VI

The International Economy

The trajectory of the international economy in 2003 can be divided into two distinct phases. The early part of the year was marked by a series of uncertainties such as the outbreak of war in Iraq and the consequent upward movement in oil prices, coupled with deteriorating expectations on the part of economic agents. At the same time, the Asian Development Bank estimated the negative impact of the behavioral changes caused by Severe Acute Respiratory Syndrome (SARS) on activity levels in the East Asian economies at between 0.6% and 2% of GDP in the countries most severely hit by the epidemic. Though less intense than originally expected, the adverse effects on the economy were concentrated in the months of April and May and were most strongly felt in the various service segments, particularly those related to tourism.

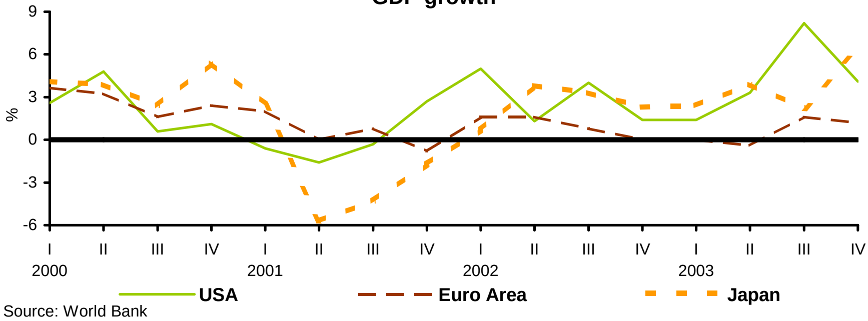
In the middle of the year, the situation of uncertainty was reversed, mainly as a consequence of macroeconomic incentives that resulted in a rapid upturn in activity levels. In the initial stages, recovery was perceived most clearly in the United States before later extending – albeit with lesser intensity – to Japan and to the Euro zone countries. In much the same way as in 2002, China expanded rapidly and generated highly positive repercussions on the outlook for economic recovery on a global scale, mainly as a result of the impact of this growth on expanded foreign sales in such diverse economic regions as East Asia and Latin America. With regard to this recovery, however, one worrisome aspect that still remains is the as yet insufficient response on the part of the labor market. Even in the United States, where growth was more accentuated, there was no significant drop in jobless levels. Since the evolution of the major employment indicators for the United States economy is an aspect of the utmost importance to the sustainability of growth on both a national and world scale, authorities began giving very special attention to the monitoring of the various employment indicators in search of signs that could point to future changes in the country's monetary policy.

Economic activity

Just as has occurred in recent years, global economic performance was directly impacted by the United States economy. Though GDP in the United States has grown at a positive pace since the end of 2001, it was only in the second quarter of 2003 that this expansion came to be considered sustainable. Though, on the one hand, the war in Iraq was a source of significant economic uncertainties, it also acted as an incentive to economic growth, particularly as a result of massive increases in military spending. Once the instability caused by the war had been overcome, the economic scenario at the start of the third quarter of the year became considerably more positive and reflected a combination of such factors as lower petroleum prices, rapid improvement in business and consumer expectations, introduction of a fiscal incentive program and financial market recovery, following exhaustion of the impact of the bursting of the stock market bubble and a series of corporate scandals. Among the factors of fundamental importance to this process, particular mention should be made of continued historically low interest rates, which have made it possible to refinance debts at sharply lower costs and, consequently, release funding for consumption and investment outlays by households and businesses. Despite the strong cutback in public sector spending in the third quarter, United States GDP expanded by an annualized rate of more than 8% in the period, with substantial increases under exports, consumer spending and, principally, investments. In the fourth quarter, the pace of growth lessened but still remained above the level of 4%.

Graph 6.1

GDP growth[1/]



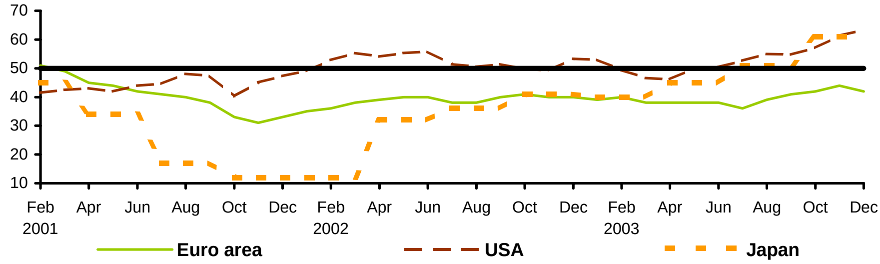
Source: World Bank

1/ Quarterly growth seasonally adjusted annualized rate.

Japan turned in positive product growth in 2003, continuing a process that began in the first quarter of 2002. In the fourth quarter of the year, the pace of growth picked up speed, indicating the possibility of overcoming the stagnation that has marked that country's economy since the start of the 1990s. In the final three months of the year, GDP expanded at an annualized rate of 6.4%, driven mainly by external demand and fixed investments. The positive growth that marked the economic scenario was generated principally by reactivation of the world economy and by steps taken by the Bank of Japan (BoJ) with the aim of strengthening liquidity. Other positive factors were important advances in the recovery of the financial system and strong growth in business profitability.

Graph 6.2

Business confidence indicators[1/]



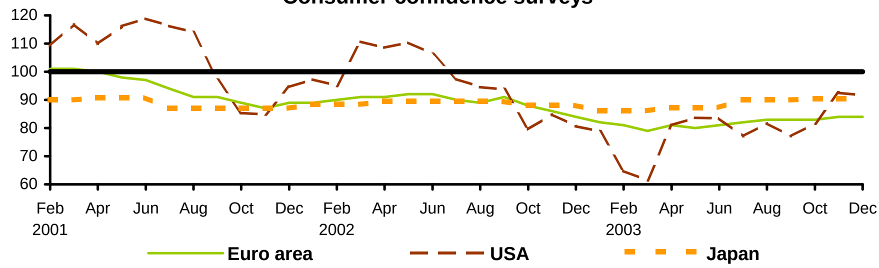
Source: European Comission, ISM, Bank of Japan

1/ Readings above 50 reflect positive expectations, below 50, negative expectations. Some of the series has been adapted to allow for comparisons.

