will make several proposals for structural reforms to be included in a new Letter of Intent. Supposed reform subjects include the oil sector and energy production and distribution and are intended to increase private investment in these sectors. Furthermore, according to the press, several state companies are to be sold and some changes of the social security are aimed at. Despite the expected conciliatory stance of the IMF we do not expect a new Stand-By Arrangement to be agreed before the end of July.

Mexico

Last week the rating agency S&P confirmed its rating (BBB-) for Mexico's long-term external debt and underlined Mexico's need of a comprehensive fiscal reform and structural reforms (like opening up the energy sector) in order to achieve a better rating. Moody's, the competing agency that apparently has a stronger focus on cyclical factors, did not rule out a further rating upgrade (currently Baa2) for Mexico this year.----Industrial

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production rose by a higher than expected 6.4% y-o-y. Over the last several months we saw a steady upward trend developing thanks to robust external demand. March dynamism, however, should prove to be an outlier.----On Friday the central bank left its monetary policy unchanged. This came in line with expectations. Recent inflation data justified a "tightening break". Nevertheless, we expect that the current tightening cycle is far from over.

Outlook: Today we expect the most important data release of the week: first quarter GDP. We expect a below-consensus growth of 2% y-o-y (despite the positive surprise in March industrial production figures), which should slightly disappoint the financial markets. Despite continuously high oil prices, which support the current account as well as the public finances, our 2004 GDP growth forecast remains unchanged at 2.8%, while the consensus is still expecting growth of 3.2%. In the second half of the year the economic activity should suffer from higher real interest rates and a slowdown in external demand.---On Wednesday INEGI will publish April's unemployment rate. Given the supportive developments in IMSS (the social security institute) employment figures we expect a slight decrease in the unemployment rate, from 3.8% in March to 3.7% in April.

Peru

Economic activity jumped by 5.5% yoy in March, well ahead of expectations (DBLA: 4%). Mining and fishing production showed considerable dynamism, while agricultural production receded slightly. We expect a continuation of the current positive trend, which has lasted for 33 months now (GDP forecast 2004: 3.8).

Outlook: The CGTP, Peru's biggest trade union, announced a general strike on July 14, calling for better working conditions, higher wages and an increase in public spending. Together with the ongoing conflict in the town of Ilave, this constitutes the government's biggest social conflict since the violent uprising in Arequipa. We would not dismiss the resignation of the government in the near term, even though nobody in the opposition seems willing to take over government responsibility in these turbulent times in Peru. ------ If, as intended by a decree approved by congress, recent advances concerning the pension reform (they imply fiscal savings) would be revoked, the president would have the possibility to veto the respective decision. We expect the government to decide on this in the coming weeks. ----- In Q1-04, the country's exports amounted to US$ 1.51 bn (+50% yoy), driven by higher prices of copper and gold (around 1/3 of exports each). We expect the current account to balance in Q1-04 (Q1-03: US$ -534 mn), as the trade balance improved by US$ 600 mn in the period.

Venezuela

As the date of the verification of the signatures given in favor of a presidential referendum keeps approaching (May 27-31), president Chávez and his supporters are resorting to threats and diversionary tactics. The uncovering of an alleged conspiracy against president Chávez, in which Colombian paramilitary forces and Venezuelan military personnel are said to be involved (more than 120 people arrested so far) is obviously being blown up and taken as an occasion to raise accusations against Colombia and the US. ----- The parliament's budget committee approved the issuance of the equivalent of US$ 1.6 bn in public debt instruments domestically and abroad (terms between 18 months and 20 years); thus issuance approvals for the year already exceed the equivalent of US$ 5 bn. We expect that the issues will be made in US$ during the third quarter of the year. ----- According to the statistics office, the jobless rate continued to drop in December 2003 (14.5%, following 15.4% in November). ----- Due to the unexpectedly high oil prices, the central bank is forecasting that foreign exchange earnings from oil will exceed budget figures by US$ 5 to 7 bn, so that the government may raise expenditure more than planned in the run-up to the possible referendum.

Outlook: This week, economic growth figures for the first quarter of the year are to be published. Given the low basis of comparison, we expect an increase of more than 20% yoy. Equally overdue are the figures concerning private manufacturing production for March.

