



FOCUS

Latin America

Presented by the Financial Strategy Team

For the past few years, a number of Latin American countries, like other emerging countries, have experienced rapid growth due to two main factors. First, higher commodity prices have stimulated exports from these countries and generated current account surpluses; and second, after years of protectionist—hence inflationary—economic policies, these countries have liberalized their economies and thus managed to normalize their macroeconomic environment.

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For the purposes of this article, we consider Latin America to include the following countries: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

| Country | MSCI Index weight | Per capita GDP (US\$) | Percentage of US level |
|------------------|-------------------|-----------------------|------------------------|
| <i>Argentina</i> | 4.0% | \$14,838.43 | 34% |
| <i>Brazil</i> | 52.9% | \$ 8,917.00 | 21% |
| <i>Chile</i> | 7.7% | \$12,737.11 | 29% |
| <i>Colombia</i> | 1.6% | \$7,645.63 | 18% |
| <i>Mexico</i> | 31.0% | \$10,603.99 | 25% |
| <i>Peru</i> | 2.3% | \$6,288.81 | 15% |
| <i>Venezuela</i> | 0.4% | \$6,467.17 | 15% |

The left column contains the relative weight of these countries in the MSCI Index. As you can see, the market capitalization of Brazil and Mexico far outweighs that of the continent. In addition, per capita GDP is relatively high, at the mid-point between third-world countries and developed countries. The last column shows per capita GDP as a percentage of the US level, which is about US \$43,000. As observed, the purchasing power of local populations remains weak in comparison to that of Americans.

| Economic growth | 1981-1991 | 1992-2002 | 2003 | 2004 | 2005 | 2006 | 2007p |
|------------------|-----------|-----------|-------|-------|------|------|-------|
| <i>Argentina</i> | 0.0% | 1.6% | 8.8% | 9.0% | 9.2% | 8.0% | 6.0% |
| <i>Brazil</i> | 1.6% | 2.6% | 0.5% | 4.9% | 2.3% | 3.6% | 4.0% |
| <i>Chile</i> | 3.6% | 5.6% | 3.9% | 6.2% | 6.3% | 5.2% | 5.5% |
| <i>Colombia</i> | 3.3% | 2.6% | 3.9% | 4.8% | 5.1% | 4.8% | 4.0% |
| <i>Mexico</i> | 2.1% | 2.9% | 1.4% | 4.2% | 3.0% | 4.0% | 3.5% |
| <i>Peru</i> | -0.4% | 4.0% | 3.9% | 5.2% | 6.4% | 6.0% | 5.0% |
| <i>Venezuela</i> | 1.8% | 0.6% | -7.7% | 17.9% | 9.3% | 7.5% | 3.7% |

Economic growth has improved significantly in the past 25 years. From an average of 1.7% (unweighted) for these seven countries in the 1980s, it rose to 2.8% in the 1990s. Since 2003, growth rates have often been over 5%, except for Venezuela, which was penalized by the national oil company's long strike.

These undeniably positive results have been coupled with the normalization of inflation rates, as shown in the table below. In the 1980s, no country had an inflation rate of less than 10%. In the 1990s, Argentina, owing to its fixed-rate policy with the United States, and Chile were the first to normalize their inflation rates. In 2006, only Argentina and Venezuela were still grappling with high inflation rates.

| Inflation rate (GDP deflator) | 1981-1991 | 1992-2002 | 2003 | 2004 | 2005 | 2006 | 2007p |
|-------------------------------|-----------|-----------|-------|-------|-------|-------|-------|
| <i>Argentina</i> | 969.4% | 4.0% | 10.5% | 9.2% | 8.8% | 15.1% | 10.6% |
| <i>Brazil</i> | 300.0% | 486.8% | 15.0% | 8.2% | 7.2% | 4.7% | 4.0% |
| <i>Chile</i> | 21.3% | 6.6% | 5.8% | 7.0% | 4.8% | 8.9% | -3.2% |
| <i>Colombia</i> | 24.9% | 16.1% | 8.1% | 6.3% | 6.1% | 3.2% | 3.8% |
| <i>Mexico</i> | 62.3% | 15.8% | 8.5% | 7.4% | 5.4% | 3.9% | 3.2% |
| <i>Peru</i> | 2,216.1% | 17.2% | 2.6% | 5.6% | 3.4% | 6.3% | 1.5% |
| <i>Venezuela</i> | 23.5% | 40.0% | 34.9% | 31.2% | 23.6% | 17.2% | 17.6% |

