

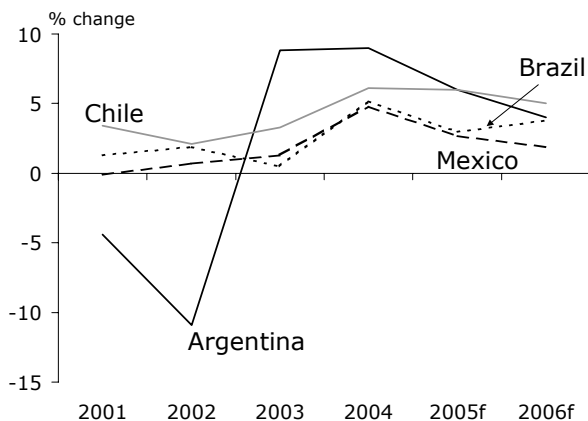
# Latin America Regional Report

## Elections are coming as economies slow

- Every major Latin American economy has federal elections by end 2006, with increased populist noise expected
- We expect growth to moderate this year and next given tighter monetary policies; there will also be concerns about inertial inflation
- The external environment should remain supportive, with the major risk coming from an unexpectedly sharp drop in US demand
- However, improved creditworthiness over the past several years means the electoral cycle should pass without major disruption

Real GDP rose 5.9% in across the region in Latin America last year, the highest single-year rate of growth experienced by the region since 1980.<sup>1</sup> This stronger-than-expected result came thanks to a very supportive external environment, with high commodity prices bolstering the current account and low US interest rates supporting capital inflows. The base effect also came into play after the low to negative growth rates of the previous several years resulting from successive financial market disruptions from 1995 through 2001.

### Real GDP growth



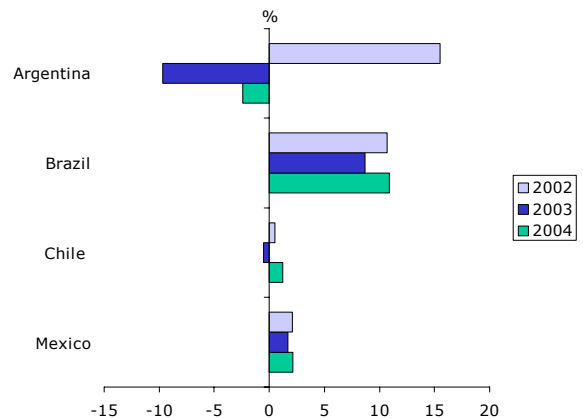
Source: Datastream

However, as growth in many economies primarily came from booming exports and the trickle down of global liquidity, inflation pressures also increased quite rapidly. Central banks swiftly tightened monetary policies, but inefficient transmission means inflation in most economies is still above 5%. In a region that remembers hyperinflation, central banks have to work hard to avoid inertial inflation. While the central banks in Mexico and Brazil in particular are hoping to have come to the end of their tightening cycle, inflation

<sup>1</sup> This and all regional economic indicators in this report are calculated on a PPP-weighted basis.

data in Brazil at least is still coming in at higher than expected.

### Real interest rates rose in 2004



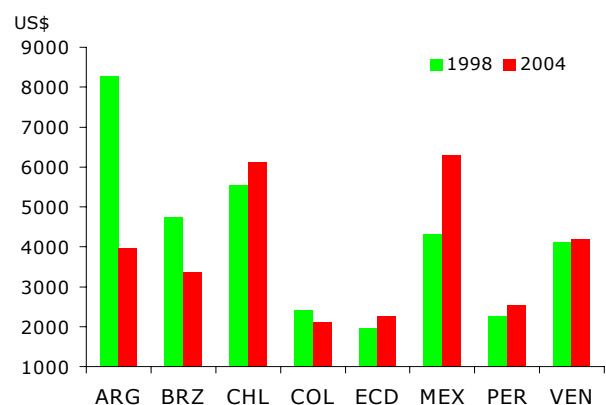
Source: Datastream

The response to higher rates has been noticeable, with growth for the region likely to have slowed to just over 4% in the first quarter of 2005 from 6.1% and 5.7% YOY in the third and fourth quarters of last year, respectively.

### Political winds begin to blow

Aside from inflation, the other long-term impact of the past eight years of crises has been wealth destruction. Income inequality has always been an issue in Latin America, but the devastation of the middle class in once wealthy countries is permanent scar. Recent strong growth has not compensated for what has been lost, and GDP per capita on a market basis is at or below 1998 levels in most countries. Mexico and Chile have diverged from the region, exhibiting the benefits of reform.

### GDP per capita: 1998 vs 2004



Source: Datastream

Elsewhere, however, populist politics are back with a vengeance in Latin America as the majority of the population have yet to experience improved living standards. The last election round brought Kirchner in Argentina, Lula in Brazil, Toledo in Peru, Chavez in Venezuela and Lagos in Chile – all left-of-centre politicians. Even conservative Uribe in Colombia is an independent, and Fox in Mexico is from a party that had never before held the executive branch.

Over the last five years, political sentiment has shifted further to the left. In an incident that would have been unheard of during the pro-market, 1990s decade of reform, the majority of Latin American governments refused to publicly back the Bush administration earlier this year in its criticism of President Chavez for importing loads of Russian-made small arms for a newly-declared civilian militia (and possibly Colombian guerrillas). In a subsequent election for the new head of the Organization of American States, the Latin heads of government refused to endorse the US-picked nominee from El Salvador, and insisted on a Chilean politician. The elections of 2005-2006 are likely to see another class of left-of-centre politicians chosen for office.

**Latin America's electoral calendar**

| Country   | Election  | Date                   | Comment                       |
|-----------|---|------------------------|-------------------------------|
| Argentina | Half of Chamber of Deputies and one-third of Senate | Oct 2005               | Presidential in 2007          |
| Brazil    | Presidential and Chamber of Deputies                | H2 2006                | Lula eligible for re-election |
| Chile     | Presidential  | Dec 2005               | Lagos not eligible            |
| Colombia  | Presidential (2 rounds) Congress & Senate           | May 2006<br>March 2006 | Uribe may be eligible*        |
| Ecuador   | Presidential  | N/A                    | Interim gov't                 |
| Mexico    | Presidential (2 rounds) Congress & Senate           | Q2 2006                | Fox not eligible              |
| Peru      | Presidential (2 rounds) and Congress                | April 2006             | Toledo not eligible           |
| Venezuela | Presidential National assembly                      | Dec 2006<br>July 2005  | New constitution              |

\* Pending likely passage of constitutional amendment

Source: www.electionworld.org; local media

Economically, an orthodox macroeconomic policy framework was held in place by the 2000-2001 political class, with the exception of Argentina and Venezuela. Lula's efforts to improve Brazil's fiscal position in particular delighted the financial markets, and the overall positive sentiment allowed the region to recover from a period of prolonged economic and financial volatility. However, Venezuela and Argentina have moved in the opposite direction, increasing the isolation of their countries from the global economy.

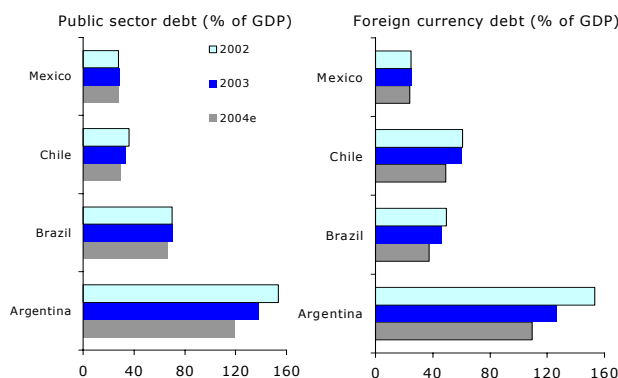
Unfortunately, even reform-minded governments were by and large unable to proceed with microeconomic reform to advance productivity and prosperity – including Fox in Mexico and Uribe in Colombia. With elections around the corner, these governments have already become lame duck, and legislative agendas are now highly unambitious. This

is unfortunate. Productivity has advanced in only a few economies, and capacity constraints will remain a challenge for future governments.