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Research Note on Brazil

In our opinion, the current widening of spreads is not attributable to changes in fundamentals. The balance-of-payments situation remains good; the state is not in danger of missing the primary surplus target of 4.25% of GDP, and the economic upturn is intact as the latest industrial production figures show.

The starting point is the financing account shown in the table. According to these figures, in 2004 a total of US$ 54 bn in external funding will be required to finance US$ 52 bn in amortization payments along with a presumably moderate capital outflow via the CC5 accounts. The international capital market (broad definition: market for bonds, notes, commercial papers, bank and intercompany loans as well as alternative financing instruments)

Public and private sector	2003	2004	Jan-April 2004	Scenario 1 Basic scenario probability 75% May-Dec 2004	Scenario 2 Stress probability 20% May-Dec 2004	Scenario 3 Stress probability 5% May-Dec 2004
Uses: 1+2	**46.7**	**54.5**	**17.0**	**37.5**	**37.5**	**41.8**
Sources: Sum 3 - 9	**47.8**	**55.5**	**18.0**	**37.6**	**37.5**	**41.7**
Financing surplus (-)/deficit (+)	**-1.1**	**-1.0**	**-1.0**	**0.0**	**0.0**	**0.0**
1) Amortizations	**45.0**	**52.0**	**16.2**	**35.8**	**35.8**	**35.8**
a) Public sector (NFPS), without IMF	9.0	11.7	5.8	5.9	5.9	5.9
b) Public financial sector	1.0	1.4	0.4	1.0	1.0	1.0
c) IMF	12.4	4.4	1.4	3.0	3.0	3.0
d) Private sector (incl. intercompany loans)	22.6	34.6	8.8	25.8	25.8	25.8
2) Capital outflows via CC5 accounts	**1.7**	**2.5**	**0.7**	**1.8**	**1.8**	**6.0**
3) Current account balance	**4.1**	**3.9**	**0.8**	**3.1**	**6.0**	**9.0**
4) Capital inflows	**14.4**	**15.0**	**5.4**	**9.6**	**9.6**	**7.2**
a) Net foreign direct investments	9.1	10	2.8	7.2	7.2	7.2
b) Portfolio investments	5.3	5.0	2.6	2.4	2.4	0.0
5) Public-sector borrowing	**24.0**	**9.5**	**3.7**	**5.8**	**4.0**	**6.7**
a) NFPS borrowing	5	8.1	3.3	4.8	3.5	2.0
b) Public financial sector borrowing	1	1.4	0.4	1.0	0.5	0.3
c) IMF/IADB/WB borrowing	18.5	0	0.0	0.0	0.0	4.4
6) Private sector borrowing	**16.8**	**29.5**	**9.3**	**20.2**	**10.1**	**6.1**
7) Change FX reserves (- = increase; + = reduction)	**-11.5**	**-2.4**	**-1.23**	**-1.1**	**7.8**	**12.8**
Stock of FX reserves	49.3	51.7	50.5	51.6	42.7	37.7
Net FX reserves according to IMF definition	17.4	22.5	21.4	22.5	13.6	8.6

Scenario 1: 80% roll-over rate in the private sector
Scenario 2: 50 % roll-over rate in the private sector, depreciation of the real up to 3.40 BRL/US$
Scenario 3: 30% roll-over rate in the private sector, no further issues of sovereign bonds, depreciation to 3.70-3.80 BRL/US$.
Note: In all scenarios we assume that short-term debt will be completely renewed.

However, the widening of the spreads and, therefore, of the refinancing costs on the international capital market, will have consequences in real terms if this trend should continue over a protracted period of time. Private enterprises either cannot raise capital on the international capital market or can only do so at higher costs. The state will also find it more difficult to refinance its debt on maturity. The declining capital inflow would weaken the currency and, in the event of a sharp depreciation, may also lead to higher inflationary pressure which would then induce the central bank not to lower interest rates any further or indeed to increase them again. This would impair the level of economic growth and could also have political consequences for the Lula government, already increasingly under fire in recent months because no appreciable improvement is discernible on the labor market.

