VI
The International Economy

Economic growth consolidated on a global scale in 2004, accelerating in the United States, spreading into Latin America, Japan and the Euro Area, regions in which the recovery had been sluggish up to 2003, and barreling along at consistently high rates in China. Consequently, according to IMF estimates, global GDP growth moved from 3.9% in 2003 to 5.1% in 2004. The solidity of this growth process was, to some extent, a result of the strengthening of the institutional frameworks charged with macroeconomic policy implementation and was patently evident in the relative ease with which the international community overcame the effects of the oil price spiral, without any untold impacts on inflation rates nor interruptions in the growth cycles of the major economies, as had occurred in similar episodes in the past.

Though rising long-term interest rates on Treasuries in the second quarter of 2004 provoked a sharp drop in private capital flows in that period, the gradualist monetary policy stance adopted in the United States coupled with the more flexible approach taken by the Euro Area and Japan led to reestablishment of international capital flows during the course of the year, together with continued growth in private capital flows to the emerging countries, which had commenced in 2003.

Foreign capital flows targeted to the emerging nations were also impacted by the steady lessening of the vulnerabilities of these economies to international financial conditions, by new investment opportunities created by more intense economic expansion in these countries, upward movement in international commodity prices and, furthermore, expectations of financial gains generated by the possibility of alterations in the rigid exchange policies adopted by several emerging countries.

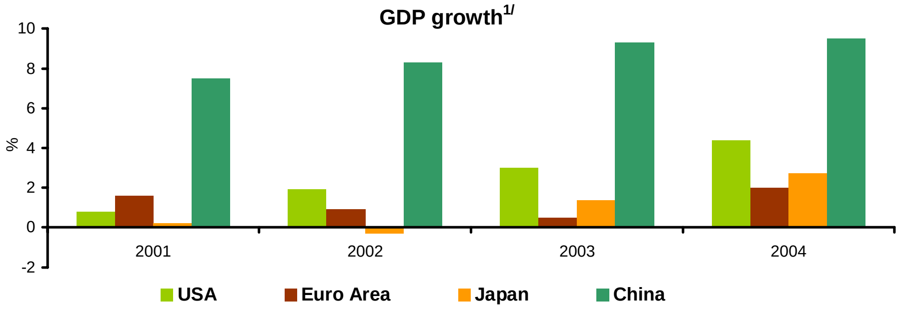
Economic activity

Powered by the fiscal policy adopted in previous years by the United States and continued low interest rates, growth in the American economy was driven by domestic demand. The low cost of credit stimulated the real estate market and, more specifically, mortgage refinancing operations, with evident repercussions on expanding liquidity.

Though macroeconomic incentives were somewhat mitigated in 2004, recovery in employment levels aided in maintaining internal demand at a high level, offsetting the net negative impact of the foreign trade sector. The sound performance of the business sector drove investments, new hirings and increased asset values, resulting in consistent growth in consumer spending, particularly for consumer durables. Private investments grew 13.2% in 2004, reflecting both increased business outlays on machines, equipment and softwares to be used in expanding output capacity, and a sharp rise in the pace of building industry activity made possible by low interest rate levels.

Graph 6.1

GDP growth[1/]



Source: *Bureau of Economic Analysis,* Eurostat, *Economic and Social Research Institute*, Bloomberg

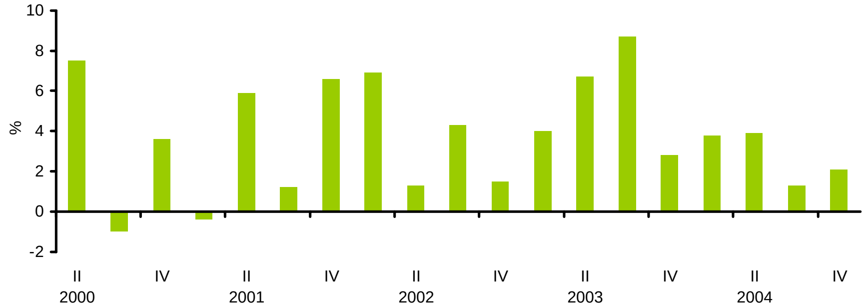
1/ Annual growth.