Finally, although these countries have run current account deficits in the past several years, the situation has been quickly turned around with the advent of higher commodity prices. Colombia is a special case because it does not have specialized exports other than coffee, for which no price increases have been recorded recently.

| Current account balance | 1981-1991 | 1992-2002 | 2003 | 2004 | 2005 | 2006 | 2007p |
|-------------------------|-----------|-----------|-------|-------|-------|-------|-------|
| <i>Argentina</i> | -1.4% | -2.1% | 6.3% | 2.2% | 1.9% | 1.0% | 0.6% |
| <i>Brazil</i> | -2.6% | -2.5% | 0.8% | 1.9% | 1.8% | 0.6% | 0.4% |
| <i>Chile</i> | -5.9% | -2.7% | -1.3% | 1.7% | 0.6% | 1.8% | 0.9% |
| <i>Colombia</i> | -1.6% | -2.5% | -1.2% | -1.0% | -1.6% | -1.2% | -1.7% |
| <i>Mexico</i> | -1.5% | -3.4% | -1.4% | -1.0% | -0.6% | -0.1% | -0.2% |
| <i>Peru</i> | 0.1% | -4.9% | -1.5% | 0.0% | 1.3% | 0.7% | 0.2% |
| <i>Venezuela</i> | 3.1% | 2.9% | 13.7% | 12.5% | 19.1% | 17.5% | 17.6% |

The existing issue for investors in this region is therefore to determine whether or not the improvement in current macroeconomic conditions will be permanent. If these changes are considered to be permanent, the recent behaviour of borrowers and international investors makes sense. In fact, several countries, and Mexico in particular, have begun to change their US dollar-denominated debt into debt denominated in their local currency, transferring the foreign exchange risk from the borrower to the investor. In the past, foreign investors have ended up with significant losses in such cases.

A number of analysts are, however, of the opinion that this trend could largely depend on whether or not there are favourable economic conditions for commodities. On the basis of this assumption, which is supported in particular by Paulo Viera da Cunha of Brazil's central bank, the additional revenue from commodity exports has been used to stimulate consumption to the detriment of long-term investment. Consequently, the potential growth rate of Latin American economies remains relatively low, in the area of 3% to 4%. If economies remain strong, it could lead to a run-up in inflation whereas if commodity prices fall, current account deficits and currency depreciation could quickly become the norm again in the region.

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Performance of Mexican bonds

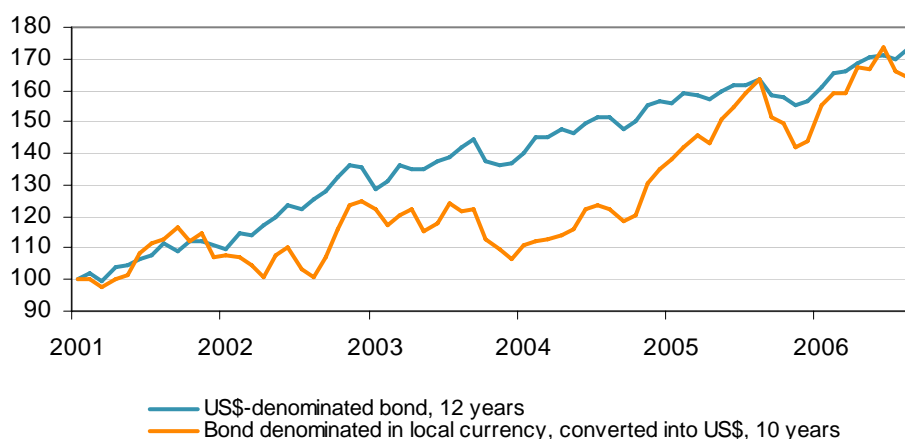
Since a number of countries in the region issue their debt in local currency, we were wondering if such debt really compensates for the currency risks involved. In order to assess this situation, we turned to Mexico, since it provides the most complete data for our analysis. Various results can be seen in the table below:

| Performance | US\$-denominated debt | Change in exchange rate | 10-year performance rate (Pesos) | 12-year performance rate (US\$) | Spread between US\$-denominated and peso-denominated debt |
|---------------------------|-----------------------|-------------------------|----------------------------------|---------------------------------|---|
| <i>Average</i> | 0.84% | -2.28% | 1.08% | 0.82% | 0.02% |
| <i>Standard deviation</i> | 2.04% | 1.95% | 2.85% | 3.92% | 3.34% |