**But ability to withstand shocks in place**

The good news is that the macroeconomic reforms undertaken across the region over the past decade have vastly improved the region's ability to withstand external shocks. In addition to liberalising capital accounts and exchange rate regimes, governments have actively worked to eliminate structural fiscal deficits and reduce the public sector's explicit and contingent liabilities. The efforts to reduce foreign currency debt in particular have led to deeper and more efficient local financial markets while reducing vulnerability to fluctuations in the local currency rate of exchange and the direction of US monetary policy.

**Debt burdens continue to decline**



Sources : JP Morgan, Datastream, national sources

Several Latin American countries have received multiple credit rating upgrades in recent years as a result of ongoing debt reduction and reduced vulnerability to external shocks. On a weighted average basis, Latin America as a region has graduated from a single-B region in 2001 to a BB- with a positive outlook in 2005 in the view of the major credit rating agencies.

**Region-wide upgrades since 2001**

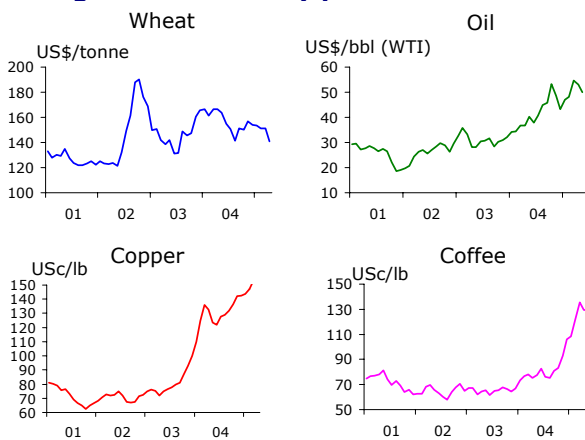
| Country   | LT FC ceiling/LT FC bank deposits |           | Change |
|-----------|-----------------------------------|-----------|--------|
|           | 2001                              | 2005      |        |
| Argentina | Caa3/Ca                           | Caa1/Caa2 | +2/+2  |
| Brazil    | B2/B3 (2002)                      | B1/B2     | +1/+1  |
| Chile     | Baa1/Baa1                         | Baa1/Baa1 | -      |
| Colombia  | Ba2/Ba3                           | Ba2/Ba3   | -      |
| Ecuador   | Caa2/Caa3                         | Caa1/Caa2 | +1/+1  |
| Mexico    | Baa3/Ba1                          | Baa1/Baa1 | +2/+3  |
| Peru      | Ba3/B1                            | Ba3/B1    | -      |
| Venezuela | Caa1/Caa1 (2003)                  | B2/B3     | +2/+1  |

Source: Moody's Investor Services

## The golden ticket: no recession, no hyperinflation

Our current expectations are that this business cycle should see Latin America achieve what has historically been an elusive dream: the soft landing. GDP growth should moderate to 3-4% in 2005 and 2006, and inflation will hover around 5% while exchange and interest rates should remain broadly stable. With luck, this period of stability will at least reduce populist pressures, and allow governments to pursue more ambitious reforms if they are so inclined. Our forecasts for relatively strong commodity prices will provide a further cushion for fiscal and external balances.

### Regional commodity prices remain strong



Source: Datastream

### Risks exist, but probability of a crisis is low

Even absent further economic reform, the improved creditworthiness of the region overall implies that an unexpected shock is unlikely to lead to a financial or economic crisis. Mexico and Brazil in particular are on the upswing, with relatively little left to do on the macro reform front aside from ongoing tax reform. The fact that Lula's opinion polls remain favorable despite a relative absence of populist policies bodes well for the next election, although the departure of parties from the PT's congressional coalition and the moves by other left-of-centre political parties to front their own candidates is a worrying trend.

Mexico's July 2006 election will generate a lot of noise and mostly likely a return of the PRI to government, but macro stability and economic ties to the US are now well entrenched. Argentina's efforts to normalize its relationship with the international capital markets could see the country on its way to recovery, although the political climate is poor and lack of consensus on the future path will remain problematic. The main concern through the region is Venezuela, where military-style rhetoric has reached uncomfortable levels and the economy is growing only because of increased government control. Most worryingly, Chavez's intervention with the oil industry could reach new levels that would

threaten the future of foreign resource companies in the country. Venezuela's shared border with Peru and Colombia as well as its status as the top foreign supplier to the US of crude oil mean developments there will continue to impact the region and the financial markets going forward.

### Final caution: 2005 could see El Nino

The Australian Bureau of Meteorology currently forecasts the probability of an El Nino occurring this year to be 30-50%, double the risk normally seen at this time of year. Flooding associated with the severe El Nino of 1996-1997 decimated the shrimping industry in Ecuador and the anchovy industry in Peru; it also affected Brazil's agricultural output. Clients interested in monitoring this risk will find the Bureau's reports useful.<sup>2</sup>

The main economic threat to our benign outlook for Latin America is a confluence of falling commodity prices and peaking US interest rates some time toward the end of 2005 or early 2006 combined with ongoing downgrades in forecasts for global economic activity. The arrival of a severe El Nino would exacerbate these weaknesses. Major global risks such as a disorderly correction of the US current account deficit and sharp swings in the US dollar or bond yields would be the likely root cause of the worst case scenario. In these circumstances, it would be difficult for the authorities in the region to achieve a balance between inflation and growth.

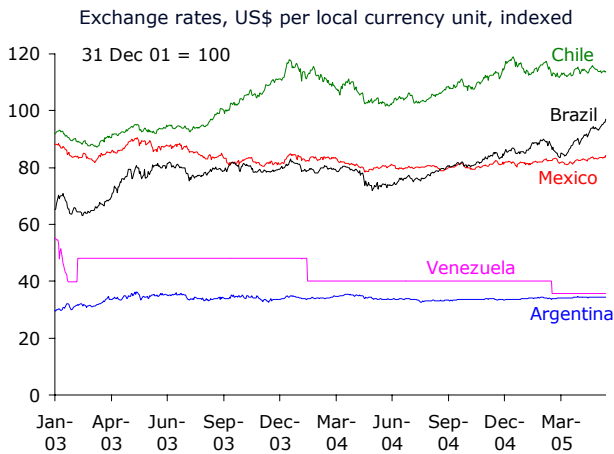
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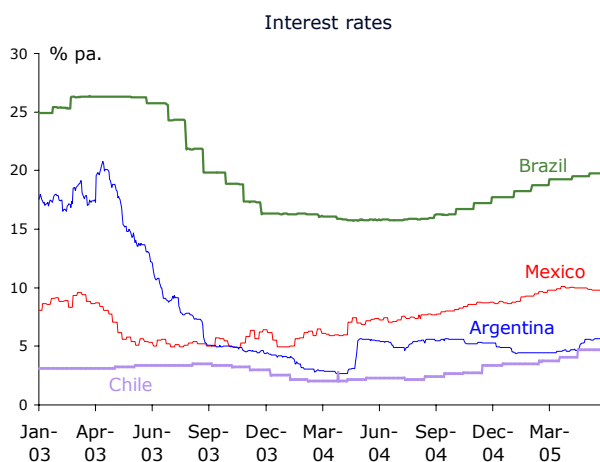
Research can also be viewed on our website:  
<http://www.anz.com/go/economics>

<sup>2</sup> <http://www.bom.gov.au/climate/enso/#current>

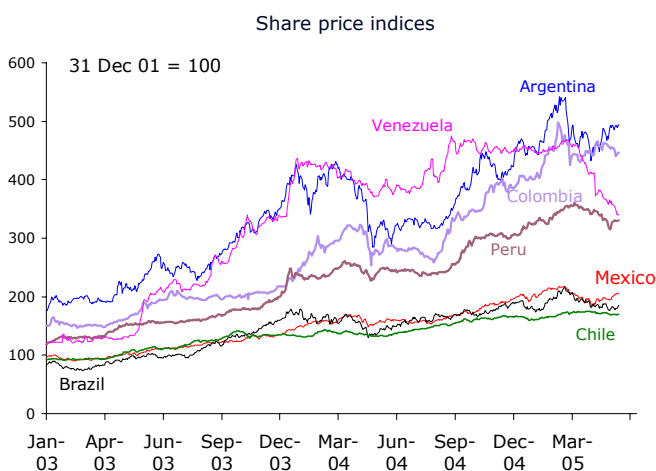
# Latin America Financial Markets Update