It is important to stress that strong productivity gains in the United States economy increased the differential of that country's growth potential in relation to other industrialized economic regions. However, in the second half of 2004, the productivity curve turned sharply downward while the unit cost of labor shifted upward, giving rise to doubts regarding the continuity of that process, which could demand changes in the Federal Reserve (Fed) monetary policy posture.

Continued high public and current account deficits also represent a significant risk to the sustainability of United States economic growth and to the stability of international financial markets, given the enormous volume of American bonds among the assets held by the world's major central banks. In 2004, the cumulative twelve-month fiscal deficit remained practically stable, at US$412 billion, equivalent to 3.6% of GDP at the end of December.

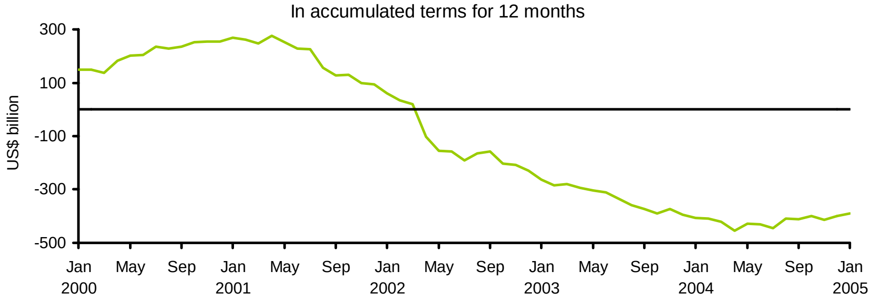
The Chinese economy was a major driving force underlying world economic growth, since the continued and rapid expansion of the output and exports of that country demanded consistently greater volumes of foreign inputs. Consequently, this growth not only aided in expanding world trade but also played a central role in sustaining the prices of various commodities. With the strong inflow of foreign investments, the Chinese economy expanded 9.5% in 2004, closing more than two decades of annual average growth above 9%. Gross fixed capital formation spiraled 26%, resulting in adoption of administrative measures aimed at reducing the imminent risk of overheating in specific productive sectors. Implemented in the second quarter of the year, these measures helped to dampen GDP growth in the following quarter. However, in the final quarter of the year, the economy once more surged forward despite an October increase in interest rates.

Graph 6.2
USA – Nonfarm productivity



Source: Bureau of Labor Statistics

Graph 6.3
USA – Fiscal balance
In accumulated terms for 12 months



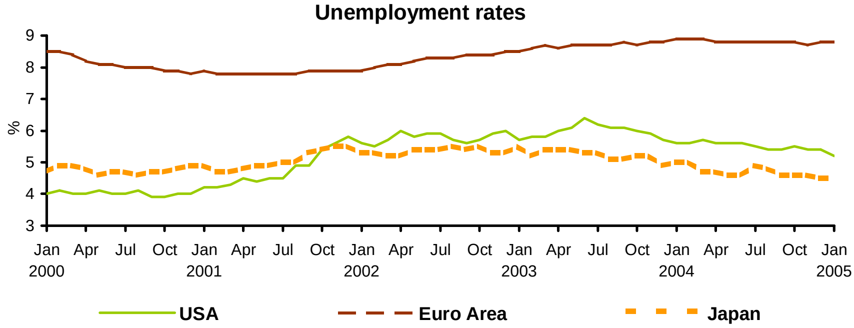
Source: Department of the Treasury

The Japanese economy benefited from positive business sector evolution, characterized by reductions in indebtedness and higher profit levels. With this, annualized growth rates came to approximately 6% in the final quarter of 2003 and first quarter of 2004. However, a sharp falloff in exports provoked a downturn in the activity level in the second half of the year. Private consumption closed with its highest growth since 1996, despite the decline that began in the second quarter.