In order to assess the danger of such a downward spiral, we have performed a balance-of-payments analysis and offer several different scenarios.

is primarily available as a source of financing; in our assessment, the state will borrow US$ 11 bn and the private sector approx. US$ 30 bn. Other sources of funding are direct investments (US$ 10 bn), portfolio investments (US$ 5 bn) and the current account surplus (US$ 4 bn). The table shows that part of foreign currency inflows or borrowing, respectively, were already realized in the first four months of the year, but that the level of financing requirements remains high, particularly for the private sector. We assume that from May through December the private sector will renew 80% of debt still to mature (in the course of the year to date, the renewal rate was in the region of 100% but recently fell to below 50%). In the process, we assume that the significantly wider spreads in recent weeks will decline again slightly and will hover within a bandwidth of 600 to 650 points.

In this base scenario, the central bank could increase its foreign currency reserves, and the government would even be in a position to finance part of its amortization payments by purchasing foreign exchange on the forex market, as planned. In this case, it will be possible for

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our scenario of 3.5% growth without macro-economic turmoil to be maintained.

If – in a second scenario – we assume that the spreads will continue to widen further and that enterprises will only be able to renew 50% of foreign debt falling due for the rest of the year, the picture is a different one, without protracted turmoil necessarily materializing in the process. In this event, the financing requirements should exceed the inflow of foreign currency by US$ 7.8 bn. It is additionally assumed in this case that the current account surplus will increase to US$ 6 bn (for the remainder of the year). In other words, we anticipate that the exchange rate will react somewhat more sharply in this unfriendly scenario (depreciation to 3.40 reais/US$), no further interest-rate cuts will take place and the level of economic activity will turn out weaker. Imports are likely to decrease again, while (based on assumptions of unchanged world economic growth), exports should increase yet again. The remaining financing gap of US$ 7.8 bn would then need to be plugged by the central bank selling off foreign currency. Alternatively, the government would also be able, contrary to its past plans, to draw the US$ 4.4 bn in credit tranches to which it is entitled under the IMF facility (which, however, we do not assume to occur). The level of growth would weaken to 2.5 – 3% p.a. We consider this scenario to have a not insignificant probability of 20%.

The situation will become more critical in scenario 3, which we have given a probability of 5%. In this context, we assume that risk aversion for the remainder of the year will increase to such an extent that it will only be possible to renew 30% of private debt falling due. The state would be unable to make any further bond issues; instead, it would resort to IMF funds (which could be tricky in political terms). Capital flight via the CC5 accounts would rise to US$ 6 bn. Again, the current account would soon respond since the exchange rate might fall to 3.70-3.80 (the surplus would rise to US$ 9 bn). This would still leave a financing gap of US$ 12.8 bn, which would cause the central bank's net foreign currency reserves to decline to US$ 8.6 bn (in gross terms, they would amount to roughly US$ 37.7 bn). Even in this extremely unfavorable scenario, the balance-of-payments situation would still remain manageable. On the other hand, the central bank would be likely to tighten interest rates more sharply, resulting in a considerable impairment to the level of economic activity. Growth should decline to approx. 2% p.a. in this scenario.

While this scenario in theory includes a certain danger of a 2002-style crisis being repeated, this need not necessarily be the case.

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Abbreviations:

mom = month-on-month
qoq = quarter-on-quarter
yoy = year-on-year
s.a. = seasonally adjusted
n.s.a. = not seasonally adjusted

Exchange rate	date	last	one week	one month	one year	end 2003	ytd-change, %	end 2004f
Argentina	14.05.2004	2.91	2.92	2.83	2.94	2.93	0.5	2.9
Brazil	14.05.2004	3.09	3.14	2.91	3.00	2.89	-6.5	3.1
Mexico	17.05.2004	11.50	11.67	11.25	10.35	11.23	-2.3	11.9
Chile	14.05.2004	638	643	595	709	593	-7.1	600
Colombia	14.05.2004	2699	2736	2623	2780	2780	3.0	2800
Peru	14.05.2004	3.48	3.49	3.47	3.49	3.46	-0.6	3.5
Venezuela	14.05.2004	1918	1918	1918	1598	1598	-16.7	2400

EMBI+ Spread							
bps	date	last	one week	one month	one year	end 2003	ytd-change, bps
Argentina	17.05.2004	4887	4779	4635	5483	5739	-852
Brazil	17.05.2004	711	805	595	801	463	248
Mexico	17.05.2004	216	255	178	233	199	17
Colombia	17.05.2004	516	568	383	485	431	85
Ecuador	17.05.2004	858	1066	740	1153	799	59
Peru	17.05.2004	459	549	327	457	312	147
Venezuela	17.05.2004	653	759	633	1136	593	60