Source: Datastream



Source: Datastream



Source: Datastream

## Exchange rates

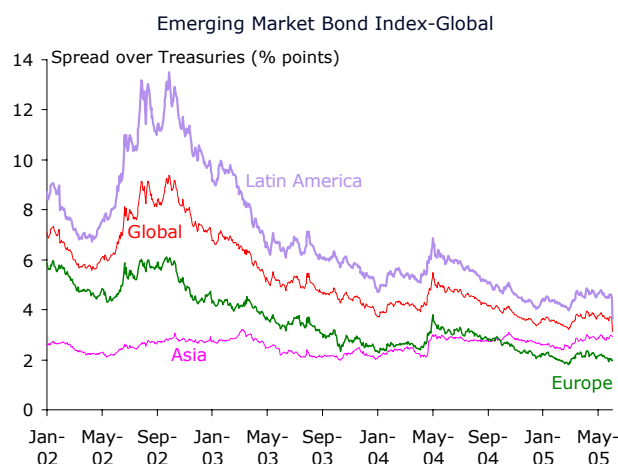
- The effect of central bank FX intervention and capital inflow sterilisation can be seen in regional exchange rates, which have remained broadly stable despite extremely favourable terms of trade and large surpluses in the external accounts.
- We expect this trend to continue, but rising US rates and falling commodity prices will ease upward pressure on local currencies.
- This is most true for Brazil, and with the economy slowing, rate cuts later this year should allow the FX rate to weaken.
- In Mexico, the authorities will seek to maintain a stable exchange rate as Banxico shifts to an interest rate targeting approach for monetary policy.
- Chile's peso has the farthest to weaken as copper prices fall.

## Interest rates

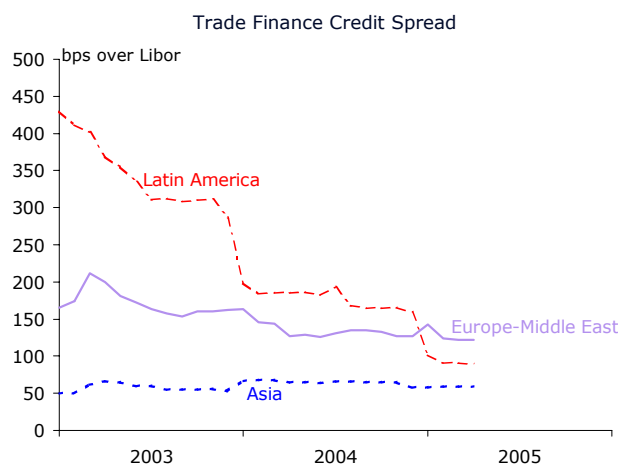
- The response to higher inflation across the region has been mixed, with the central banks in Brazil and Mexico raising rates while the authorities in Argentina and Venezuela have relied on administrative measures to stem inflation expectations.
- Real interest rates in Brazil and Mexico have risen even farther than the chart at left suggests, as inflation has dropped significantly.
- The success of monetary policy thus far in slowing growth in Brazil and Mexico should be seen as an achievement, as it is unprecedented in Latin America's history.
- Expect further ructions on FX and monetary policy in Argentina and Venezuela given the move away from market clearing mechanisms.

## Stockmarket

- With the notable exception of Venezuela, Latin American stock markets have outperformed the G7 and most developing country equity markets with returns of 6%+ year-to-date. After drifting downward at the end of 2004 in the face of rising local rates, the likelihood of a soft landing has comforted the market.
- Strong commodity prices and FDI will continue to support local markets, given the large weightings of resource companies in local indices. The risk of hot money outflows is low as net portfolio inflows to the region have been negative for several years.
- After outperforming the regional market in 2004, Venezuela's stock market has slid 34% YTD.
- Argentina's Merval index has shrunk to only 11 companies with a total market capitalisation of only US\$20 bn, compared with more than US\$200 bn in Brazil and US\$150 bn in Mexico.



Source: JP Morgan



Source: LTP Trade Finance Index, LTP Risk Management

## Bond markets

- The spread over US Treasuries of the Latin American sub-index of sovereign debt in JP Morgan's EMBIG index has declined from a high of more than 1,300 basis points in 2002 to less than 380 bps currently, the lowest level since the index's inception in 1998.
- The compression in spreads reflects fundamental improvements in Latin America, a net reduction of foreign currency debt and, in the past year, a global chase for yield from US investors.
- The global emerging bond market continues to track Latin America as it remains the largest region by capitalisation in the index. However, its index weight has fallen from 65% of the index in 2000 to 57% currently.

## Trade finance

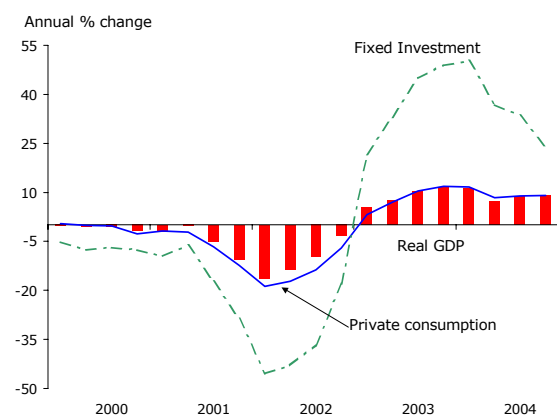
- The chart at left also shows compression in trade finance spreads for Latin America, from more than 400 bps above LIBOR in early 2003 to less than 100 bps presently.
- The implication of this chart and the bond index chart above is that Latin American foreign currency risk is approaching Asian levels.
- Relatively high commodity prices – as compared with historic levels – on the back of strong global growth and demand from rising consumption in Asia should see demand for trade finance out of Latin America continue.
- However, trade finance in Argentina and Venezuela in particular will be vulnerable to political events.

## Financial market forecasts

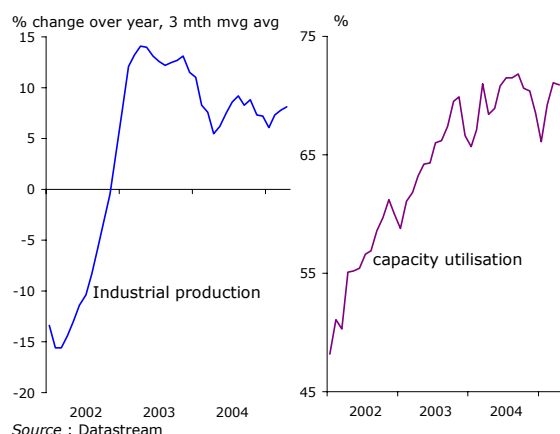
|  | 1999  | 2000  | 2001  | 2002  | 2003  | 2004e | 2005f | 2006f |
|--|-------|-------|-------|-------|-------|-------|-------|-------|
| <b>Argentina</b>                             |       |       |       |       |       |       |       |       |
| ARG/US\$, eop                                | 1.00  | 1.00  | 1.00  | 3.32  | 2.91  | 2.96  | 2.90  | 2.95  |
| ARG/US\$, average annual rate                | 1.00  | 1.00  | 1.00  | 3.063 | 2.90  | 2.92  | 2.91  | 2.93  |
| Interest rates (60 days & over time deposit) | 8.0   | 9.4   | 17.2  | 38.4  | 13.2  | 3.1   | 4.0   | 4.5   |
| <b>Brazil</b>                                |       |       |       |       |       |       |       |       |
| BRL/US\$, eop                                | 1.79  | 1.95  | 2.32  | 3.53  | 2.89  | 2.65  | 2.44  | 2.65  |
| BRL/US\$, average annual rate                | 1.19  | 1.83  | 2.35  | 2.91  | 3.08  | 2.92  | 2.46  | 2.55  |
| Interest rates (overnight SELIC)             | 19.0  | 15.8  | 19.1  | 24.9  | 16.3  | 17.8  | 17.0  | 15.5  |
| <b>Chile</b>                                 |       |       |       |       |       |       |       |       |
| CLP/US\$, eop                                | 530.1 | 572.7 | 656.2 | 712.4 | 599.4 | 559.8 | 590   | 610   |
| CLP/US\$, average annual rate                | 508.8 | 539.6 | 634.9 | 688.9 | 691.4 | 609.4 | 582   | 605   |
| Interest rates (90 days & over deposit)      | 8.9   | 8.7   | 6.5   | 4.1   | 3.2   | 2.4   | 4.0   | 3.5   |
| <b>Mexico</b>                                |       |       |       |       |       |       |       |       |
| MXN/US\$, eop                                | 9.51  | 9.62  | 9.16  | 10.39 | 11.23 | 11.15 | 11.00 | 10.80 |
| MXN/US\$, average annual rate                | 9.56  | 9.46  | 9.34  | 9.67  | 10.80 | 11.29 | 11.19 | 11.08 |
| Interest rates (90-day Cetes)                | 17.7  | 17.4  | 7.53  | 7.27  | 6.18  | 8.72  | 7.20  | 7.10  |