A similar performance was noted in the Euro Area. In this case, the promising results that marked the start of the year gave way to much less intense economic activity in the second half, particularly in Germany and Italy where GDP rose by just 1.6% and 1.1% in 2004, respectively. Among the factors that contributed to the bloc's growth, mention should be made of moderate upturns in household consumption and investments, as well as 6% export growth, despite exchange appreciation. Nonetheless, external demand diminished and, as consumer expectation indicators demonstrated, internal demand turned sluggish and incapable of driving the activity level upward. The difficulties involved in achieving higher growth levels are explained by a series of factors, including structural obstacles to productivity gains that not only jeopardize the competitiveness of the goods and services produced but add to consumer insecurity, at a time of high unemployment.

Following 1.9% growth in 2003, Latin American GDP expanded 5.5% in 2004, according to estimates released by the Economic Commission for Latin America and the Caribbean (Cepal), an entity of the United Nations Organization. The highest rates of growth were registered by Argentina, Uruguay and Venezuela. Just as occurred in the previous year, the countries of the region benefited from the general upturn in global growth and, more particularly, from significant hikes in the prices of various important commodities, such as oil and metals, both of which have considerable weight among the exports of the region's major economies. Given the impact of growth on tax flows, the solid macroeconomic performances registered by these countries contributed to sustained fiscal improvement and recovery in job levels.

Graph 6.4
Unemployment rates



Sources: Bureau of Labor Statistics, Eurostat, Ministry of Internal Affairs and Communications

The advances registered by the global economic scenario led to significant recovery in employment indicators. In the United States, the number of formal job openings increased 2.17 million in 2004, following a rise of just 94 thousand in the previous year. The jobless rate slipped from 5.7% at the end of 2003 to 5.4% in December 2004, demonstrating the return of workers to the job market and an expanding labor force. Using the same basis of comparison, unemployment dropped from 4.9% to 4.5% in Japan and from 10.7% to 10% in Latin America, while remaining stable at 8.8% in the Euro Area.

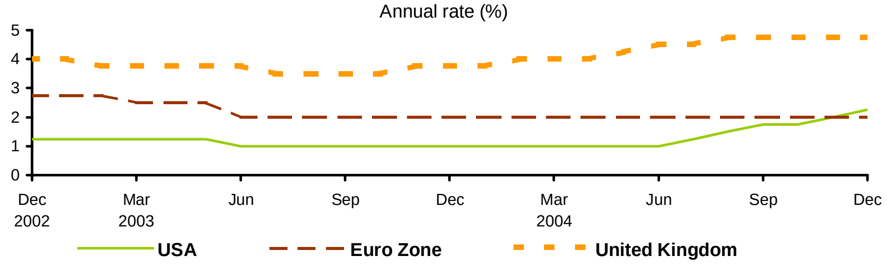
Monetary policy and inflation

At the end of June, the Fed initiated a process of gradually restricting monetary policy. In the months preceding this alteration – primarily in April and May – speculation regarding the imminent end of the period of low interest that had marked the last five decades impacted the high in earnings on Treasuries. However, in the immediately subsequent period, market rates began dropping once again and accompanied the pace at which the official rate was raised, as the gradualist policy adopted by the Fed became increasingly clear. Despite the brief period of nervousness that gripped financial markets in the second quarter of the year, the Fed was successful in its efforts to coordinate the process of formation of expectations, avoiding the possibility of an accentuated high in rates in the longer segment of the earnings curve frustrating the process of economic recovery. At the end of the year, the fed fund target had been raised by 1 p.p. to 2.25% per year. Producer and consumer inflation rates followed a parallel trajectory, increasing 1 p.p. in the year. Core inflation also moved upward in 2004, registering a cumulative high of just over 2% in December. More important than the interest level in itself was the fact that the upward trajectory of inflation served to solidify perceptions of a steady high in Fed interest rates.