In the Euro zone countries, indicators that reflect business expectations improved consistently in 2003, signaling a process of economic expansion that did not come about with the forecast intensity. Following three quarters of nil or negative growth, the region's GDP expanded by 1.6% and 1.2% in annualized terms in the last two quarters of the year. Internal demand was insufficient, while exports – the major force underlying GDP growth – were hampered by appreciation of the euro. European consumers remained wary not only in the first half of the year, in the context of the uncertainties that marked the world economy, but also in the final six months, particularly as a result of a very weak labor market.

Graph 6.3

Consumer confidence surveys[1/]



Source: European Comission, Conference Board, Economic and Social Research Institute (Japan)

1/ Readings above 100 reflect positive expectations, below 100, negative expectations. Some of the series have been adapted to allow for comparisons.

Once again, the Chinese economy managed to generate the strong economic growth that has become characteristic of recent years, closing 2003 with expansion of 9.1% of GDP. Aside from continued rapid growth under foreign sales, imports also grew sharply and were sufficient to impact the trade balance results not only of East Asian countries, which were the largest beneficiaries, but also in other region's of the world, including Brazil. Chinese demand for imports produced strong growth in such commodity prices as steel, copper and soybeans, making it possible for exporter countries to achieve recovery in their terms of trade.

Though it has been lower than in such other developing regions as East Asia and Eastern Europe, the economic performance of Latin America was considerably more positive in 2003, mainly as a consequence of the repercussions of recovery in the United States and Japan and strong expansion in China. As a result, the overall GDP of the region expanded by 1.5%, compared to a reduction of 0.4% in 2002.

The highest growth was registered in Argentina (8.7%), following negative results of 4.4% in 2001 and 10.8% in 2002. Performance in 2003 was marked by strong growth under investments and a sharp downturn in the jobless rate. Notwithstanding growth under imports, which had previously been quite low, the trade surplus remained high. In the opposite sense, Venezuelan product dropped by 9.5% in 2003, as a result of the shutdown of the country's petroleum output at the start of the year. Mexico and Chile closed with respective growth rates of 1.2% and 3.2%.

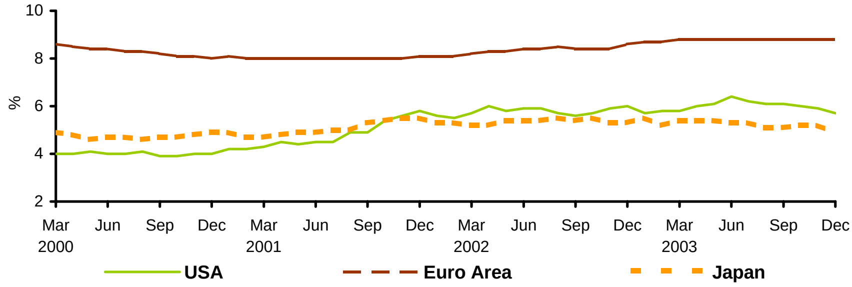
Another factor of importance to the start of the recovery process in the region was that the nations of the region, particularly Argentina and Brazil, managed to overcome the financial instability that had characterized 2002. This fact, coupled with less risk aversion on the international scenario, made it possible to reduce the external debt spreads of the major economies of the region. On the other hand, the ratio of investments to GDP continued on the downward curve that dates back to 1999 while, just as occurred in the major developed countries, the unemployment rate remained quite high, reaching the mark of 10.7% in 2003.

Despite the strong upturn in economic growth in a number of important economies, employment levels remained sluggish. After peaking at 6.4% in June, the jobless rate in the United States moved into a downward trajectory, closing December at 5.7%. However, this reduction was attributed mostly to a lesser number of people seeking employment than to an expanded supply of job opportunities. Here, it is important to note that job positions remained practically stable during the entire year and were even below the level registered up to mid-2001. Among the causes of continued slow growth in job levels, various analysts have pointed to such factors as strong productivity gains registered particularly in the manufacturing sector, coupled with introduction of important structural changes in productive activities. A similar performance was registered by labor market indicators in the Euro zone countries, where unemployment remained stable at 8.8% in the period extending from March to December 2003.

In Japan, on the other hand, unemployment dropped sharply from 5.5% in January to 5% in December, as a direct consequence of economic expansion.

Graph 6.4

Unemployment rates



Source: Bureau of Labor Statistics (USA), Eurostat, Ministry of Public Management, Home Affairs, Posts and Telecommunications (Japan)

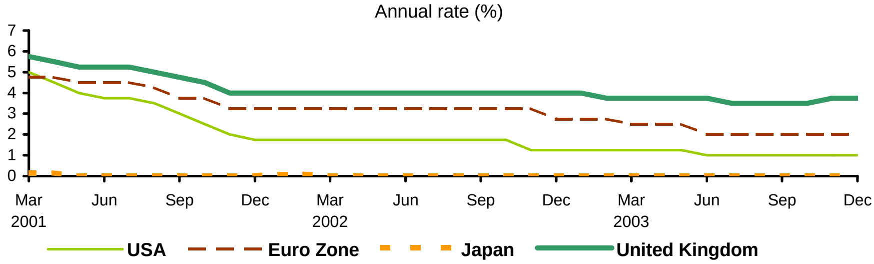
Monetary policy and inflation

Monetary policy in the United States has reflected the rather flexible posture adopted by the Federal Reserve (Fed) since the stock market bubble burst toward the end of 2000. The only interest reduction occurred in June, when the rate was lowered to just 1% per year where it has remained since that time, even though the American economy has begun showing signs of sustained recovery. This more optimistic scenario became more evident as of the midpoint of the year, principally following announcement of the extraordinary rate of GDP growth in the third quarter. From that point forward, many analysts began predicting the date on which the Fed would begin the process of raising interest rates. However, since labor market performance was unable to keep pace with the more optimistic expectations, previous forecasts, which had indicated a more gradual though solid recovery in the activity level and a progressive rise in interest rates, gained greater credibility. Depreciation of the dollar against the major currencies and, particularly, against the euro, did not produce inflationary impacts, except in the case of imported goods at the wholesale level. Given the high level of idle capacity, particularly in the industrial

Graph 6.5

Official interest rates[1/]

Annual rate (%)