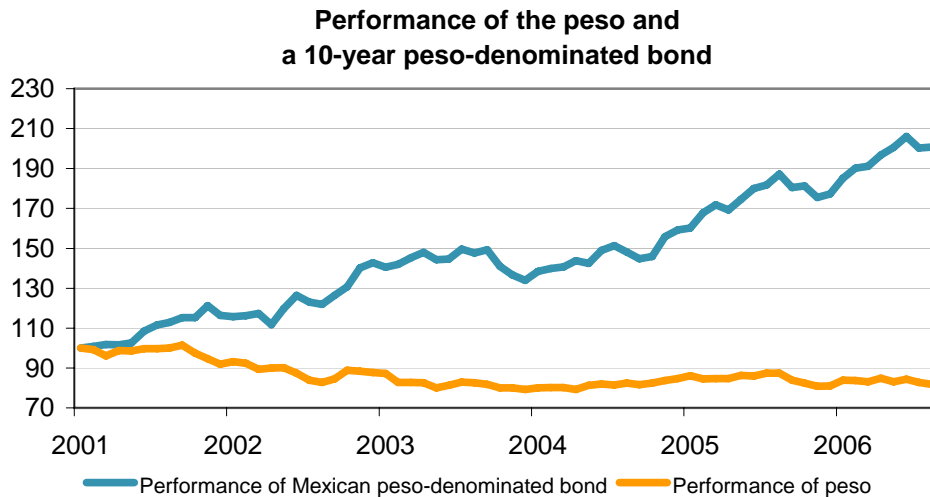
For the analysis, we used a 12-year, US dollar-denominated bond and a 10-year peso-denominated bond, which we then converted into U.S. dollars in order to compare the performance of the two bonds. We selected a 12-year bond because that is the one for which we had the most complete data. Comparing a 12-year bond with a 10-year bond will not affect our results because rate spreads beyond 10 years are negligible.

Averages were determined for a sample from 2001 to the present. Based on our analysis, the Mexican bond denominated in US dollars had an average performance of 0.84%, whereas the bond issued in pesos and then converted into US dollars recorded a performance of 0.82%. The performances are largely similar, as shown in the graph below. However, the peso-denominated bond converted into US dollars is nearly twice as volatile as the US dollar-denominated one. It therefore seems that the yield of the peso-denominated bond poorly compensates for the risk assumed.

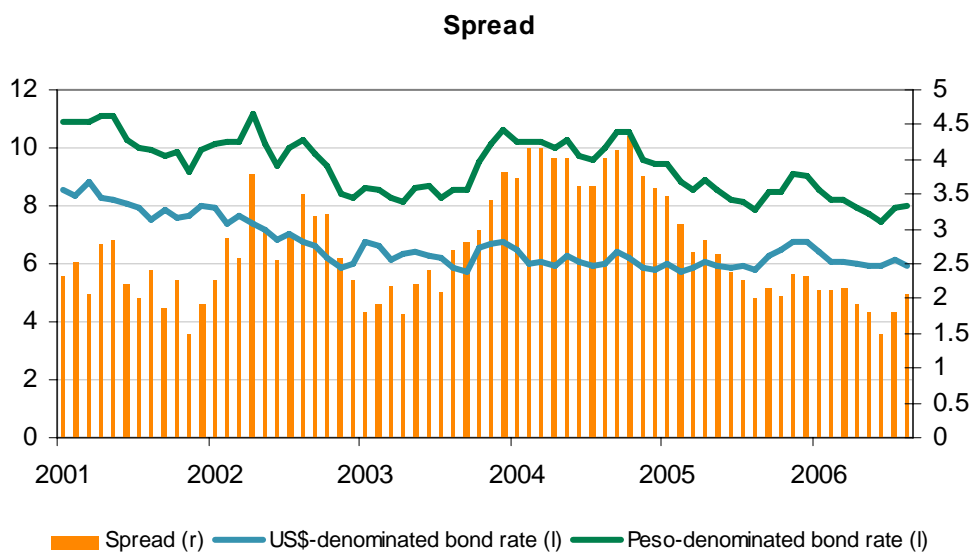
Bond performance



If we compare the performance of the peso and the 10-year bond, we can see that the cyclical aspect of the currency significantly impacts the bond's yield. The peso fell from 2001 to 2004, adversely affecting the performance of the 10-year bond for three years. Subsequently, the trend was somewhat reversed when the Mexican currency firmed slightly, helping to bring the 10-year bond's performance close to that of the 12-year bond. The peso tumbled again at the end of 2005, pushing down the performance of the 10-year bond. The peso's behaviour therefore substantially influences the 10-year bond's volatility, but the bond's performance does not compensate for the volatility caused by the currency.