Graph 6.5

Official interest rates[1/]

Annual rate (%)



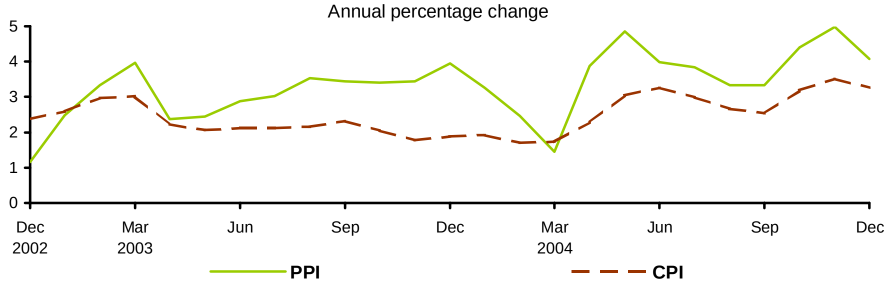
Source: USA – Federal Reserve, Euro Area – ECB, and United Kingdom – Bank of England

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

Graph 6.6

USA: Inflation[1/]

Annual percentage change



Source: Bureau of Labor Statistics

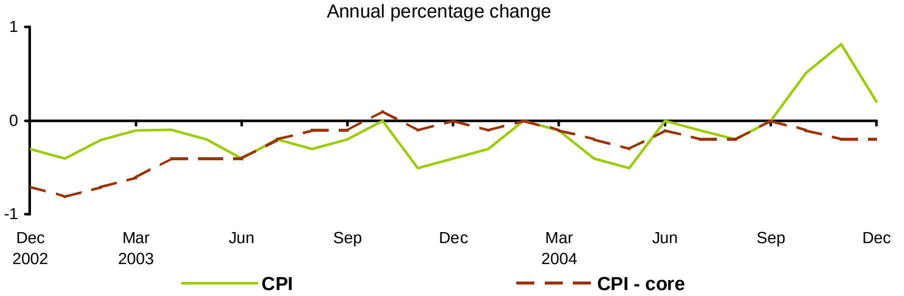
1/ Producer and consumer prices.

In 2004, the Central Bank of Japan (BoJ) maintained its zero interest policy. Only one alteration was introduced into the policy of gradually shifting the target to the interval of the banking reserve balance deposited at the central bank, moving from ¥ 27 – 32 trillion to ¥ 30 – 35 trillion in January. Maintenance of the banking reserves target for almost the entire year suggests that the monetary authority had reduced the intensity of its exchange market interventions, as is demonstrated by appreciation of the yen in the period. The process of price deflation continued as the GDP deflator remained negative and consumer inflation moved to a slightly positive level at the end of the year, without revealing any signs of a continued rise.

Graph 6.7

Japan: Inflation[1/]

Annual percentage change



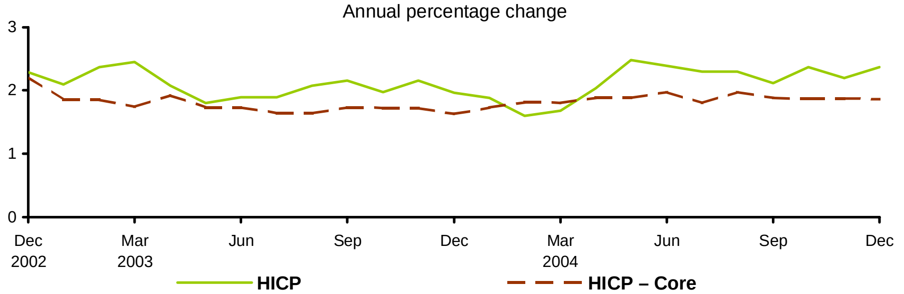
Source: Bloomberg
1/ Consumer prices.