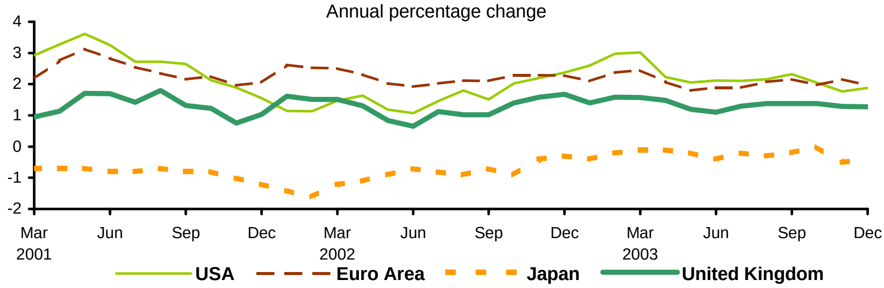
Source: USA – Federal Reserve, Euro Area – ECB, Japan – Bank of Japan and United Kingdom – Bank of England

1/ USA – fed funds target rate, Euro Area – minimum bid rate, Japan – call rate and United Kingdom – securities repurchase.

Graph 6.6

Inflation[1/]

Annual percentage change



Source: USA – ILS, Euro Zone – Eurostat, Japan – Bloomberg and United Kingdom – ONS

1/ Consumer prices.

sector, these impacts had relatively little effect in other areas of the economy. As a matter of fact, consumer inflation declined during the year, as core inflation fell consistently before closing December at just 1%.

During the entire year, the BoJ maintained its zero interest policy. However, principally as a consequence of exchange market operations performed by the Japanese central bank in order to avoid pressures generated by valuation of the yen, the monetary policy centered on growth in the monetary aggregates was strongly expansionary. Since many of these interventions were not offset by sterilization operations, the money supply expanded sharply. Therefore, the BoJ sought to accommodate the increased supply by shifting the upper limit of the banking reserve targets upward, increasing it by ¥12 trillion over the course of the year. As a result these parameters were set at ¥27-32 trillion on October 10.

Table 6.1 – 2003 BoJ monetary policy

Date	Reserves target (trillions of yen)	Other announced changes
January	15-20	
April 1	17-22	
April 30	22-27	
May 20	27-30	
June 11		Program to purchase asset-backed securities
October 10	27-32	

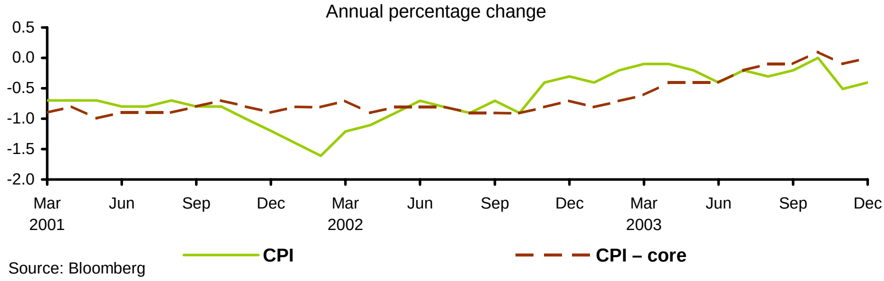
Source: Bank of Japan

Deflation continued as the major monetary policy problem in the sense that it blocked transmission channels to the broader monetary aggregates. Thus, once again, the GDP deflator turned downward. The results under consumer prices, however, were considerably more positive, as the CPI core moved gradually toward zero at the end of the year.

Graph 6.7

Japan: Inflation[1/]

Annual percentage change



Source: Bloomberg

1/ Consumer prices.

In the Euro zone countries, the European Central Bank (ECB) reduced interest rates on only two occasions, both of which occurred in the first six months of the year. The rather conservative stance taken by the Bank was sharply criticized, as analysts felt that, since the region had absorbed the largest share of the impact of depreciation of the dollar in 2003, it would be entitled to receive compensatory monetary incentives in a volume required to avoid exaggerated appreciation of the euro. However, inflation in the region proved to be quite resistant to downward pressures and tended to oscillate in the range of the annual target of 2%. If, on the one hand, this posture may have hindered economic growth in the region, on the other hand it may well have avoided the possibility of rapidly exhausting the effectiveness of a monetary policy based on interest rate adjustments.

The Bank of England (BoE) adopted highly distinct monetary policy positions over the course of the year, reducing interest in the early part of the period, only to raise rates toward the end of the year. The expansionary position that marked most of the year was interpreted as a type of "insurance" against the risks of an upturn in world economic growth that were felt in the first half of the year, when signs of a more sustained recovery in the American economy had not yet become clear. Once these risks had been dissipated, the BoE assumed a more defensive stance in light of the threats represented by the real estate bubble. Important alterations were introduced into the monetary policy framework, including substitution of the retail price index, excluding mortgage interest (RPIX), with the harmonized consumer price index (IPC-H). The British Treasury defined the new official inflation target at 2% per year. When consumer inflation dropped below the target, the BoE found itself in the rather paradoxical position of further restricting its monetary policy in November, precisely when the current framework provided it with increased leeway in pursuing the target. However, the BoE explained that monetary policy restrictions had the objective of maintaining inflation within the officially defined target over a horizon of 1.5 to 2 years, which is the time span required for full transmission of monetary impacts.

In Southeast Asia, monetary policy was marked by alignment with the United States dollar, following the examples of such major regional economies as Japan and China. With this, the competitiveness of export products was preserved and countries intensified their accumulation of international reserves. To a great extent, these reserves were converted into United States Treasury papers, which, in turn, aided in holding interest rates in that country at low levels. In the case of China, where a fixed rate of exchange is used, the entire impact of the change in the value of the dollar was absorbed by the central bank with the consequence of strong monetary expansion, just as occurred in Japan. Vigorous economic growth and the first signs of upward movement in inflation generated expectations of appreciation of the yuan. The country, which had registered deflation in 2001 and 2002, closed with inflation of 3.6% (IPC) in the year under analysis.

