EXECUTIVE SUMMARY

INTRODUCTION

It is estimated that the Latin American and Caribbean region's GDP will grow by around 4.5% in 2004, which translates into a 3.0% increase in per capita terms. Almost all the economies of the region have made a recovery since reaching the low point in this business cycle during the first quarter of 2002.

As noted in the *Preliminary Overview of the Economies of Latin America and the Caribbean*,[1] the favourable conditions for the region that have prevailed at the international level for quite some time now have been one of the main factors that has made this recovery possible. The decline in sovereign risk premiums from their highs of September-October 2002, stronger commodity prices, the upswing in tourism and the growth of non-oil exports to the United States and other major markets have been the main positive impulses generated by the international economy. The fact remains, nonetheless, that the region's ability to capitalize upon this favourable external climate is in large measure a reflection of its implementation of domestic economic policies geared towards maintaining tighter fiscal and monetary control and more competitive exchange rates.

The durability of this growth phase is, however, threatened by both internal and external factors. On the internal front, the weakness of demand in many of the region's economies casts some doubt as to the recovery's consolidation. On the external front, a number of economic disequilibria exist that will have to be dealt with sooner or later. Although these imbalances do not represent an imminent danger, they would appear to presage a slower pace of growth for the world economy in the medium term.

EXTERNAL SECTOR

International economy

World GDP grew by 2.7% (compared to 1.8% in 2002), while global trade, measured at constant prices, expanded by 5.8%, or somewhat more than double the preceding year's rate. The forward momentum that economic activity began to exhibit in the second half of 2003 has carried over into 2004 and, as a result, GDP growth for 2004 is projected at around 3.8%, which is far higher than the figures generally seen since 2001. Projections for the second half of 2004 and for 2005 indicate that the pace of GDP growth will diminish somewhat, however. The growth of world trade, which has regained its pre-recession buoyancy, is likely to be in the vicinity of 7% in 2004.

The main hubs of world economic growth have been the United States and the Asian countries, particularly India and China. China has acted as a powerful engine for growth in its own region (where it has spurred, for example, Japanese exports and those of emerging

[1] Economic Commission for Latin America and the Caribbean (ECLAC), Preliminary Overview of the Economies of Latin America and the Caribbean, 2003 (LC/G.2223-P/I), Santiago, Chile, December 2003. Unites Nations publication, Sales No. E.03.II.G.186.

industrialized economies) as well as generating a strong demand for commodities that has benefited some of the Latin American economies.

In 2004 the United States economy is expected to achieve a growth rate of 4%, after having expanded by 3.0% in 2003. China's economy grew by 9.1% in 2003 and by 9.7% in the first half of 2004 relative to the same period of the preceding year, while the Japanese economy expanded by 3.5% in 2003 after suffering a setback the year before (0.3%). In 2004, this trend is expected to result in an annual growth rate of over 4%, largely as a reflection of China's economic dynamism. The reactivation was more hesitant in the European Union in 2003, where the growth rate was a mere 0.9%. This increase was concentrated in the second half of the year, however, and growth accelerated further in the first quarter of 2004, when an annualized rate of 2.5% was recorded.

The world economy's growth in 2003-2003 has been reflected in stronger demand, which in turn has had a positive impact on the Latin American and Caribbean economies. The momentum generated by United States and Chinese imports has been a particularly significant factor. In 2003, the price index for commodities exported by Latin America and the Caribbean climbed by 15.4%, while the non-fuel commodity price index rose by 7.2%. Between April and June 2004, these markets softened, however, and the prices of a number of products fell.

The region's external sector

In 2003, Latin America and the Caribbean posted a US$ 56 billion surplus on the balance-of-payments current account (equivalent to 0.3% of the region's GDP) for the first time since 1953. Among the other main components of the balance of payments, the capital and financial accounts (including errors and omissions) yielded a US$ 5.1 billion surplus and a total of US$ 18.8 billion in compensatory financing was registered. As a result of these movements, reserve assets jumped to US$ 29.6 billion (1.7% of GDP). This build-up of reserves in 2003 played a key role in stabilizing foreign-exchange markets in some countries.

Based on the trends observed during the first five months of the year, a surplus on the balance-of-payments current account of around 0.8% of GDP is expected again in 2004. The merchandise trade surplus will surpass its 2003 level thanks to the fact that the extraordinarily robust growth of exports will more than offset the upswing in imports.