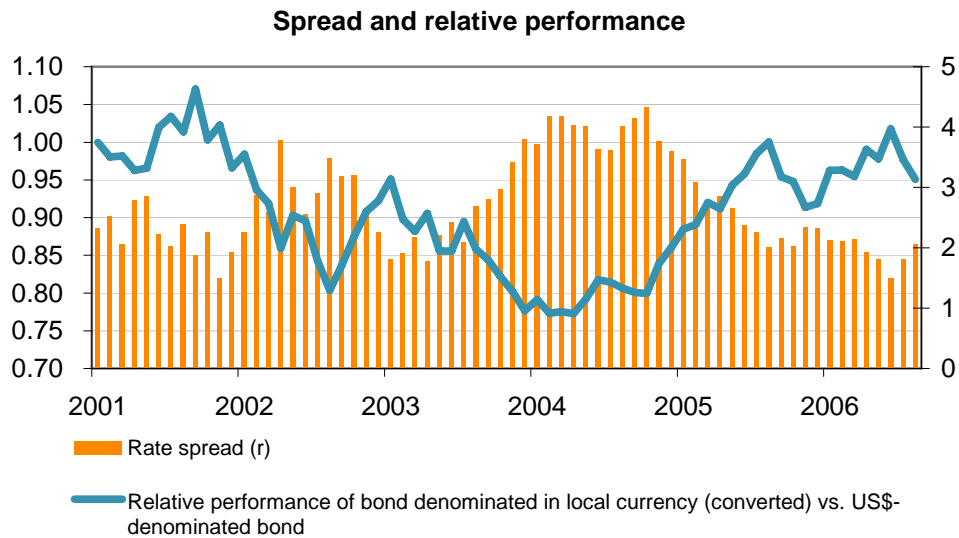
The spread between the 10-year bond denominated in local currency and the 12-year, US dollar-denominated bond should be wider to amply reflect the risk associated with fluctuations in the Mexican peso, a risk that is assumed by foreign investors.



Even if the rates offered may be attractive in the short term for certain periods, generally the risk will not be offset by a higher yield for investors who held the bonds from 2001 until the present. In the case of Mexico, investors should therefore prefer US dollar-denominated bonds to Mexican peso-denominated ones. This does not mean,

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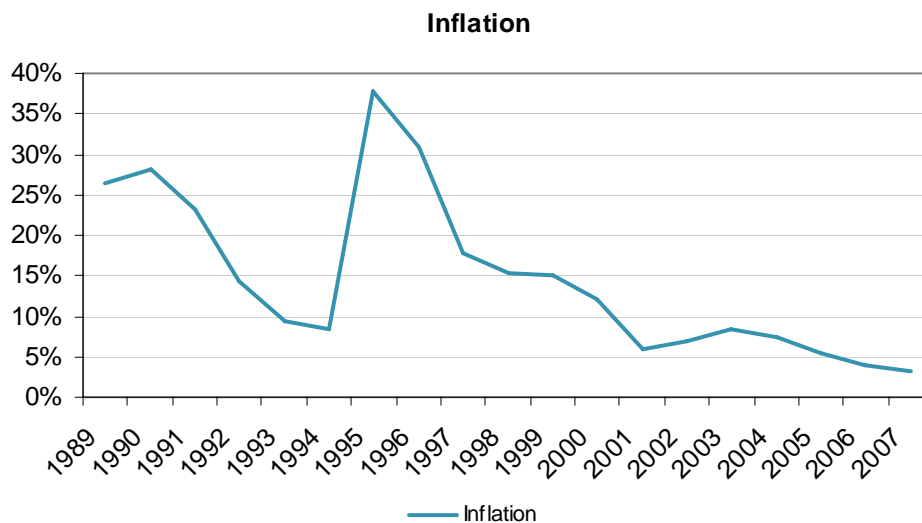
however, that an investor may not resort to tactical management. The relative performance of the 10-year bond to the 12-year bond may provide a solid yield over a short period. If the spread were to widen to its maximum limit, as was the case in early 2004, the relative performance of the 10-year bond becomes attractive. Therefore, for investors wishing to manage the market tactically, there are periods of possibly attractive gains.