The European Central Bank (ECB) maintained interest at the 2% level in effect since June 2003. The position adopted by the monetary authority was a consequence of the evolution of inflation, which surpassed the official target during most of the year, despite moderate growth in the region and strong appreciation of the euro. Another factor that may well have contributed to the rigid stance adopted by the ECB was the behavior of the M3 monetary aggregate, which pointed to rapid currency and credit expansion. On the other hand, core inflation remained consistently below the 2% limit.

Graph 6.8

Euro area: Inflation[1/]

Annual percentage change



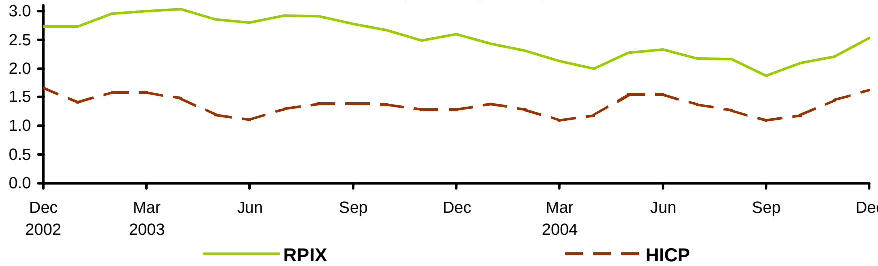
Source: Bloomberg
1/ Consumer prices.

In the United Kingdom, the official rate of interest moved upward in February, May, June and August, closing the year at 4.75%. The monetary policy adjustment implemented by the Bank of England (BoE) reflected developments in both the real sector and financial sector. As a matter of fact, the British economy had been expanding at a rate higher than the average of its European Union partners. This factor, coupled with abundant liquidity, triggered strong valuation in assets, particularly in the real estate market. Following a somewhat different trend, the prices of goods and services evolved only moderately, especially in the case of the harmonized consumer price index. On several occasions, the BoE raised interest rates when inflation began decelerating, suggesting efforts to avoid formation of an asset bubble through careful management of credit conditions and, consequently, control of household indebtedness.

Graph 6.9

United Kingdom: Inflation[1/]

Annual percentage change



Source: Bloomberg

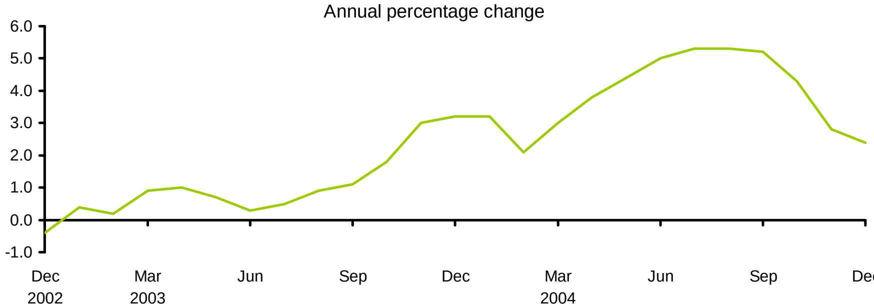
1/ Consumer prices. RPIX stands for retail price index excluding mortgage interest payments.

In the period extending through September 2004, inflation rose in China, before dropping sharply in the final quarter of the year. To some extent, this came as a surprise, since economic expansion at the end of the year was quite a bit higher than expected, primarily when one considers the measures taken by the government to dampen growth. Since the country operates within a fixed exchange system, the Central Bank intervened heavily in the exchange market with the purpose of acquiring the foreign resources

Graph 6.10

China: Inflation – Consumer prices

Annual percentage change



Source: Bloomberg

generated by the strong foreign trade surplus and inflows of speculative capital triggered, in the latter case, by speculation regarding an exchange policy modification in that country.