# Country Update Argentina

## Economy expected to moderate after robust growth in 2003 and 2004



## Increased pressure on capacity



- Argentina posted another year of robust growth, expanding by 9% in 2005. The strong rates of expansion over the past two years have assisted the recovery in GDP per capita, which is estimated to have reached nearly US\$4,000, in nominal terms, in 2004. This was 47% higher than in 2002 but still falls short of the pre-crisis level of US\$7,190 in 2001.
- Preliminary data suggests that the economy grew at a relatively healthy, albeit slower, pace in the first quarter, expanding by around 8¼% against the same quarter of 2004 compared with 9.1% in the year to the fourth quarter of 2004. Real GDP is projected to decelerate in 2005 to around 6%, reflecting in part the high base achieved and a slowdown in domestic demand.
- Inflation has edged up and is expected to continue to rise reflecting supply-side bottlenecks, increases in utility tariffs that are expected to be phased in, relatively healthy consumption and the impact of a previously-accommodative monetary stance.
- On the political front, congressional elections are due in October 2005 where seats for half of the Chamber of Deputies and one-third of the Senate will be contested. Despite political infighting, the Peronist party is expected to remain a dominant force in the legislature.
- President Kirchner's popularity rating remains high reflecting support for his hardline approach with the IMF and creditors. The debt exchange, amounting to a participation rate of around 76%, is moving ahead and will significantly improve its debt profile, bringing Argentina closer to normalising ties with financial markets. The government, however, has to come up with a strategy to deal with the 24% of bondholders who did not accept the swap offer. A new programme with the IMF has yet to be concluded and negotiations are likely to be difficult. The IMF has agreed to defer US\$2.5 bn in payments due between May 2005 and April 2006.

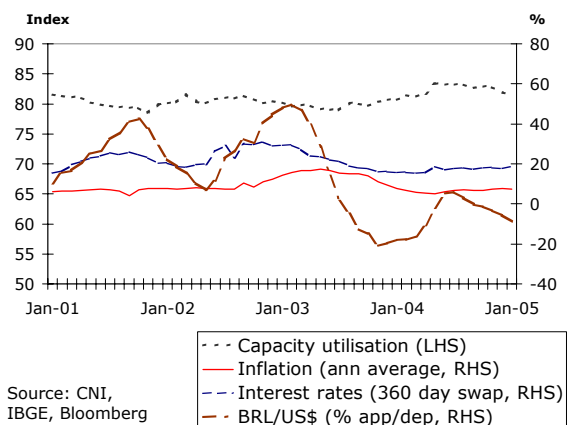
## Economic data and debt statistics

| Argentina                                   | 1999  | 2000  | 2001  | 2002  | 2003  | 2004e | 2005f | 2006f |
|---|-------|-------|-------|-------|-------|-------|-------|-------|
| Real GDP growth (%)                         | -3.4  | -0.8  | -4.4  | -10.9 | 8.8   | 9.0   | 6.0   | 4.0   |
| Nominal GDP (US\$ bn)                       | 283.7 | 284.3 | 268.8 | 102.0 | 129.6 | 153.0 | 172.0 | 187.5 |
| CPI (yr av, % YOY)                          | -1.2  | -0.9  | -1.1  | 25.9  | 13.4  | 4.4   | 8.9   | 10.2  |
| Exchange rate (eop, ARG/US\$)               | 1.00  | 1.00  | 1.00  | 3.32  | 2.91  | 2.96  | 2.90  | 2.95  |
| Interest rate (60-days & over time deposit) | 8.0   | 9.4   | 17.2  | 38.4  | 13.2  | 3.1   | 4.0   | 4.5   |
| M2 (% YOY)                                  | 4.1   | 1.5   | -19.4 | 19.7  | 29.6  | 21.4  | 21.7  | 15.0  |
| Nominal fiscal balance (% of GDP)           | -1.7  | -2.4  | -3.2  | -1.5  | 0.5   | 2.6   | 2.0   | 2.2   |
| Total public sector debt (% GDP)            | 49.2  | 45.1  | 53.6  | 153.4 | 138.1 | 119.2 | 81.0  | 74.3  |
| Of which, local currency (% GDP)            | 15.7  | 15.2  | 20.9  | 63.1  | 55.0  | 43.0  | 26.9  | 24.4  |
| Of which, foreign currency (% GDP)          | 33.5  | 29.9  | 32.7  | 90.3  | 83.1  | 76.2  | 54.1  | 49.9  |
| Current account balance (% GDP)             | -11.9 | -9.0  | -3.9  | 8.6   | 7.4   | 3.0   | 2.2   | 0.4   |
| Net FDI (US\$ bn)                           | 22.6  | 11.3  | 2.3   | 1.7   | 1.1   | 3.9   | 2.1   | 2.0   |
| Total foreign currency debt (% GDP)         | 51.5  | 53.1  | 55.4  | 153.1 | 127.1 | 109.7 | 77.7  | 65.0  |
| Net international FX reserves (US\$ bn)     | 26.3  | 25.1  | 14.6  | 10.5  | 14.2  | 18.9  | 21.0  | 22.5  |

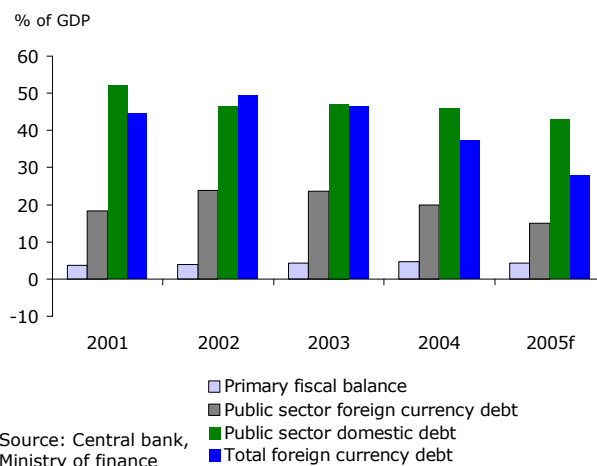
Sources: EIU, IIF, JPMorgan, ANZ Bank

# Country Update: Brazil

## Higher interest rates will slow growth in 2005 and 2006



## Brazil's improving debt profile



- Growth of 5.2% last year was higher than expected, but Brazil was left with an upward spiral of higher inflation, tighter monetary policy and stronger currency that attracted capital inflows. Monetary policy has been progressively tightened with the COPOM raising the SELIC rate eight times over the past year to 19.75%. Real interest rates are thus above 10%. The top chart at left supports the notion that liquidity and not capacity constraints have been responsible for higher inflation.
- Fiscal balances have improved and the public debt burden has been progressively reduced under this administration. Nonetheless, public sector local currency debt is near 50% of GDP, so high nominal interest rates put pressure on the budget.
- We forecast a soft landing in which inflation declines and rates are eased, but there are risks to this scenario. The biggest is the potential for inflation expectations to arise from the real economy, which would force COPOM to maintain higher rates and strain the budget as the elections approach. Serious solvency issues are unlikely, but debt service is an indicator to monitor. A second, related risk is a prolonged downturn in global liquidity. However, the current account is still in surplus, which provides some cushion.
- The national 2006 elections will introduce volatility. Lula is eligible to run and his popularity remains high. However, the number of parties in his congressional coalition has fallen from 9 to 6. An election loss would be disastrous for the left, so expect noise and attempts by other left-of-centre parties to push their preferred candidates.
- The El Nino risk holds a potential negative for Brazil's agricultural harvest, and therefore on growth for this year should the event occur.