Mexico

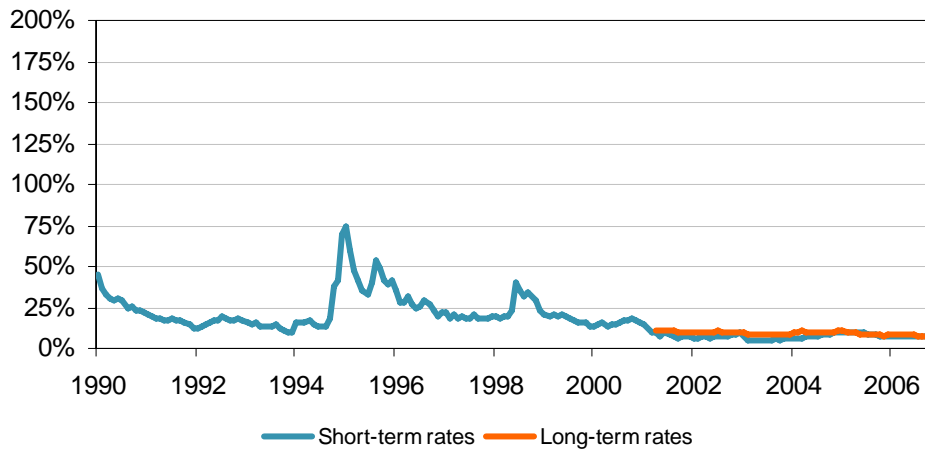


After being held in check for years, Mexico's inflation recently began to grow sharply again. The annual inflation rate in February was 4.1%, up from 3.9% in 2006. Although inflation is well below what it was in the mid-1990s, it is still above the 3% target set by the central bank. This situation can be explained by the strong demand for ethanol, which has helped push up corn prices. Even if this proves to be good news for farmers, it is not at all the case for city dwellers. In fact, this situation has led to a marked increase in the price of tortillas, which are made of cornmeal and even today account for a very high percentage of calories in the Mexican diet. The higher cost of tortillas has therefore significantly affected the daily lives of the less affluent. It fell 10%, however, in the last half of January and should therefore not greatly affect Mexico's inflation in the months ahead. That is at least what we were told by Francisco Gil Diaz, Mexico's former Minister of Finance. According to Mr. Diaz, the central bank will closely monitor inflation through a daily consumer price index, among other things. He expects inflation to drop in the coming months.



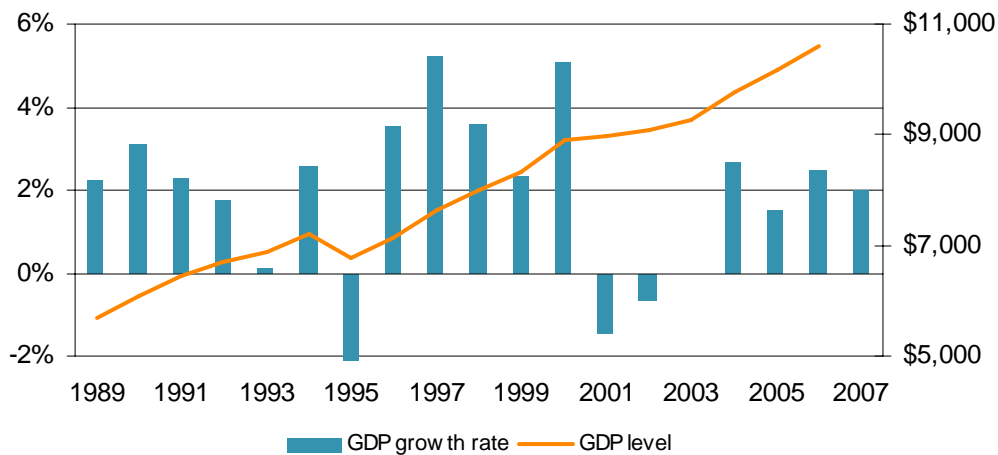
Short-term rates have been stable at 7% for almost a year whereas long-term rates have continued to trend down slightly since mid-2006 to approximate short-term rates.