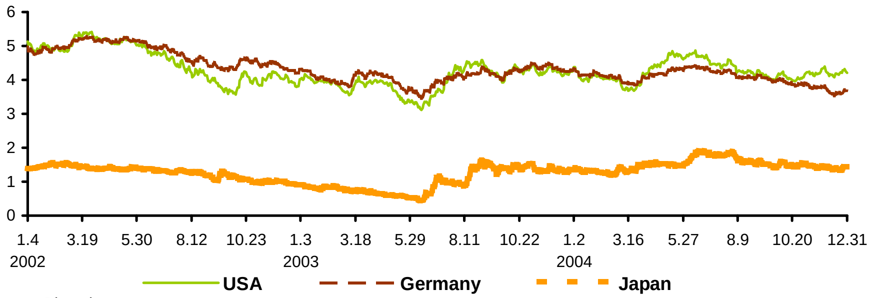
International financial market

The stability that characterized international financial markets in early 2004 – based on signs of recovery in economic activity in the industrialized economies, abundant international liquidity and reduced risk aversion – dissipated as of mid-March. The scenario of financial instability was marked by an accentuated rise in long-term interest rates on the treasury bonds issued by the industrialized economies, devaluation of variable income assets and a sharp downturn in the prices of emerging market bonds. Basically, the turbulence that hit the market was generated by uncertainties surrounding the behavior of inflation in the major economies, the direction to be taken in United States monetary policy, the impact of the announced induced deceleration of the Chinese economy and increasingly higher oil prices.

As the uncertainties regarding inflation in Europe and the United States were dispelled, as of May returns on the ten-year government bonds issued by the industrialized countries shifted back into the downward trajectory that marked most of 2004. In Europe and Japan, returns on fixed income assets remained low due to the perception that a monetary stimulus would be needed to sustain the cycle of economic growth, reinforced by appreciation of the euro and the yen.

Graph 6.11

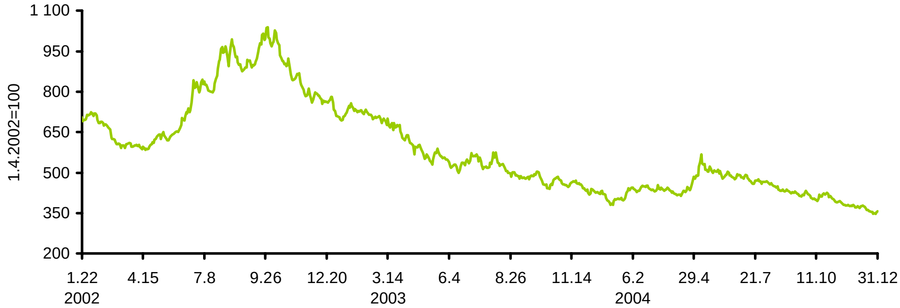
Yield on treasury bonds[1/]



Source: Bloomberg
1/ 10 year treasury nominal yields.

During the major part of the year, ample international liquidity and market receptivity to risk exposure made it possible to reduce spreads in almost all types of financing, independently of the debtor profile and the degree of risk involved. The only exception to this tendency occurred between mid-April and May when, despite positive economic performances in most of the emerging economies, the Embi+, which is used as a proxy for the external debt risk of these economies, expanded 37% to 567 points on May 10, the highest level registered in the year. As of that date, tensions declined and the Embi+ shifted steadily downward, ending 2004 at 358 points. This tendency was further reinforced by the gradualist approach adopted by United States monetary policy and consolidation of the economic fundamentals of most of the emerging economies in the second half of the year.

Graph 6.12
Emerging Markets Bond Index Plus (Embi +)



Source: Bloomberg

According to the Institute of International Finance (IIF), foreign direct investments expanded 43.9% compared to 2003. Flows to the emerging countries increased 32.5%. IIF data also indicate that capital flows involving bank credits, stock portfolios and nonbank credits rose 86.4%, 12.6% and 4.5%, respectively, in the year.

The persistent rise in international oil prices generated negative impacts on stock market evolution, reflecting concerns with the long-term tendencies of oil supply and demand, as well as the potential adverse impact of these trends on renewed economic growth. Stock market price declines in the United States as of the second quarter of the year were a clear reflection of these uncertainties, while impacts on other markets were less accentuated.