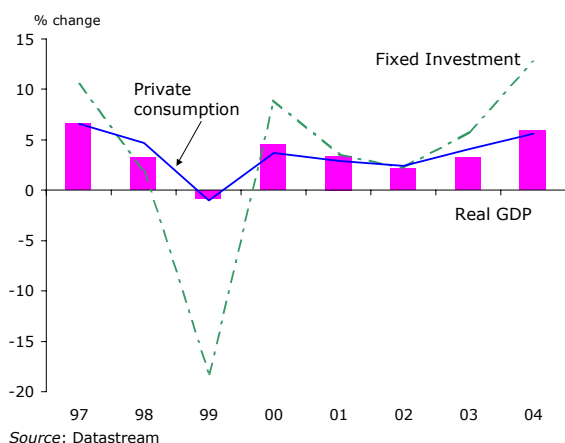
## Economic data and debt statistics

| Brazil                                  | 1999  | 2000  | 2001  | 2002  | 2003  | 2004e | 2005f | 2006f |
|---|-------|-------|-------|-------|-------|-------|-------|-------|
| Real GDP growth (%)                     | 0.8   | 4.4   | 1.5   | 1.9   | 0.6   | 5.2   | 3.0   | 3.8   |
| Nominal GDP (US\$ bn)                   | 821.8 | 602.1 | 509.8 | 462.6 | 505.7 | 601.6 | 791.2 | 831.8 |
| CPI (yr av, % YOY)                      | 4.9   | 7.0   | 6.8   | 8.5   | 14.7  | 6.6   | 7.5   | 5.1   |
| Exchange rate (eop, BRL/US\$)           | 1.789 | 1.955 | 2.320 | 3.532 | 2.888 | 2.653 | 2.440 | 2.650 |
| Interest rate (3-month deposit)         | 19.0  | 15.8  | 19.1  | 24.9  | 16.3  | 17.8  | 17.0  | 15.5  |
| M2 (% YOY)                              | 23.6  | -1.5  | 11.7  | 37.6  | -0.11 | 21.2  | 14.0  | 16.0  |
| Nominal fiscal balance (% of GDP)       | -9.3  | -3.6  | -3.6  | -4.6  | -5.1  | -2.7  | -3.1  | -2.6  |
| Total public sector debt (% GDP)        | 73.0  | 71.9  | 70.3  | 70.2  | 70.7  | 66.0  | 57.4  | 56.5  |
| Of which, local currency (% GDP)        | 54.6  | 53.4  | 52.1  | 46.3  | 47.0  | 46.0  | 42.5  | 42.5  |
| Of which, foreign currency (% GDP)      | 18.5  | 18.5  | 18.3  | 23.9  | 23.7  | 19.9  | 14.9  | 14.1  |
| Current account balance (% GDP)         | -4.8  | -4.2  | -4.6  | -1.6  | 0.8   | 1.9   | 0.5   | -0.4  |
| Net FDI (US\$ bn)                       | 28.9  | 28.3  | 20.5  | 14.7  | 9.3   | 11.8  | 11.5  | 12.0  |
| Total foreign currency debt (% GDP)     | 42.0  | 41.9  | 44.6  | 49.5  | 46.6  | 37.3  | 27.5  | 26.0  |
| Net international FX reserves (US\$ bn) | 36.1  | 33.1  | 35.7  | 37.7  | 49.1  | 52.7  | 64.7  | 67.7  |

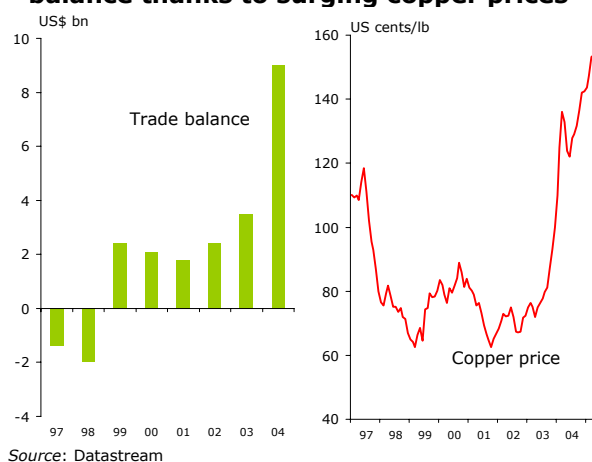
Sources: Central Bank of Brazil, IIF, ANZ Bank

# Country Update: Chile

## Robust GDP growth supported by strong domestic demand



## Substantial improvement in the trade balance thanks to surging copper prices



- Economic management in Chile is stronger than in other Latin American countries and growth prospects for 2005 and 2006 are favourable. The economy picked up in 2004, expanding by 6% supported by rising private consumption, accelerating investment and healthy exports. Growth in the March quarter was 6.3% higher than in Q1 2004 and the economy is on track to produce another year of healthy growth underpinned by strong domestic demand. Real GDP is forecast to expand by around 6% in 2005, making it the strongest expansion phase since 1997.
- The main downside risk to the economic growth forecast is the threat of a shortage in energy supply. Chile is heavily reliant on energy-related imports to meet domestic requirements. The cut in natural gas imports from Argentina and the prospect of gas-related investment only generating supply in the medium term means that Chile could face electricity shortages in the short term.
- Chile has benefited from sharply improved copper prices, achieving a substantial increase in the trade surplus in 2004, which rose to US\$9 bn from US\$3.5 bn in 2003. Copper exports account for about 45% of total exports. This also means that Chile is vulnerable to pronounced changes in international copper prices.
- Presidential and congressional elections are due in December 2005. President Lagos is not eligible, under the constitution, to stand for re-election. However, the ruling centre-left Concertacion coalition candidate, former defence minister Michelle Bachelet, is expected to benefit from the president's popularity and Chile's strong economic performance. At this stage, the opposition centre-right Alianza coalition is split with two contenders - Joaquin Lavín (leader of the Independent Democratic Union and head of the coalition itself) and Sebastian Pinera, leader of the National Renewal party - for the elections. Whatever the outcome, however, sound macroeconomic management is expected to be maintained.