Table 6.2 – Asian foreign exchange reserves, end-2003

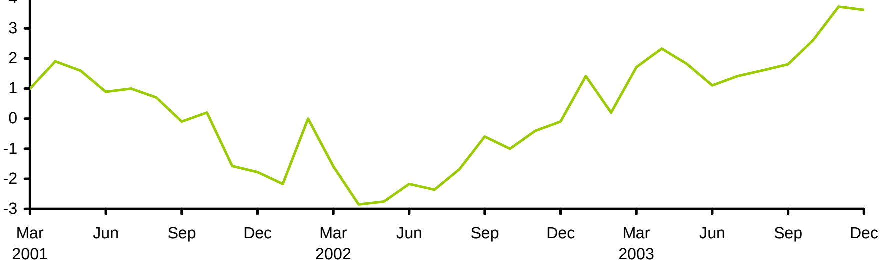
	US$ billion	% of GDP
Japan	674	17
China	403	33
Taiwan	207	73
Singapore	163	110
Korea	155	33
Hong Kong	119	74
India	97	18
Regional total	1 863	25

Source: JP Morgan

Graph 6.8

China: Inflation[1/]

Annual percentage change



Source: Bloomberg

1/ Consumer prices.

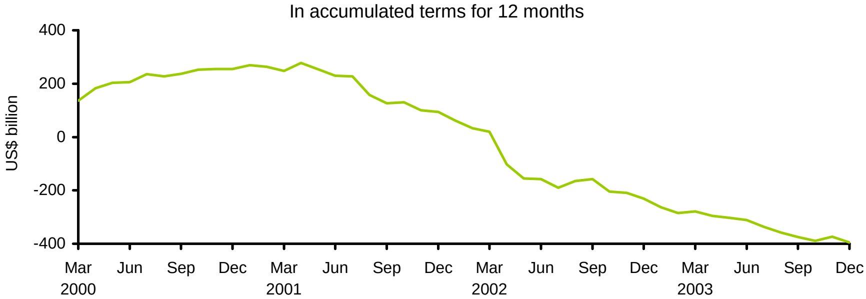
Across-the-board reductions in inflation were registered in Latin America, at the same time in which enhanced fiscal discipline pushed interest rates downward in most of the countries of the region. In the southern cone nations, the 2002 interest rate high was reversed, due mostly to the severe process of exchange depreciation that had occurred in the previous year. Interest rates in the Andean countries – with the sole exception of Colombia – continued on the downward curve that had marked previous years, while inflation fell to historically low levels in both Peru and Chile. In Mexico, the inflationary peak that occurred in 2002 when rates surpassed the predefined target, led to adoption of a more restrictive monetary policy at the start of the year. However, when inflation began to decrease, the country also began a process of sharp interest rate cutbacks. The political and social climate that has taken hold in Venezuela generated alterations in the country's system of exchange, together with measures to control prices. However, despite upward movement under inflation, these measures did not avoid reductions in interbank interest rates over the course of the year.

Fiscal policy

One of the fundamental components of the recovery in the United States economy in 2003 was the incentive provided by the fiscal policy implemented at the midpoint of the year, which included reductions in taxes on dividends earned and the granting of tax credits to families with children. The combination of these measures with strong growth in military spending generated by the Iraqi war resulted in sharp deterioration in that country's fiscal result. The public deficit, which stood at US$157.8 billion in the fiscal year ended in September 2002, climbed to US$374 billion at the end of the 2003 fiscal year. Financing of this effort was achieved as a result of massive purchases of American bonds by the major Asian economies.

As had occurred in 2002, the fiscal deficit in the major Euro zone economies remained above the limit of 3% of GDP, defined by the Stability and Growth Pact, closing at

Graph 6.9
USA – Fiscal balance
In accumulated terms for 12 months



Source: Department of the Treasury

respective levels of 3.9% and 4% of GDP in Germany and France, according to preliminary government estimates.

The major Latin American countries registered increasingly higher primary surpluses, in some cases within the framework of agreements negotiated with the International Monetary Fund (IMF). In the region as a whole, the primary result was a surplus of 0.6% of GDP, in contrast to a 2002 deficit of 0.3% of GDP. Here, particular mention should be made of the progress achieved in the Argentine fiscal adjustment. This was a factor of importance to economic growth in that nation and resulted in a sharp rise in tax inflows and stringent control over government spending, as exemplified by the restrictions imposed on federal civil service pay increases.

International financial markets

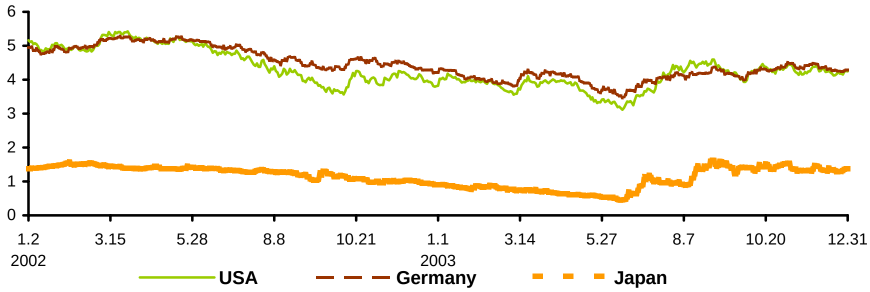
International financial market performance can be divided into two distinct periods in 2003. While the risks consequent upon geopolitical tensions in the Middle East continued, markets were characterized by high levels of risk aversion which, in turn, generated increased negative pressures on spreads and tended to restrict liquidity on a global scale. However, the instabilities caused by the war in Iraq were gradually dissipated, at the same time in which a more optimistic view of the outlook for economic growth solidified, particularly in the United States and Japan. Taken together, these factors encouraged agents to accept greater exposure to risk, generating increased liquidity and migration of investors toward assets with higher risk and return ratios.

Returns on government papers in the industrialized countries were quite low, principally as a result of the highly flexible monetary policies adopted. In the United States, returns on Treasury bonds increased slightly in June caused, on the one hand, by a lessening of the possibility of the Fed adopting nonconventional strategies involving secondary market purchases of long-term securities to ward off eventual deflationary pressures and, on the other, by technical adjustments in the fixed income market related specifically to the operations of mortgage bond portfolios held by mortgage securitization companies. Starting in June, however, United States Treasury securities produced stable income levels since, despite the very large supply of papers to be used in financing the American government's fiscal deficit, the prices of these papers remained high, partly as a response to the enormous and growing demand for these papers, particularly by Asian central banks.