Starting in the month of November, United States stock markets moved into a sustained upward trajectory, rather closely aligned with the performances of other markets in the period. Basically, this was caused by recovery of confidence regarding the vigor of the global economic recovery as well as growth in corporate profits. In 2004, the Nasdaq index registered nominal valuation of 8.6%, while the Dow Jones and Standard & Poor's 500 indices turned in growth of 3.1% and 9%, respectively.

Table 6.1– Emerging markets: foreign private capital flows

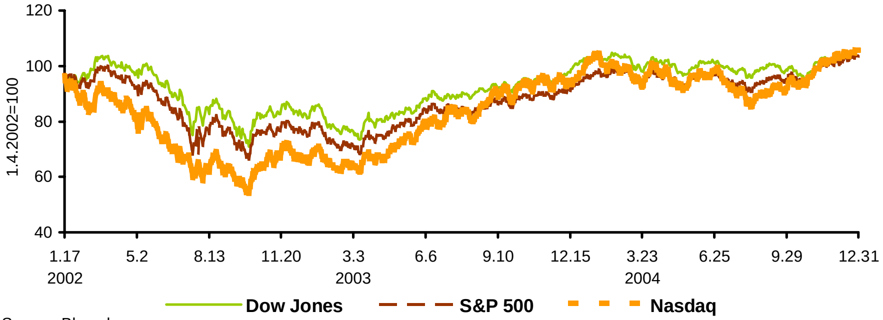
US$ billion

	2001	2002	2003	2004
Private capital flows	130.5	124.9	210.7	279.1
Africa	9.4	1.5	3.5	9.2
Latin America	52.9	17.3	25.2	26.1
Asia	51.4	60.5	116.3	146.3
Europe	16.8	45.6	65.6	97.4

Source: IIF

Graph 6.13

Stock exchanges – USA

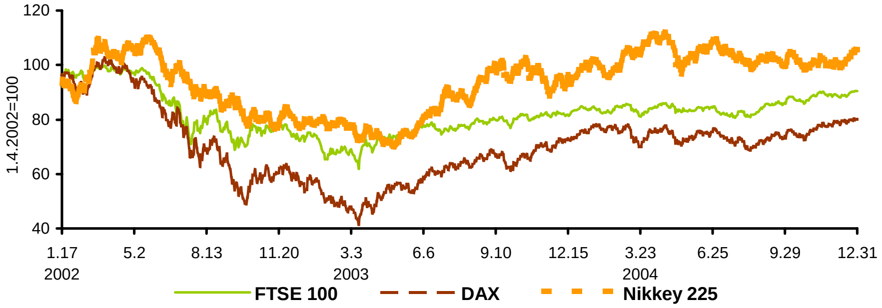


Source: Bloomberg

In Japan, the Nikkei index rose 7.6%. Here, one should stress that the evolution of Japanese exchanges was negatively impacted by the only moderate pace of economic activity in that country as of the second half of the year, as well as the adverse pressures perceived by United States markets. European exchanges were less volatile than those of the United States and Japan, as the FTSE 100, the London stock exchange index, and the Frankfurt DAX rose 7.5% and 7%, in that order.