In 2003 the deterioration seen in the region's terms of trade between 1998 and 2002 came to a halt. The 1998-2002 trend had resulted in a cumulative loss of 14.8% for non-oil-exporters and of 3.4% for the region as a whole (including countries that are net oil exporters). This change of sign notwithstanding, the actual improvement was modest: 1.1% for the region as a whole, 2.5% for oil-exporters and 0.5% for the rest. The terms of trade are expected to make a more robust recovery in 2004, with an improvement of nearly 3%.

Since mid-2002, the Latin American and Caribbean region has been posting a surplus on the merchandise trade balance. In 2003, this surplus was not the result of a reduction in imports, as it had been in 2002, but rather of the fact that export growth (8.2%) outstripped the increase in imports (3.2%). Export levels were higher in 2003 in most of the MERCOSUR and Andean Community member countries as well as in Chile. In a majority of the countries, this upturn was chiefly attributable to an expansion in the volume of exports rather than higher prices. In 2004, it is estimated that exports could climb by 15%, while the increase in prices is projected at 6%.

In 2003, a modest recovery in the net capital inflows received by Latin America and the Caribbean brought them to the equivalent of 1.4% of GDP. The outlook for 2004 points to a continuation of this upturn, which could amount to as much as 1.8% of GDP, with an especially steep increase being expected in private capital inflows. Despite this improvement and the fact that no significant change in factor payments is projected, the region is expected to witness a negative transfer of around US$ 22 billion.

Foreign direct investment (FDI) in the region has undergone a gradual yet nonetheless marked decline over the past four years that has deprived it of its former momentum. In 2003, this category of investment amounted to US$ 29.2 billion in gross terms, which was well below the 1990-2002 average of US$ 39 billion per year. Nevertheless, the prospects for 2004 are for a recovery of FDI inflows, which should climb to some US$ 35 billion.

With world financial markets in the midst of a recovery, the average cost of external financing for the region dropped from 12.7% to 9.9% in 2003. The mean cost in 2003 was thus similar to the level recorded for the first half of 1997, before the outbreak of the Asian crisis. This decline continued in the first quarter of 2004, bringing the cost of such financing to an annual figure of 9.4%, but in the second quarter it rose by one percentage point in response to a fairly widespread increase in risk premiums and a 0.6% rise in bond yields.

ECONOMIC POLICY

Fiscal policy

In recent years, the chief objective of the countries' fiscal policies has been to reduce their deficits. Attention has also been focused on the countries' hefty public debts and short-term financing, rather than on the possibility of using fiscal policy to perform a countercyclical function. Within this context, the countries of the region made a significant improvement in their fiscal accounts in 2003. Progress in this direction is continuing to be made in 2004, and the (simple) average primary surplus is expected to amount to one percentage point of GDP for the first time in many years.

Exchange-rate policy

Between December 2002 and December 2003, the currencies of the Latin American and Caribbean countries appreciated by an average of 4.9% against the dollar in real terms. This upward trend was evident in all the South American countries except Bolivia and followed the sharp depreciations against the dollar in real terms witnessed by the region in 2002. The extent of the appreciation was particularly marked in Brazil (24.9%), Paraguay (19.4%), Argentina (15.3%) and Chile (13.7%). The resulting average real appreciation against the dollar for the currencies of this subregion amounted to 8.9%.

The Central American countries' currencies depreciated slightly, on average, against the dollar (0.5%). In Mexico, the real depreciation was steeper (8.1%) and contrasted with the real appreciation of the Mexican peso that occurred between 1995 and 2002. The Caribbean countries' performance in this respect was mixed. The problems experienced by Jamaica and the Dominican Republic caused their currencies to depreciate substantially against the dollar in real terms, whereas Trinidad and Tobago's and Haiti's currencies appreciated against the United States dollar in real terms.

Between December 2003 and May 2004, a slight real depreciation against the dollar (1.2%) and a slight real appreciation against the euro (2.2%) were registered for the Latin American and Caribbean currencies as a group. In real terms, the South American currencies depreciated against the dollar by 1.9%, the Central American currencies appreciated slightly (–0.2%) and the Mexican peso continued to decline against the dollar (3.3%). In the Caribbean, exchange-rate movements have stabilized, following the volatility they exhibited in 2003. Five months into the year 2004, the region's average real effective exchange rate was 18% higher than it had been in 1997 and 2000.

Monetary policy

The external environment is of fundamental importance for the region's monetary policies, as its economies' scope for action is in some measure determined by movements in international interest rates. In mid-2003, the global economy began to become more liquid as the money supply expanded in the United States, Europe and Japan and international flows picked up in the world's capital markets. Thanks to this situation, the more heavily indebted countries in the region benefited from larger capital inflows and narrower credit spreads. In April 2004 this trend began to reverse itself, however, as long-term interest rates started to climb, equity prices declined and risk premiums rose.