In the other large financial centers, the earnings curve of government securities followed the American trajectory, with upward movement in June followed by stability. In Europe, earnings on long-term public securities reflected expectations that more consistent growth in the United States economy would generate positive repercussions on the activity level of the region. A similar movement occurred with long-term Japanese government papers, despite the fact that the measures taken by the BoJ over the course of the year, particularly through interventions in the secondary securities market, clearly ratified its commitment to maintenance of an expansionary monetary policy.

Graph 6.10

Yield on treasury bonds[1/]



Source: Bloomberg

1/ 10 year treasury nominal yields.

In their pursuit of more attractive earnings, investors reallocated their portfolios, raising their exposure to assets with higher risk classifications. In the case of the emerging economies, this movement resulted in a sharp drop in financing costs, as demonstrated by the trajectory of the Emerging Markets Bond Index (Embi+), which is the proxy for measuring emerging market risk. The result of all this was creation of an environment propitious to the contracting of funding operations on foreign markets.

Graph 6.11

Emerging Markets Bond Index (Embi +)

Source: Bloomberg

According to preliminary estimates issued by the Institute of International Finance (IIF), the net flow of private capital toward the emerging economies is expected to reach US$187.4 billion in 2003, compared to US$124.2 billion in the previous year, mostly as a result of vigorous expansion in portfolio investments and in loans by the nonbanking sector. However, foreign direct investment is expected to drop by 16%, when the same basis of comparison is used. From the regional point of view, Asian countries are expected to occupy the lead position in the expansion of private capital flows to the emerging countries, while the participation of Latin America is expected to drop from 14.9% in 2002 to 14.1%, even though the overall volume of these flows will increase in absolute terms.

Table 6.3 – Net capital flows to emerging economies

US$ billion

Itemization	2001	2002	2003 1/	2004 2/
Private flows	126.6	124.2	187.4	196.2
Latin America	49.5	18.6	26.5	38.7
Direct investment, net	139.8	112.1	93.6	110.7
Latin America	57.7	34.7	26.0	29.1
Private portfolio investment, net	7.7	1.1	30.3	28.6
Latin America	-0.7	-0.2	-2.5	-0.7
Commercial banks, net	-26.7	-6.2	18.8	11.9
Latin America	-9.7	-12.9	-7.0	-7.5
Other private flows	5.8	17.2	44.7	45
Latin America	2.2	-3.0	10	17.8
Official flows	11.2	-4.6	-12.9	-9.8
Latin America	22.6	7.4	3.0	-1.8

Source: IIF (2004). Capital Flows to Emerging Market Economies, January

1/ Estimate.
2/ Forecast.

With respect to nonbank loans, sharp growth was registered in public and private sector bond issues in the emerging countries, with a 2003 total of US$64.2 billion, the highest issue level since 1997 according to data released by the Bank for International Settlements (BIS). Brazil accounted for about 22% of these issues and closed the year as the largest net issuer among the emerging economies.

Even through the exposure of international banks in emerging markets increased in the period, banking sector loans decreased in relative terms, as demonstrated by BIS statistics for the third quarter of 2003. According to that institution, while total international banking assets of the banks reporting to the BIS expanded by 17.4%, compared to the same quarter of the previous year, the share of this volume in the developing countries dropped from 10.4% to 10% in the same period, mainly reflecting the reduction in exposure to assets in Latin America.

Table 6.4 – Banks' foreign claims[1/]

US$ billion

Period		All countries	Developing countries	Latin America & the Caribbean	Asia[2/]	Europe[2/]	Brazil
2002	I	11 474.3	1 334.4	528.1	386.1	264.8	134.9
	II	12 426.9	1 335.0	487.9	391.8	288.5	123.3
	III	12 478.8	1 303.3	449.2	396.2	292.7	105.0
	IV	13 153.6	1 343.2	480.4	381.0	314.1	103.4
2003	I	13 810.9	1 362.0	461.5	402.3	328.1	100.6
	II	14 584.9	1 403.9	470.2	416.3	343.5	103.5
	III	14 659.0	1 458.7	468.2	447.2	362.9	105.8

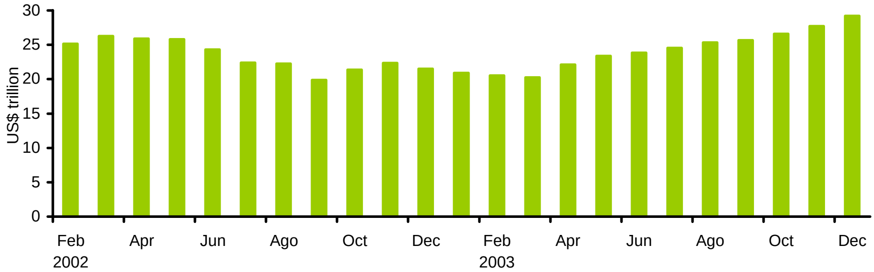
Source: BIS (BIS Consolidated Banking Statistics)

1/ Cross-border claims plus their foreign affiliates' claims.
2/ Developing countries.

The scenario of historically low interest rates contributed to the strong private sector capital adjustment achieved through the refinancing of debts and the consequent reduction in the level of business leverage. Better-structured liabilities combined with high productivity and a more favorable environment in terms of reductions in risk aversion on a global scale and a more dynamic pace of economic activity were reflected in increases in corporate profits. When all these factors are taken together, the result was a framework conducive to improved performances on the world's stock exchanges, as demonstrated by the Morgan Stanley Capital Index (MSCI), which registered an increase of 23% in 2003. Simultaneously, stock capitalization of the world's 33 major stock exchange came to approximately US$30 trillion in December. According to data released by the International Federation of Stock Exchanges, this was the highest value registered since January 2001. It should be stressed here that appreciation of local currencies in relation to the dollar in several different countries made investments in the assets of these markets even

Graph 6.12

World market capitalization[1/]



Fonte: World Federation of Exchanges

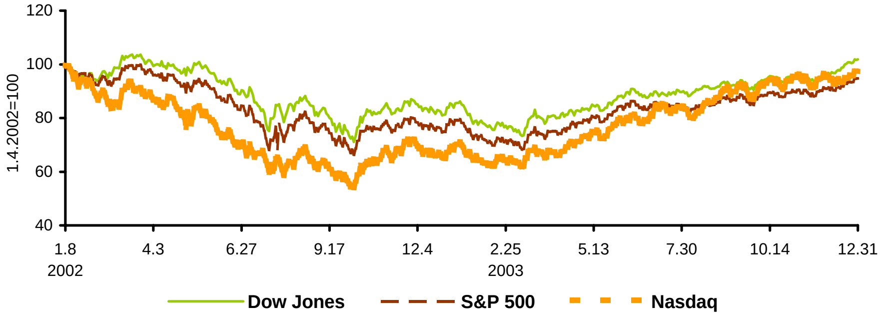
1/ Data from 33 stock exchanges.

more attractive to foreigners, due to the exchange rate gain. This was a factor that impacted the value rise in stock markets in Europe and several emerging countries.