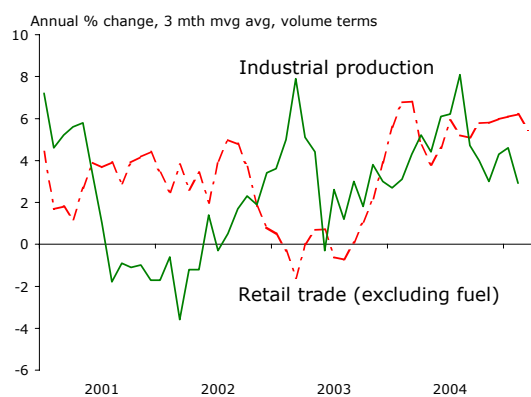
## Economic data and debt statistics

| Chile                                   | 1999  | 2000  | 2001  | 2002  | 2003  | 2004e | 2005f | 2006f |
|---|-------|-------|-------|-------|-------|-------|-------|-------|
| Real GDP growth (%)                     | -0.8  | 4.5   | 3.4   | 2.2   | 3.7   | 6.1   | 6.0   | 5.0   |
| Nominal GDP (US\$ bn)                   | 73.0  | 75.2  | 68.4  | 67.4  | 72.1  | 87.7  | 99.5  | 103.9 |
| CPI (yr av, % YOY)                      | 3.3   | 3.8   | 3.6   | 2.5   | 2.8   | 1.1   | 2.2   | 3.4   |
| Exchange rate (eop, CLP/US\$)           | 530.1 | 572.7 | 656.2 | 712.4 | 599.4 | 559.8 | 590   | 610   |
| Interest rate (90 days & over deposit)  | 8.9   | 8.7   | 6.5   | 4.1   | 3.2   | 2.4   | 4.0   | 3.5   |
| M2 (% YOY)                              | 7.8   | 6.1   | 2.3   | -0.3  | 8.1   | 9.8   | 5.6   | 6.0   |
| Nominal fiscal balance (% of GDP)       | -1.4  | 0.1   | -0.3  | -0.8  | -0.8  | 2.2   | 1.8   | 1.1   |
| Total public sector debt (% GDP)        | 39.7  | 36.2  | 36.6  | 36.4  | 33.7  | 29.2  | 26.7  | 24.7  |
| Of which, local currency (% GDP)        | 31.5  | 28.2  | 27.7  | 25.7  | 21.0  | 18.7  | 18.1  | 16.7  |
| Of which, foreign currency (% GDP)      | 8.2   | 8.0   | 8.9   | 10.7  | 12.7  | 10.5  | 8.7   | 8.0   |
| Current account balance (% GDP)         | 0.1   | -1.2  | -1.6  | -0.9  | -1.5  | 1.5   | 0.7   | -0.7  |
| Net FDI (US\$ bn)                       | 7.3   | 0.0   | 3.1   | 2.2   | 2.5   | 5.0   | 4.5   | 4.2   |
| Total foreign currency debt (% GDP)     | 49.4  | 49.8  | 56.9  | 61.0  | 60.6  | 49.0  | 45.3  | 46.2  |
| Net international FX reserves (US\$ bn) | 14.6  | 15.0  | 14.4  | 15.3  | 15.8  | 16.0  | 17.2  | 18.4  |

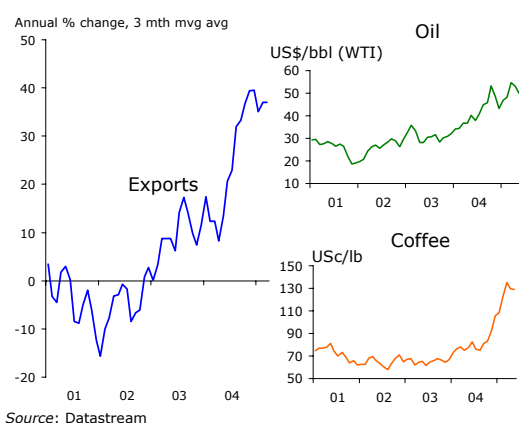
Sources: EIU, IIF, IMF, JPMorgan, ANZ Bank

# Country Update: Colombia

## Economic indicators suggest economy tracking well



## High commodity prices benefit exports



- Security conditions have improved markedly since President Uribe assumed office in August 2002. This, together with an improvement in the labour market, has contributed to him enjoying a high approval rating of around 70% according to recent polls. Congressional and Presidential elections are due in March and May 2006 respectively. President Uribe is awaiting court approval of a constitutional change allowing him to seek re-election. If that is passed, he is expected to seek a second four-year term. Meanwhile, reforms are likely to take a backseat in the run-up to the polls while the security situation, although improved, is expected to be tenuous especially ahead of the elections.
- Real GDP grew by close to 4% in 2004, underpinned by a pick-up in consumption and relatively healthy growth in private investment. Colombia also benefited from higher coffee and oil prices, which lifted export earnings. Leading indicators such as retail sales and industrial production show some slowing in activity but the economy is tracking well. Real GDP is forecast to expand by around 3-3½% in 2005 and 2006. Improving the fiscal position, however, remains a challenge. While the nonfinancial fiscal deficit narrowed sharply to 1.7% of GDP in 2004 (3.2% in 2003), this was due largely to higher contributions from state-owned oil company, Ecopetrol and better performance from regional and local governments. The central government deficit, on the other hand, rose to 5.6% of GDP in 2004. Without fiscal reform, the deficit is likely to stay in the range of 5-6% of GDP over the medium term, putting pressure on public finances.
- Overall, investor confidence has improved underpinned by better security conditions and supportive economic fundamentals. This has been reflected in the relatively small amount of credit negotiated under the latest standby agreement with the IMF signifying Colombia's reduced dependence on the latter for financial support. The current 18-month arrangement, which is treated as a precautionary measure, is for US\$613 mn compared with a US\$2.3 bn 2-year agreement that expired on 2 May 2005.

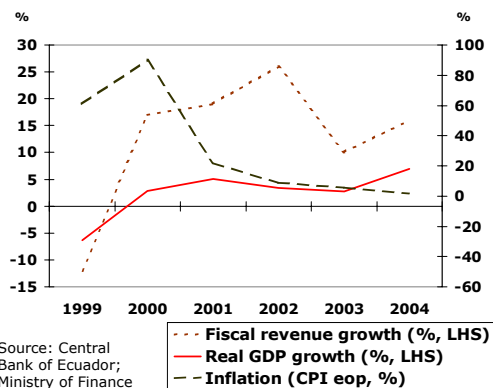
## Economic data and debt statistics

| Colombia                                | 1999  | 2000  | 2001  | 2002  | 2003  | 2004e | 2005f | 2006f |
|---|-------|-------|-------|-------|-------|-------|-------|-------|
| Real GDP growth (%)                     | -4.2  | 2.9   | 1.5   | 1.8   | 3.9   | 4.0   | 3.5   | 3.3   |
| Nominal GDP (US\$ bn)                   | 86.3  | 83.8  | 81.7  | 80.8  | 77.6  | 93.5  | 107   | 111   |
| CPI (yr av, % YOY)                      | 10.9  | 9.2   | 8.0   | 6.3   | 7.1   | 5.9   | 5.2   | 4.8   |
| Exchange rate (eop, COL/US\$)           | 1,874 | 2,187 | 2,301 | 2,865 | 2,781 | 2,354 | 2,295 | 2,400 |
| Interest rate (3-month CDs)             | 16.1  | 13.3  | 11.4  | 7.7   | 7.9   | 7.8   | 7.2   | 7.0   |
| M2 (% YOY)                              | 13.7  | 14.7  | 16.0  | 13.6  | 9.9   | 18.2  | 12    | 9     |
| Nominal fiscal balance (% of GDP)       | -6.4  | -3.5  | -3.5  | -4.2  | -3.2  | -1.7  | -2.5  | -2.1  |
| Total public sector debt (% GDP)        | 38.9  | 43.9  | 50.2  | 58.5  | 56.4  | 52.5  | 50.8  | 49.8  |
| Of which, local currency (% GDP)        | 17.1  | 20.4  | 21.6  | 26.3  | 24.7  | 24.0  | 23.1  | 26.3  |
| Of which, foreign currency (% GDP)      | 21.8  | 23.5  | 28.6  | 32.2  | 31.7  | 28.5  | 27.7  | 23.5  |
| Current account balance (% GDP)         | 0.8   | 0.9   | -1.4  | -1.7  | -1.5  | -1.4  | -1.9  | -2.8  |
| Net FDI (US\$ bn)                       | 1.4   | 2.0   | 2.5   | 1.2   | 1.5   | 2.3   | 1.4   | 1.3   |
| Total foreign currency debt (% GDP)     | 43.1  | 43.5  | 47.8  | 46.3  | 49.7  | 41.3  | 37.5  | 37.6  |
| Net international FX reserves (US\$ bn) | 8.0   | 8.9   | 10.2  | 10.7  | 10.8  | 13.4  | 12.8  | 13.2  |

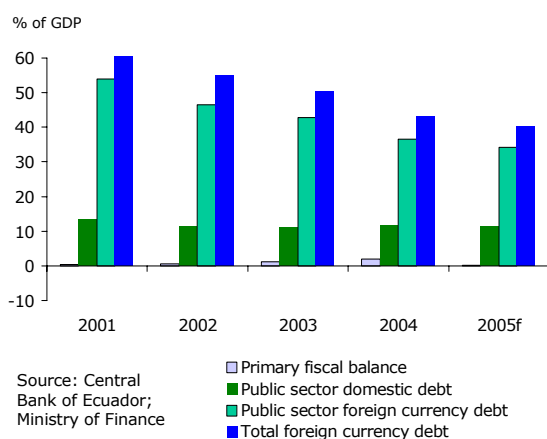
Sources: EIU, IIF, IMF, Banco de la Republica Colombia, ANZ Bank