Short and long-term rates



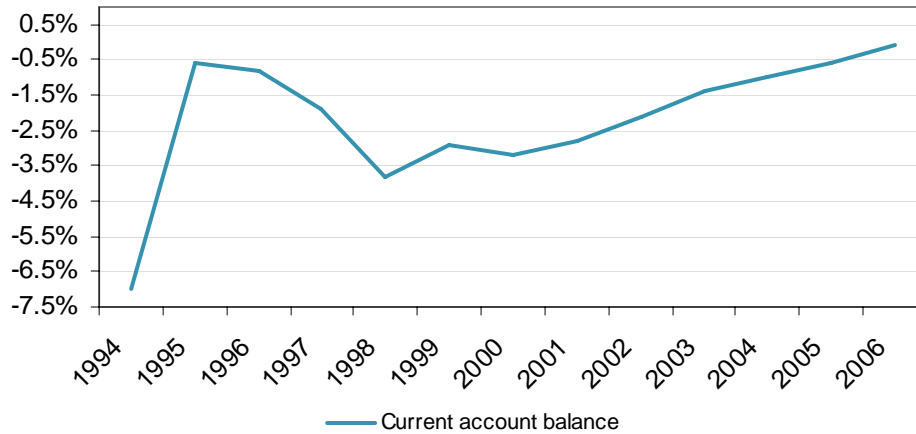
Mexico's economy grew 4.8% in 2006, and per capita GDP rose 2.5%, with both these indicators up over 2005 levels. In addition, Mexican exports to the United States kept pace with Chinese exports in the past year. The maquiladora industry, i.e. plants near the US border whose production is solely for export, seems to be firmly withstanding Chinese competition. The auto parts plants whose production is earmarked for the US market are by far the largest. It is therefore not surprising that this sector performed well in 2006 given US growth in the past year. Just like the Canadian economy, Mexico's economy is tied to the United States, where a slowdown this year would greatly affect it. This was evident in the growth rate of Mexican exports in the fourth quarter of 2006, which was down and has remained low since the beginning of 2007 because of the US economic slowdown. The less brisk demand for automobiles manufactured in Mexico is another factor that accounts for the situation. Given the large proportion of auto parts in Mexican exports, we will need to monitor the situation for any possible closures of auto parts plants in the coming quarters in order to accurately assess the future of Mexico's export sector. Moreover, industrial expansion is at its lowest rate since 2006, whereas unemployment has been growing since the fourth quarter of 2006.

Growth in per capita GDP



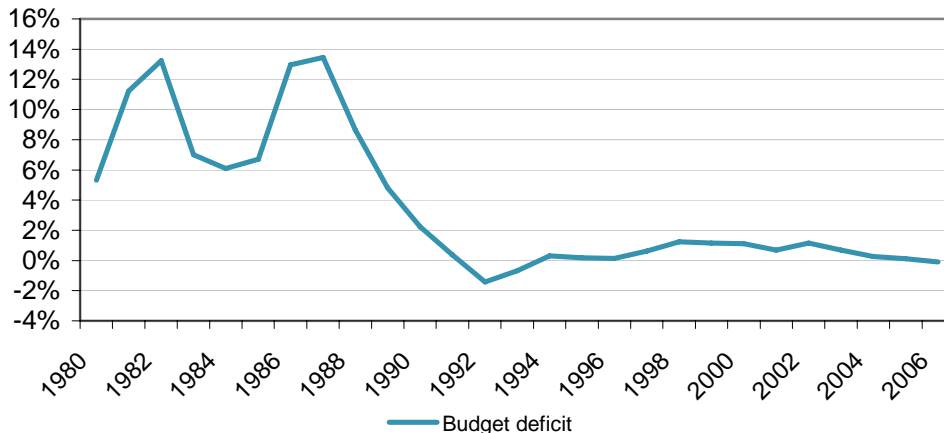
Mexico's economy is not as open as it seems because there are still numerous import barriers. There is no doubt that removing the import tax would improve the productivity of Mexican companies. These barriers cannot be levelled overnight as a certain amount of political courage will be required. Nonetheless, government members are working on it. In addition, structural reforms would allow Mexico to improve its investment rate, which at 21% of GDP is low for a developing country. Consequently, growth in domestic demand and exports will continue to be limited by inefficient infrastructures and by a lack of labour reforms likely to push up employment.

Current account balance



It should, however, be mentioned that the Mexican government is updating retirement plan regulations. Currently, a Mexican worker who loses his or her job is stripped of all his or her privileges. In order to correct this situation, the government intends to create individual accounts that will then be recognized as an expense. Once this measure has been implemented, the budgetary balance, which is now close to 0% of GDP, will most likely turn into a deficit, forcing the government to control its expenses in the years ahead. However, the income tax reform in the works should lead to higher tax revenues.