American stock exchanges registered a strongly positive performance and were led by upward movement in the value of the stocks of companies operating in the segments of computers, software and semiconductors. In this sense, the Index of the National Association of Securities Dealers Automated Quotations (Nasdaq), which is mostly concentrated in high technology companies, registered upward movement of 50% over the course of the year, while the Dow Jones Industrial Average (Dow Jones) and Standard & Poor's 500 closed with respective increases of 25% and 26%, in the same period. No less important was the fact that United States exchanges were driven by the additional incentive of the fiscal package approved by Congress in May, reducing the tax load on dividend payments.

Graph 6.13

Stock exchanges – USA

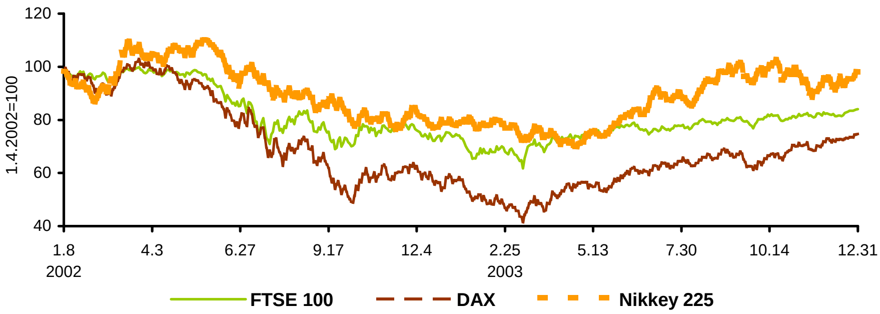


Source: Bloomberg

In Europe, stock exchanges kept pace with the United States, though their returns were generally lower. This result is evident in such indicators as the London Exchange's Financial Times Securities Exchange Index (FTSE 100), the Deutscher Aktienindex (DAX), issued by the Frankfurt market, and the Cotation Assistée en

Graph 6.14

Stock exchanges – Europe and Japan



Source: Bloomberg

Continue (CAC-40), issued by the Paris Exchange. Even though domestic demand was still sluggish and appreciation of the euro had begun generating negative impacts on foreign sales as of November, European companies still managed to register profit growth, mostly as a consequence of the restructuring of their liabilities and of reductions in financing costs.

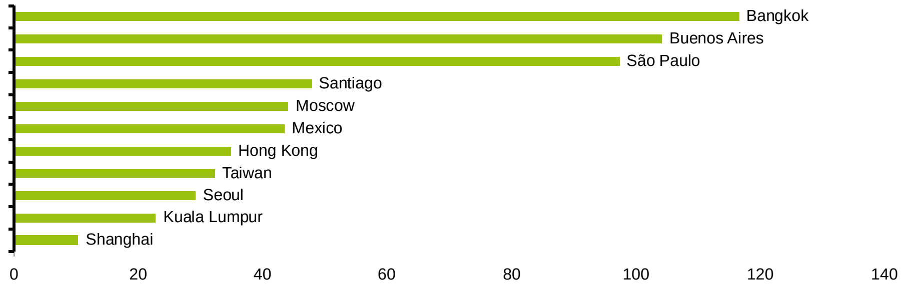
In the early part of the year in Japan, the primary sources of stock market uncertainties were fears that, aside from the effects of the troubled global geopolitical scenario, the SARS epidemic would produce highly negative impacts on economic growth on a global scale. However, once this period of instability had been overcome, the Tokyo exchange began moving sharply upward, mostly under the influence of the optimism generated by macroeconomic indicators that pointed to clear signs of recovery in the activity level coupled with a sharp rise in corporate profits. Improvement in the situation of the Banking sector acted as an added incentive to the positive trajectory of the Japanese stock market in 2003 due, to some extent, to successive initiatives taken by the government with the aim of reducing the volume of matured and unpaid loans held by banks.

Such factors as the pursuit of more attractive returns, a more favorable environment for investments in higher risk assets and the more stable macroeconomic scenario came together to raise the participation of variable income assets issued by the emerging countries in international investor portfolios. This was the fundamental element underlying the strong positive stock market performance of most emerging nations.

Asian markets tended to accompany the Japanese trajectory and registered negative growth in the early part of the year. However, from April onward, most of these markets turned positive, with the sole exception of Shanghai, which registered a highly distinct performance when expressed in local currency. This can be explained by restrictions on the participation of foreign capital, which made it impossible for the Chinese stock market to take advantage of greater demand for higher return emerging market assets.

In Latin America, an improved macroeconomic environment in Brazil, following the crisis of confidence that occurred in 2002, resulted in accentuated growth in foreign capital flows toward variable income assets and this flow, in turn, made a decisive contribution to the upward trajectory of Ibovespa. In Argentina, which managed to register strong growth in activity and greater institutional stability in 2003, the measures implemented in June to control capital inflows did not hinder 104% upward value movement in local currency in the Merval Index, issued by the Buenos Aires Exchange.