# Country Update: Ecuador

## Growth and inflation stabilise



## Debt profile has improved significantly



- Real GDP rose by 6.9% last year thanks to high oil revenues and the stabilisation of monetary policy under dollarisation. Inflation fell to under 2%, a level that has not been seen in more than two decades. Nominal GDP in US dollar terms rose above US\$30 billion. Partly as a result of the surge in GDP, public sector debt fell below 50% of GDP, again a record low in recent history.
- Unfortunately, this stabilisation is largely due to high oil prices and a fixed exchange rate, with little improvement in the underlying economy or policy framework. Moreover, political uncertainty remains very high. For the second time in the past five years, another president has failed to reach the end of his term, with President Gutierrez ousted in April. Interim President Palacios has appointed a new government and will likely remain at the helm until the 2006 scheduled national elections. There is no indication in the political discourse that the warring factions in Quito and Guayaquil have come any closer to reaching a consensus on how to move the country forward.
- The government's fiscal position has improved substantially over the past several years, thanks in part to the Fiscal Responsibility Law and the requirements of the Oil Stabilization and Debt Repayment Fund. However, the lack of trickle-down growth has brought increasing political pressure to use windfall oil revenues to increase current expenditure and there are moves to water down legal fiscal constraints, particularly the mandate that 70% of the Fund be used for debt buybacks. At the same time, Ecuador's external debt service are rising as the capitalization of the Global bonds issued in 2000 begins in 2006.
- The possibility of an El Nino event occurring in the latter half of this year is currently 30-50%. El Nino events are damaging to Ecuador's shrimp industry; traditional non-oil exports declined by more than 15% in the aftermath of the last major El Nino event of 1996-1997.

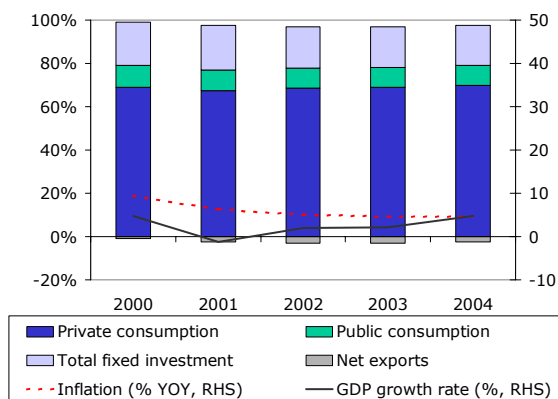
## Economic data and debt statistics

| Ecuador                                 | 1999   | 2000   | 2001   | 2002   | 2003   | 2004   | 2005f  | 2006f  |
|---|--------|--------|--------|--------|--------|--------|--------|--------|
| Real GDP growth (%)                     | -6.3   | 2.8    | 5.1    | 3.4    | 2.7    | 6.9    | 3.3    | 3.0    |
| Nominal GDP (US\$ bn)                   | 16.7   | 15.9   | 21.0   | 24.3   | 26.8   | 30.3   | 32.5   | 33.1   |
| CPI (yr av, % YOY)                      | 61.0   | 90.9   | 22.4   | 9.36   | 6.06   | 1.95   | 1.30   | 1.10   |
| Exchange rate (eop, ECS/US\$)           | 10,968 | 18,520 | 25,000 | 25,000 | 25,000 | 25,000 | 25,000 | 25,000 |
| Interest rate (3-month deposit)         | 60.0   | 16.8   | 16.2   | 15.4   | 13.5   | 9.8    | 8.5    | 6.2    |
| M2 (% YOY)                              | 82.5   | -66.1  | 10.5   | 5.2    | -83.6  | 16.9   | 14.0   | 12.0   |
| Nominal fiscal balance (% of GDP)       | -3.9   | 1.5    | 0.4    | 0.6    | 1.2    | 2.0    | 0.6    | -3.3   |
| Total public sector debt (% GDP)        | 100.0  | 86.7   | 67.3   | 58.0   | 54.0   | 48.0   | 11.4   | 12.1   |
| Of which, local currency (% GDP)        | 19.8   | 17.8   | 13.4   | 11.4   | 11.2   | 11.5   | 11.4   | 12.1   |
| Of which, foreign currency (% GDP)      | 88.6   | 69.0   | 53.9   | 46.6   | 42.8   | 36.5   | 34.2   | 33.5   |
| Current account balance (% GDP)         | 1.0    | 1.0    | -0.5   | -1.3   | -1.1   | -0.8   | -0.5   | -0.3   |
| Net FDI (US\$ bn)                       | 0.6    | 0.7    | 1.3    | 1.3    | 1.5    | 1.2    | 1.0    | 0.8    |
| Total foreign currency debt (% GDP)     | 97.6   | 87.2   | 63.4   | 54.9   | 50.2   | 43.1   | 40.3   | 39.6   |
| Net international FX reserves (US\$ bn) | 0.9    | 1.2    | 1.1    | 1.0    | 1.2    | 1.4    | 1.3    | 1.3    |

Sources: Banco Central del Ecuador; Ministry of Finance; National Census and Statistical Institute (INEC), ANZ Bank

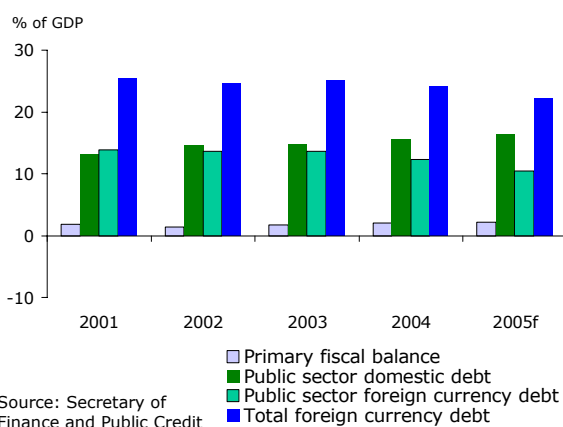
# Country Update: Mexico

## GDP growth has been balanced but will slow with tighter monetary policy



Source: INEGI, Central Bank of Mexico

## Public sector is replacing foreign currency debt with domestic



Source: Secretary of Finance and Public Credit

- Real GDP rose nearly 5% in 2004 on the back of a boom in the mining and metals sector that also spurred growth in construction and transport. Exports rose 14.5% and have again reached 28% of GDP, levels last seen during the strong period of US growth in the late 1990s. However, the chart at left shows that in real terms, net exports were negative and that the recent period of growth has been driven by consumption and domestic investment. Notably, total fixed investment rose 7.5% in real terms last year.
- The CPI reached 5.3% in October 2004 before hikes in the *corto* (Banxico's main policy instrument) began to take effect. The tightening cycle is approaching its end, and CPI is declining. Banxico will likely use this opportunity to switch from the *corto* to an interest rate targeting strategy – similar to the Fed – to make monetary policy more transparent. Tighter liquidity, higher US interest rates and moderating oil prices will slow the economy in 2005 and 2006.
- High oil prices have bolstered the primary surplus while active debt management has reduced the public debt burden to 27% of GDP. Moody's cited the improved debt position when it upgraded Mexico's long-term foreign currency rating to Baa1 in January, putting Mexico on par with Chile.
- The focus has shifted to the elections in the first half of next year. President Fox's PAN has lost control of Congress, and the PRI is looking to regain control of the executive. With Fox not eligible to run for a second term, all eyes are on front-runner Mexico City Mayor Andres Manuel Lopes Obrador and any re-emerging populist tendencies of the PRI.
- Unfortunately, Fox has been unable to push through significant economic reform during his tenure. Mexico has made macro progress, but major productivity gains will not come without micro reforms.