Benchmark interest rates							ytd-change	
%	date	last	one week	one month	one year	end 2003	%-points	end 2004f
Argentina, Peso 7 days	14.05.2004	2.13	2.00	1.63	6.94	1.81	0.3	4.0
Brazil Selic	14.05.2004	15.74	15.73	15.80	26.32	16.33	-0.6	14.0
Mexico Cetes 28 days	14.05.2004	6.81	6.96	6.31	5.34	6.01	0.8	6.5
Chile 90 days, PDBC	13.05.2004	1.37	1.33	1.49	2.48	2.29	-0.9	2.8
Colombia Prime Rate	23.04.2004			11.13	10.63	11.32		7.5
Peru Overnight	14.05.2004	2.55	2.55	2.55	3.88	2.50	0.0	2.6
Venezuela Prime Rate								

Foreign exchange reserves								
US$, bn	date	last	one week	one month	one year	end 2003	ytd-change	end 2004f
Argentina	12.05.2004	16.1	16.0	15.1	11.4	14.1	2.0	17.0
Brazil	13.05.2004	49.9	50.6	50.8	43.3	49.3	0.7	54.2
Mexico	07.05.2004	69.2	68.9	68.2	55.9	65.8	3.4	65.0
Chile	30.04.2004	16.0		15.96	15.89	15.89	0.1	16.6
Colombia	4/2/04	11.33						
Peru	4/2/04	10.5						
Venezuela (FEM&Gold incl.)	13.05.2004	24.7	24.565	23.65	24.57	21.30	3.4	-6.7

Economic activity								
GDP (yoy, %)	2003e	2004f	2005f	Q303	Q403e	Q104f	Q204f	GDP 2003e, US$ bn
Argentina	8.7	6.5	3.8	10.2	11.3	8.8	6.8	127
Brazil	-0.2	3.5	3.5	-1.5	-0.1	2.4	5.2	492
Mexico	1.3	2.8	2.6	0.6	2.0	1.8	3.7	614
Chile	3.3	4.8	4.5	3.1	3.3	4.4	4.8	72
Colombia	3.7	4.0	3.7	4.1	4.5	5.1	4.1	78
Ecuador	2.7	4.8	2.9					27
Peru	4.0	3.8	3.7	3.5	2.8	2.9	2.3	61
Venezuela	-9.2	6.0	5.0	-7.2	9.0	26.4	3.4	82

Public sector	Budget balance, % of GDP		Public debt, % of GDP		Amortization, US$ bn		Gr. financing needs, US$ bn	
	2003e	2004f	2003e	2004f	2003e	2004f	2003e	2004f
Argentina	1.2	1.6	140	150	19.8	19.8	19.1	18.2
Brazil*	-5.2	-2.6	83	79	94.2	83.2	72.1	67.3
Mexico**	-0.6	-0.3	28	28	23	29	26	31
Chile***	-1.0	0.2	16	14	0.8	0.8	1.4	0.8
Colombia	-2.8	-2.8	63	61	6.2	5.3	8.4	7.9
Peru	-1.9	-1.4	47	46	1.1	1.5	2.3	2.4
Venezuela	-3.6	-4.5	42	47	4.7	6.1	7.7	10.0

* Amortisations only federal debt, including short term debt ** Amortisations without Cetes *** debt, amortization and financing needs: central government only

External Sector 2004f	External debt		Debt service		Current account		Trade Balance	FDI (net)	Import cover
	% of exports	s.t., % of total	US$ bn	% of exports	% of GDP	US$ bn	US$ bn	US$ bn	months
Argentina	374	30	32.3	82	2.2	3.3	11.5	0.0	5.6
Brazil	237	12	64.0	69	0.6	3.3	26.3	13.0	7.1
Mexico	83	28	33.3	17	-1.8	-11.0	-7.8	14.0	3.5
Chile	135	18	6.8	21	1.8	1.6	6.0	1.5	6.3
Colombia	243	12	7.9	49	-1.3	-1.2	0.9	2.0	6.3
Ecuador	226	14	2.6	35	-2.0	-0.6	0.1	1.2	1.2
Peru	238	16	3.6	28	0.0	0.0	1.7	1.1	9.4
Venezuela	122	11	5.0	18	9.5	8.3	14.2	1.4	11.1