Graph 6.15
Stock exchanges – Emerging markets
Percentual change in 2003 in local currency



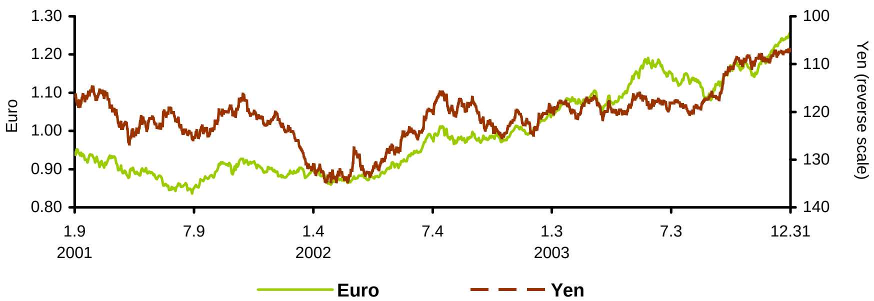
Source: Bloomberg

During the year under analysis, the exchange market was characterized by sharp volatility and strong depreciation of the dollar against the currencies of the Euro zone countries and Japan. The American dollar devalued by 20% against the euro and 10% against the yen. The euro was particularly volatile during the year as a result of the increased flexibility adopted by the ECB in managing its exchange policy, in contrast to the interventionist approach of the BoJ.

In the midst of the international geopolitical uncertainties that followed upon the Middle East conflict, the euro appreciated in the first half of 2003 up to the end of June, while the yen remained relatively stable.

In the second half of the year, following a downward slide that lasted from June to the end of August, both the European currency and the yen shifted into a process of sharp appreciation and continued on that trajectory to the end of the year, as the euro climbed to a level of US$1.26/•, the highest level in the history of that currency. Accentuated oscillations were registered in intraday operations, leading the ECB to declare that the excessive volatility was unwanted and could result in uncertainties

Graph 6.16
US dollar exchange rates



Source: Bloomberg

in the region. However, it also confirmed that the level of exchange would not jeopardize the economic upturn in the Euro zone and, consequently, dismissed the danger of short-term exchange market intervention.

In the case of the Japanese currency, which closed the year at ¥107.2/US$, appreciation would have been even greater had it not been for strong market intervention by the BoJ. In the final quarter of the year alone, that institution accumulated approximately US$69 billion in foreign currency reserves.

Basically, strong depreciation of the dollar was caused by rising uncertainties consequent upon the increasing size of the twin deficits registered in the United States and the doubts raised with regard to the sustainability of economic growth in that nation.

The trajectory of depreciation of the dollar was also driven by a communiqué released by the G-7 finance ministers on September 20, affirming that exchange rates should reflect market economic fundamentals, stressing that greater exchange flexibility was desirable in order to foster needed international financial system adjustments. The communiqué made it clear that the intention of the United States government was to allow the dollar to depreciate as a way of improving its trade balance and, in this way, stimulate the process of economic recovery.

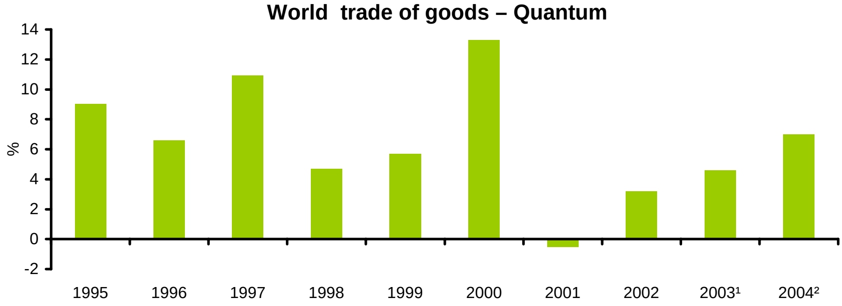
The declaration was also interpreted as an attempt to bring added pressure on the Asian countries, and particularly China, so that they would initiate processes of liberalizing their exchange systems. Such a move would have the result of realigning these currencies in relation to the dollar, with the aim of balancing trade flows and reducing the surplus of the Asian countries with the rest of the world. However, it is important to observe that little progress had been made in this discussion by the end of 2003.

World trade

According to preliminary IMF estimates, the volume of trade is expected to increase by 4.5% in 2003 and 6.8% in 2004, reflecting the process of world economic recovery underway since the second half of last year. In the same sense, the World Trade Organization estimates growth of 4.5% in the international commerce of goods in 2003.

In the first half of the year, trade flows remained practically stagnated and were impacted by the still incipient growth in the world economy and by the uncertainties rooted in the Middle East conflict and the outbreak of the SARS epidemic. Among

Graph 6.17
World trade of goods – Quantum



Source: IMF
1/ Estimate.
2/ Forecast.

the wealthy nations, the loss of dynamics in European economies became a source of concern with respect to the possibilities of economic recovery in the region. Tensions in the Middle East were reflected in higher world energy costs, a clear threat to the outlook for global recovery. On the other hand, the spread of the SARS epidemic was limited to East Asia and had a particularly strong impact on the sectors of tourism and air transportation.

Starting in the second half of the year, improved trade flows were accompanied by consistent signs of world economic recovery led by the United States, reductions in the uncertainties generated by the war in Iraq and containment of the SARS outbreak. The dynamics of the American and Asian economies produced strong demand for imports. This was particularly true in China and, in the final months of the year, was the element responsible for the rapid rise registered in the prices of the major commodities in 2003.

Recovery of the United States economy, especially as of the second half of the year, generated increased import demand and resulted in deterioration of that country's trade balance. Consequently, the deficit in trade in goods increased to US$549.4 billion in the year, reflecting an increase of US$66.5 billion over the 2002 level. Here, it is important to note that this occurred despite depreciation of the dollar against the major currencies. The bilateral trade balance with China set a new record, with a deficit of US$124 billion, followed in second position by the US$66 billion deficit in trade with Japan

In the year under analysis, trade flows in the Euro zone countries diminished as the surplus dropped from € 98.9 billion in 2002 to € 72.7 billion in 2003, as a result of a sharper falloff under exports than under imports. Trade flows increased sharply, particularly in operations with China, but also with Russia, Poland, the Czech Republic and Hungary. Parallel to this, trade flows with the United States and the United Kingdom diminished.

Following a rather weak performance in the first quarter of the year, Japanese ties to China resulted in strong growth in the country's foreign sales, despite appreciation of the yen, particularly in the final quarter of 2003. With this, the trade surplus expanded by approximately 3%, moving to a level of ¥10.3 trillion, or approximately US$89 billion. Net exports of goods and services accounted for growth of 0.7 percentage points of GDP in 2003 and made a major contribution to Japanese economic recovery.