Budgetary balance



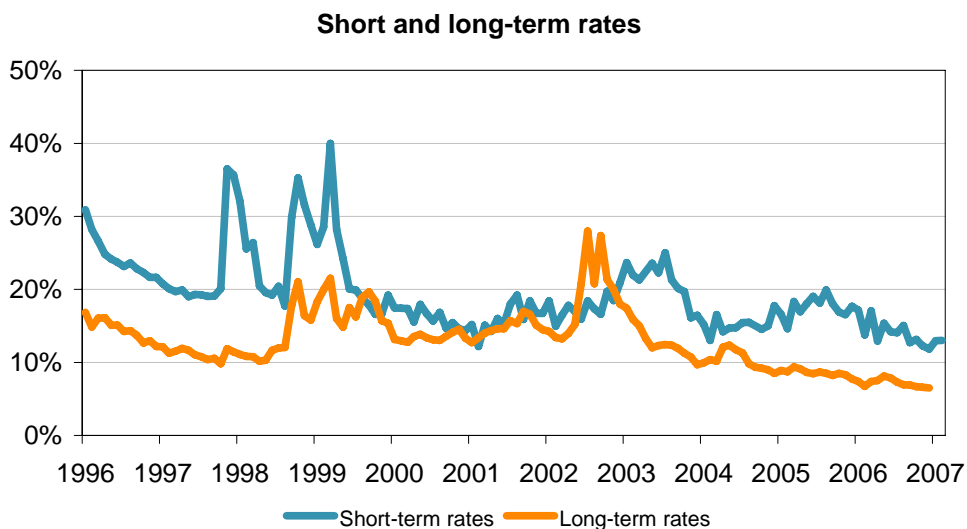
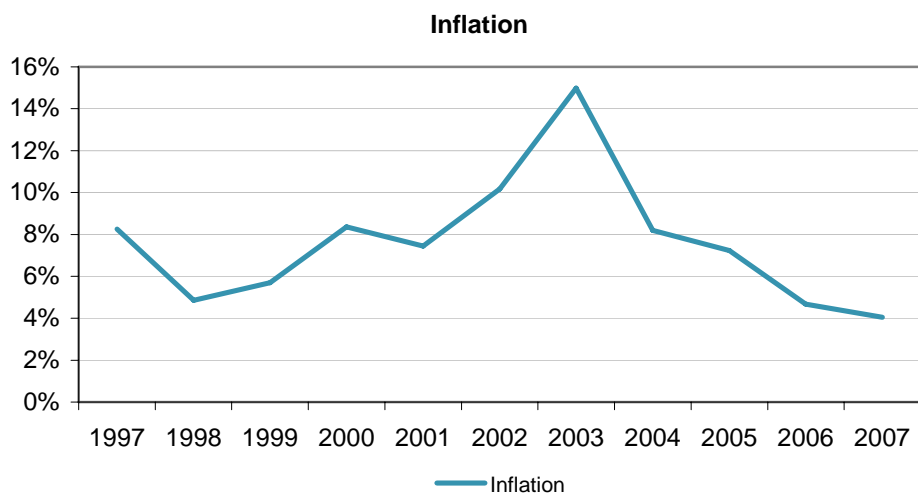
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The real estate and construction sectors are in very good shape. Many Americans are retiring in Mexico, and Mexicans are benefiting from improved access to mortgages, thus contributing to the boom in the real estate industry. Since Mexico's economy will be in lock-step with the US economy, higher-than-expected growth in the United States in 2007 will boost the Mexican economy. Moreover, transfers from the Mexican diaspora of the United States, which account for a large part of private consumption, should remain high. However, the US manufacturing sector, which is critical to Mexico's export market, is showing signs of weakness and could have a negative impact on Mexico's GDP.