## Economic data and debt statistics

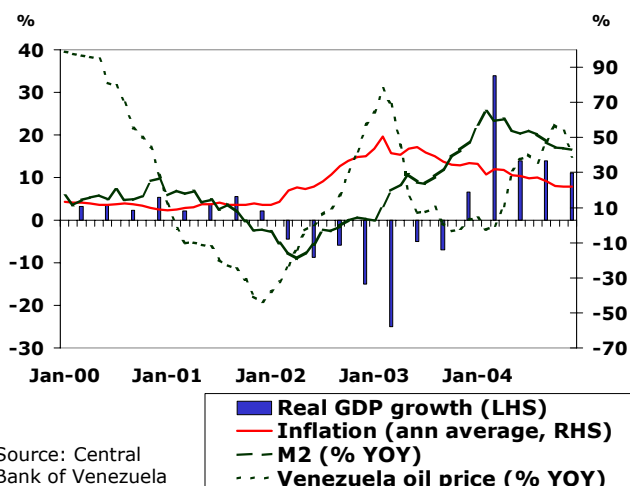
| Mexico                                  | 1999  | 2000  | 2001  | 2002  | 2003  | 2004e | 2005f | 2006f |
|---|-------|-------|-------|-------|-------|-------|-------|-------|
| Real GDP growth (%)                     | 5.4   | 4.7   | -1.3  | 2.0   | 2.2   | 4.8   | 2.7   | 1.9   |
| Nominal GDP (US\$ bn)                   | 481.2 | 581.4 | 622.3 | 648.4 | 638.7 | 667.4 | 680.2 | 725.9 |
| CPI (yr av, % YOY)                      | 16.6  | 9.5   | 6.4   | 5.0   | 4.6   | 4.7   | 4.4   | 3.8   |
| Exchange rate (eop, MXP/US\$)           | 9.6   | 9.5   | 9.3   | 9.7   | 10.8  | 11.3  | 11.0  | 10.8  |
| Interest rate (90-day Cetes eop)        | 17.7  | 17.4  | 7.5   | 7.3   | 6.2   | 8.7   | 7.2   | 7.1   |
| M2 (% YOY)                              | 43.5  | 10.7  | 8.0   | 17.0  | 15.0  | 12.0  | 12.3  | 13.5  |
| Nominal fiscal balance (% of GDP)       | -1.2  | -1.1  | -0.7  | -1.2  | -0.7  | -0.3  | -0.3  | -0.4  |
| Total public sector debt (% GDP)        | 31.2  | 27.6  | 27.1  | 28.1  | 28.3  | 27.7  | 28.7  | 27.9  |
| Of which, local currency (% GDP)        | 11.0  | 12.3  | 13.1  | 14.5  | 14.7  | 15.5  | 15.9  | 16.5  |
| Of which, foreign currency (% GDP)      | 20.2  | 15.3  | 13.9  | 13.6  | 13.6  | 12.3  | 12.8  | 11.3  |
| Current account balance (% GDP)         | -2.9  | -2.8  | -2.8  | -2.9  | -2.2  | -1.3  | -0.8  | -0.9  |
| Net FDI (US\$ bn)                       | 13.2  | 16.8  | 27.6  | 15.1  | 11.4  | 16.7  | 15.4  | 14.0  |
| Total foreign currency debt (% GDP)     | 31.8  | 27.3  | 25.4  | 24.6  | 25.1  | 24.1  | 23.9  | 22.5  |
| Net international FX reserves (US\$ bn) | 31.8  | 35.5  | 44.7  | 50.6  | 59.0  | 62.4  | 65.2  | 67.7  |

Sources: Banxico, INEGI, IIF, ANZ Bank

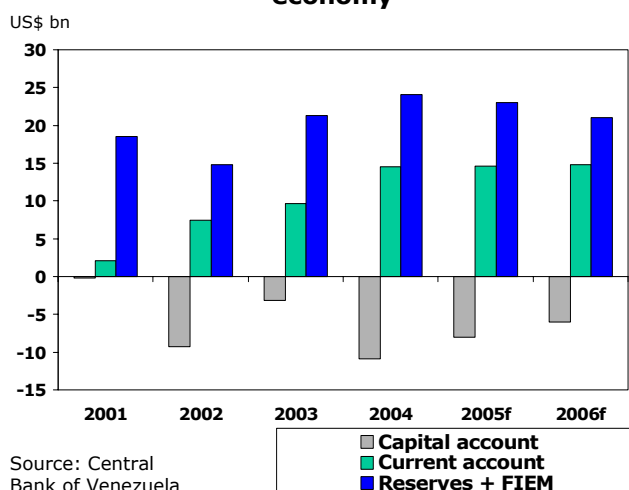


# Country Update: Venezuela

## High oil prices only boosted growth following capital controls in 2002



## Oil inflows will continue to support domestic economy



## Economic data and debt statistics

| Venezuela                               | 1999 | 2000  | 2001  | 2002 | 2003 | 2004e | 2005f | 2006f |
|---|------|-------|-------|------|------|-------|-------|-------|
| Real GDP growth (%)                     | -6.0 | 3.7   | 3.4   | -8.9 | -7.7 | 17.3  | 5.5   | 4.7   |
| Nominal GDP (US\$ bn)                   | 99.5 | 107.0 | 116.5 | 79.5 | 72.7 | 86.8  | 98.1  | 106.8 |
| CPI (yr av, % YOY)                      | 31.9 | 16.5  | 12.6  | 20.3 | 31.1 | 22.1  | 15.2  | 12.7  |
| Exchange rate (eop, VEB/US\$)           | 653  | 700   | 758   | 1403 | 1600 | 1920  | 2147  | 2343  |
| Interest rate (90-day deposit rate)     | 16.4 | 13.1  | 17.9  | 26.5 | 14.3 | 13.8  | 10.8  | 10.0  |
| M2 (% GDP)                              | 32.4 | 27.8  | 11.9  | 18.9 | 42.1 | 51.1  | 35.0  | 25.0  |
| Nominal fiscal balance (% of GDP)       | 0.1  | 0.0   | -0.4  | 0.1  | 1.6  | 2.2   | -1.0  | -2.7  |
| Total public sector debt (% GDP)        | 26.5 | 28.3  | 29.7  | 40.3 | 52.4 | 44.9  | 40.0  | 37.4  |
| Of which, local currency (% GDP)        | 5.3  | 9.2   | 11.9  | 14.1 | 19.9 | 16.4  | 14.5  | 13.9  |
| Of which, foreign currency (% GDP)      | 21.2 | 19.1  | 17.9  | 26.3 | 32.4 | 28.5  | 25.5  | 23.4  |
| Current account balance (% GDP)         | 1.9  | 11.3  | 1.8   | 9.4  | 13.2 | 16.8  | 14.8  | 13.8  |
| Net FDI (US\$ bn)                       | 2.0  | 4.2   | 3.5   | -0.2 | 1.4  | 1.3   | 1.0   | 0.8   |
| Total foreign currency debt (% GDP)     | 27.6 | 25.0  | 23.0  | 33.6 | 40.4 | 34.8  | 30.8  | 28.1  |
| Net international FX reserves (US\$ bn) | 11.7 | 12.7  | 9.4   | 9.0  | 17.7 | 20.2  | 22.1  | 20.1  |

Sources: Central Bank of Venezuela, Ministry of Finance, IIF, ANZ Bank

- Real GDP rose by more than 17% last year thanks to a 40% nominal increase in government expenditure and the imposition of capital controls in 2002 to keep money from fleeing offshore. Price controls have dampened inflationary pressures stemming from the loose fiscal stance; the monetary base expanded by more than 50% last year and the stock of domestic debt has nearly doubled since 2002 to reach 16% of GDP. The Bolivar was devalued from VEB1,920/US\$ (rate as of Feb 2004) to VEB2,147/US\$ in early March.
- Despite strong growth, political uncertainty and the alienation of the business elite has wiped nearly US\$30 bn from the economy and brought GDP per capita (in market terms) to less than US\$4,000 for the first time in the country's history. Nonetheless, the political opposition remains fragmented and Chavez is likely to win re-election in 2006.
- Economic imbalances continue to grow with the imposition of more government control. Most recently the authorities recently decreed maximum lending rates and minimum savings rates for banks. A new Land Law has encouraged expropriation of land and disrupted iron ore mining. The Hydrocarbons Law forces foreign oil companies to move from operating contracts to JVs with PDVSA, possibly weakening their negotiating position.
- Chavez' decision to end Venezuela's 35-year military cooperation agreement with the US, initiate arms purchases from Russia and create a volunteer Military Reserve are worrying signs. Venezuela could well become a source of instability for the northern part of the continent.

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