Table 6.5 – International trade of goods

US$ billions

Countries/ Regions	Exports			Imports		
	2002	2003 1/	Percentage change	2002	2003 1/	Percentage change
USA	681.9	713.8	4.7	1 164.7	1 263.2	8.5
Canada	284.6	288.5	1.4	244.6	245.8	0.5
Euro Area 2/	1 082.9	1 053.1	- 2.8	984.0	980.3	- 0.4
Germany 2/	619.5	755.4	21.9	493.5	609.5	23.5
France 2/	314.4	368.3	17.1	308.5	367.2	19.0
Italy 2/	128.6	150.1	16.7	124.3	149.9	20.6
United Kingdom	281.3	308.7	9.7	351.9	385.0	9.4
Japan	419.2	472.3	12.7	339.2	383.1	12.9
Latin America and the Caribbean	346.4	371.9	7.4	322.8	330.8	2.5
China	325.6	438.5	34.7	295.3	413.1	39.9
South Korea	162.5	193.8	19.3	152.1	178.8	17.6

Source: Bloomberg and Eclac (Latin America and the Caribbean)

1/ Estimate and forecast.
2/ With the rest of the world.

Strong growth in the Chinese economy stimulated the economies of neighboring countries by raising demand for their exports, transforming the emerging Asian countries into the second most important center of economic growth, following only the United States. Aside from its verticalized productive structure, the Chinese balance of trade also benefited from an exchange system that defined parity between the yuan and the dollar in the second half of the 1990s. This measure was responsible for the increased competitiveness of the nation's exports, at the same time in which its effects were further enhanced by depreciation of the dollar against major currencies as of 2002. In 2003, growth in Chinese imports surpassed that registered under exports by 39.9% against 34.7%, respectively, and provoked a reduction in the trade surplus in the period to a level of 210 billion yuan or about US$25.5 billion.

Just as in the case of China, South Korea and Taiwan have sustained the strong demand of the emerging Asian countries, while demand among the member countries of the Association of Southeast Asian Nations (Asean) remained moderate.

The countries of Latin America benefited from the more favorable international scenario in 2003, as well as from the strengthening of the economies of the region. In almost all of the subregions and particularly in the Mercosul countries, the most important component of GDP growth was external demand. Increased volumes of exports and higher prices for basic export products made it possible to achieve high trade surpluses, with an overall current account surplus of US$6 billion.

The year under analysis was marked by across-the-board improvement in commodity prices. The SARS epidemic, which had caused some degree of market havoc in the first half of the year, was quickly brought under control while the simultaneous upward movement in the world's major economies exerted added pressures on the prices of raw materials, metals, farm products and petroleum derivatives.

Pressure on these prices was caused not only by increased world demand, but also by depreciation of the dollar against other currencies and higher shipping costs. In the latter case, between the midpoint and end of 2003, these costs rose by approximately 120% due mostly to the greater volume of Chinese imports. The Baltic Dry[6] Index, which is composed of median freight costs charged on the major shipping routes rose to a level three times greater than the average for the last 20 years. The difficulties involved in providing a greater number of vessels over the short-term are expected to hold prices at high levels in 2004.

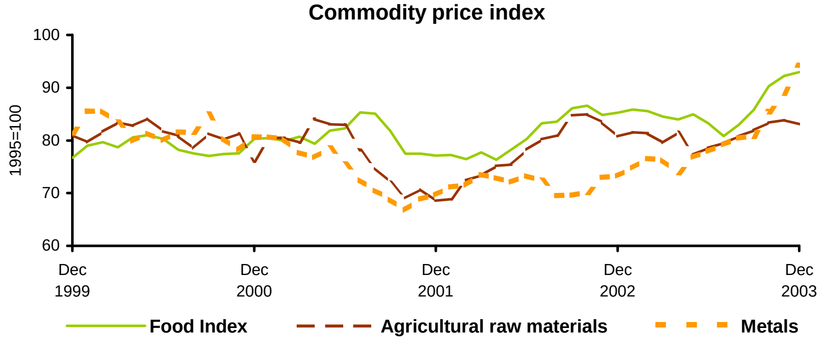
The price index of metals, calculated by the IMF, showed upward price movement of 29% in 2003, thus continuing the recovery that began in 2002 following the generalized decline in the previous year. With regard to Special Drawing Rights (SDR), the 2003 increase came to 17.4%. Copper prices increased by 38.2%, iron ore by 9% and nickel by 97%. Strong upward movement in the value of gold, which had reached the highest level of the past seven years at the beginning of December, reflected depreciation of the dollar and uncertainties regarding its point of equilibrium. In 2002, gold had increased in value by about 25% and, in 2003, continued on this trajectory, rising by an additional 19%.

Farm commodities in general registered positive growth, though the overall price increase was less intense as a consequence of depreciation of the dollar. However, such products as soybeans and corn benefited from the reduced United States harvest, which provoked not only a falloff in that country's stock levels but also

6/ Index calculated by the B. E., a traditional British association whitch includes shipowners and brokers in the freight market.

sharp reductions in its export capacity, at the same time in which Asian demand – particularly in China – rose sharply. Soybean prices increased by about 40% in 2003, reaching their highest level in sixteen years.

Graph 6.18
Commodity price index



Source: IMF

The outbreak of bird influenza and mad cow disease produced an accentuated impact on world supply of chicken meat and beef. When this factor is added to the process of world economic recovery, the prices of chicken meat and beef rose by respective rates of 12% and 25.5%.

In historical terms, petroleum prices remained high in 2003. The median per barrel price of Brent type petroleum, which had reached US$27.5 in 2002, increased to US$27.8, still within the parameters of US$22 to US$28 per barrel defined as the target price by the Organization of Petroleum Exporting Countries (Opec). To some extent, the persistently high prices in effect over the course of 2003 was a consequence of the tensions generated by the war in Iraq and of production cutbacks decreed by Opec, as well as of the effects of the strike among Venezuelan oil workers at the start of the year, and of recovery in the world economy. The level of international stocks remained at an historically low level during all of 2003, repeating the performance of the final six months of 2002.

Graph 6.19
Brent oil – Spot market

Source: Bloomberg