As is customary, during the period under review the prime objective of monetary policy in the region was to curb inflation and, in those instances where it is already under control, to contribute to the economy's reactivation. The region's central banks have probably lowered interest rates as much as they are going to, but it remains to be seen how fast regional interest rates will change and how much they may or may not lag behind the policy moves made by the United States Federal Reserve.

DOMESTIC PERFORMANCE

Economic activity

GDP growth for the Latin American and Caribbean countries as a group in 2004 is estimated at around 4.5% —a notable improvement over the 2003 rate of 1.5%. In 2003, economic activity gathered momentum as the year proceeded; whereas the performance of the region's economies was mixed in the first half of the year, activity picked up in almost all of the countries during the second.

Although exports continued to be the most dynamic component of demand, consumption (especially private consumption) was slightly higher than in 2002. The level of gross fixed capital formation in 2003 was similar to what it had been in 2002, when a small upturn in investment in the construction industry was offset by a contraction in investment in machinery and equipment. As a result of the stagnation of this variable in 2003 and the fact that in 2002 it was 5.9% lower than it had been the year before, gross fixed investment stands at 17.9% of the region's GDP —the lowest level to be recorded since the early 1970s.

As noted in the 2003 edition of the *Preliminary Overview of the Economies of Latin America and the Caribbean*, the expansion of economic activity seen throughout 2003 was the reflection of a variety of both internal and external factors. Internal factors included the trend in real exchange rates, whose depreciation stimulated the production of tradable goods. Another factor was that monetary policy-makers kept pace with the decline in inflationary expectations by lowering interest rates, which also spurred internal activity. In addition, the existence of idle installed capacity in some sectors enabled the countries to take advantage of the upswing in demand brought on by favourable conditions in the international economy. The relevant external factors have been associated with the relative improvement in the global economic situation since mid-2003.

Regional inflation

It is estimated that the regional inflation rate for 2004 will be slightly lower than the year before, when the overall rate was 8.5%, or nearly four percentage points lower than the rate for 2002 (12.1%).

Employment and wages

After the serious deterioration in the employment situation observed since 1998, in 2003 the beginnings of a recovery in the Latin American and Caribbean economies had some positive effects on the labour market, especially in terms of job creation. Since these promising signs stimulated the labour supply as well as demand, however, the pace of economic growth was too slow to permit new entrants to be absorbed into productive occupations. As a result, the regional unemployment rate was quite high (10.5%) even though the employment rate rose from 51.6% to 52%. The weighted average of real wages declined by 4.4%.

In the first half of 2004, the situation in the region's labour markets remained mixed, but unemployment levels were sharply lower in some of the countries that have undergone severe crises in recent years. The regional unemployment rate is estimated to have dropped to 10.3% from the 10.7% rate registered for the corresponding period of 2003. A similar trend was seen in wages, with countries that had experienced a steep downturn in 2003 observing an easing of this trend in early 2004.

ECONOMIC GROWTH: A MEDIUM-TERM PERSPECTIVE

Per capita growth rates in Latin America and the Caribbean have been low and volatile in recent decades. The last few decades of the twentieth century were marked by unstable capital flows, constant fluctuations in the terms of trade, economic reforms and swift changes in the world economy. Against this backdrop, the region's economic growth rate reflects a complex interaction of differing trends that overlap with cycles of varying intensity and duration. Furthermore, growth patterns in the countries have also been highly variable. In fact, over the past 30 or 40 years, booms lasting nearly a decade have been interspersed with bouts of stagnation and outright growth collapses in a number of countries in the region.

An analysis of the sources of growth indicates that the slowdown in capital formation accounts, on average, for nearly one third of the decrease in GDP growth observed since 1980 in Latin America. The data show that public investment was more volatile than private investment in 1980-2002, a period during which most of the Latin American countries were adopting adjustment measures in an effort to put a stop to the incessant fiscal crises that have repeatedly triggered cutbacks in public investment. This analysis also shows that total factor productivity either failed to increase or actually detracted from the economic growth of a majority of the countries in the region.

These sustained growth phases and protracted slumps attest to the wide array of impulses that contribute to sustained growth as well as the range of factors that impede growth and propel countries into what are sometimes long-lasting spirals of negative growth. It is interesting to note that when growth phases have occurred in the region, they have been coupled with sustained increases in total factor productivity. Furthermore, such phases have occurred both in the 1960s and 1970s, when import-substitution policies were still in use, and in the 1990s, when market-oriented policies predominated. On the other hand, protracted growth collapses have greatly impaired the population's quality of life and have driven up poverty levels in the countries concerned.