Brazil

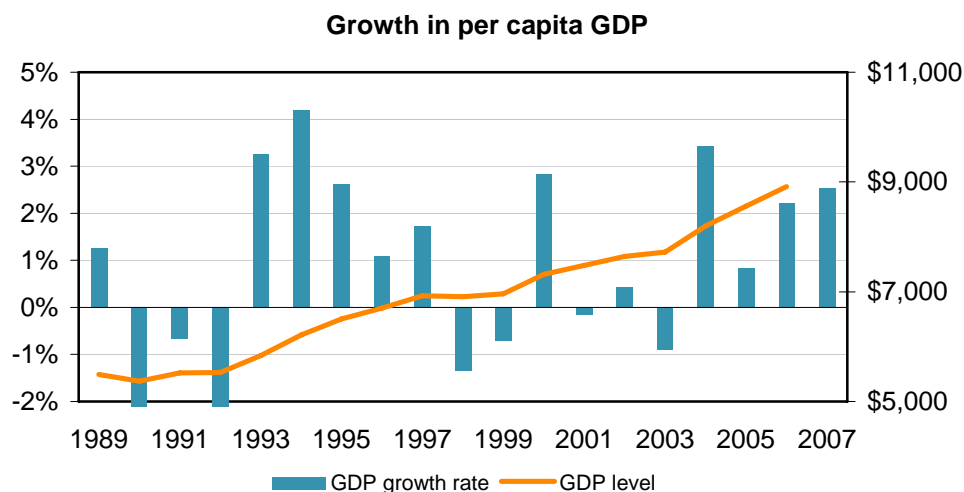


Brazil's inflation has been sloping down since 2003 and is currently hovering around 4%. The central bank is now focused on normalizing interest rates. It will maintain its interest rate reduction policy, under which rates are presently 13%, so that monetary policy and inflation will move toward developed economies' levels. Hence real interest rates are very high in Brazil and are attracting foreign investors, while creating upward pressures on the Brazilian Real.



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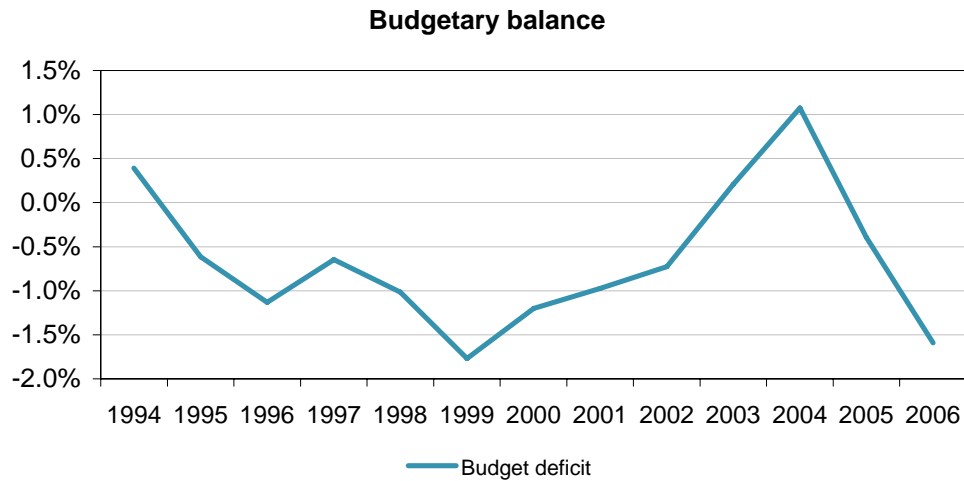
Brazil's economic growth rate is relatively solid in view of its potential growth rate. We learned, however, from our meeting with Brazil's central bank that Brazil has a very low multifactor productivity rate for a developing country: an estimated 0.43% out of a 3.5% GDP growth rate. A country in catch-up mode like Brazil should have a higher productivity rate than the United States since it is easier for a lagging country to catch up with one that has already paved the way technologically speaking. In reality, the multifactor productivity rate is 20% less than in the United States, which means that Brazil does not seem to be catching up technologically.



In addition, the capital accumulation rate has been declining for the past 20 years. Real interest rates do not seem to have any impact on capital accumulation since capital accumulation is not any higher despite lower interest rates. The ratio of capital cost to GDP in Brazil is trending up, whereas it is down in countries experiencing sustained industrialization. For instance, computer prices continue to decrease in highly industrialized countries, which is not the case in Brazil. This situation seems to be due to an excessively high protection rate for Brazilian imports, especially on motor vehicles, industrial machinery and electrical appliances.

The savings rate in Brazil is also low, which translates into a low capital accumulation rate. Brazil is therefore a special case in which investment costs are increasing while capital accumulation is declining. In addition, Brazil seems to be relying too much on its capital for growth, which in turn is becoming increasingly costly.

Brazilians' tax burden has been growing by leaps and bounds since the end of the 1990s. Its plight is similar to that of the United Kingdom, but Brazil's per capita GDP is 10 times lower. Soaring public expenditure accounts for this situation.



Growth in pension plan expenses is behind the high level of public expenditure, and is outpacing the population growth rate. In order to illustrate this situation, let us say that Brazil has one third fewer senior citizens than the Netherlands, but its expenses are just as high. The pension system in Brazil protects the elderly more than it does the youth. Without social transfer payments, the poverty rate of the elderly would skyrocket, without affecting that of young people.

In addition, public investment is decreasing sharply even if tax revenues are growing. Public investment as a percentage of GDP is one of the lowest in the world. Since Brazil seems to be well aware of the situation, a political process is under way to resolve these problems, which are detrimental to the country's economic growth.