Graph 6.14

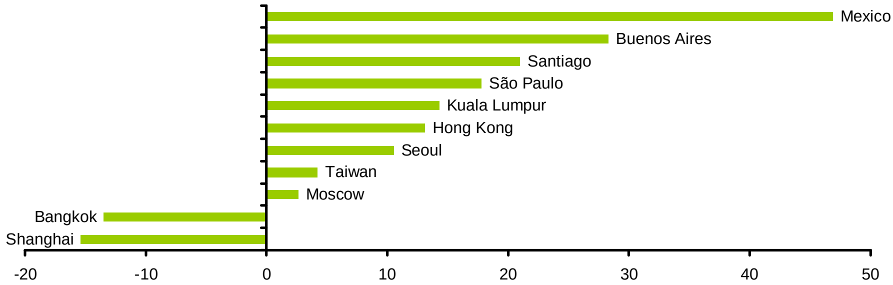
Stock exchanges – Europe and Japan



Source: Bloomberg

In most of the emerging stock markets, the negative effects of high and volatile oil prices were partially offset by migration of resources into more profitable assets. Particularly as of the second half of the year, recovery in stock market prices was driven primarily by attenuation of the risks of an interruption in the petroleum supply, perception that inflation had been effectively harnessed in the major economies, the attractiveness of stock prices and announcement of considerably more robust economic activity indicators. In Latin America, the major Mexican and Argentine stock indices rose 46.8% and 28.3%, respectively, while the Chilean and Brazilian indices posted hikes of 21% and 17.8%, in that order.

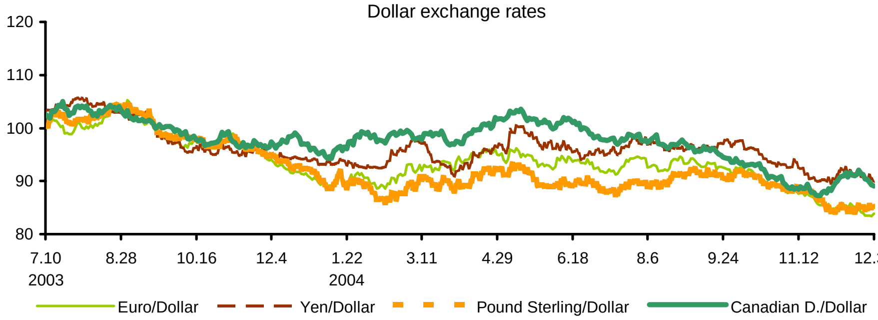
Graph 6.15
Stock exchanges – Emerging markets
Percentual change in 2004 in local currency



Source: Bloomberg

As far as exchange markets are concerned, job market recovery and higher long-term interest rates on treasury bonds resulted in appreciation of the American dollar against the currencies of the other developed countries in the period extending from February to May 2004. However, this tendency was reversed in the second half of the year, primarily as a result of uncertainties regarding economic growth generated by weak labor markets and the persistent steady rise in international oil prices, as well as questions raised with respect to the possibility of financing the enormous and growing American current account deficit. Thus, when one considers average December 2004 and 2003 exchange rates, the pound sterling appreciated 10.1%, the Euro, 8.9%, the Canadian dollar, 7.7%, and the yen, 3.8%, in relation to the American dollar.

Graph 6.16
Developed countries
Dollar exchange rates



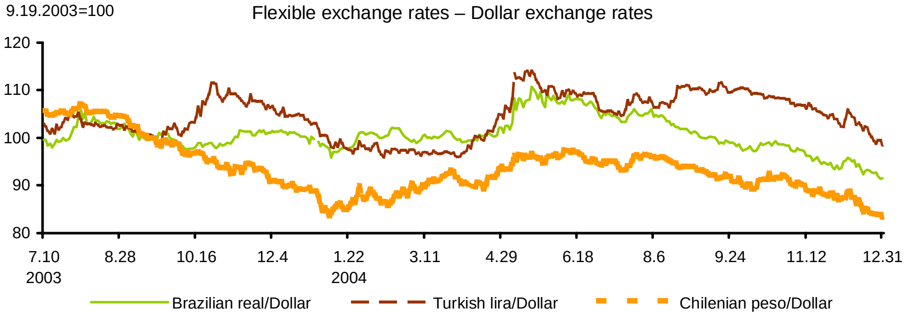
Source: Bloomberg

The excellent exchange supply conditions generated by the positive evolution of emerging country balance of payments current and financial accounts led to currency appreciation against the dollar in those nations that had flexible exchange systems. This trend was temporarily interrupted in the second quarter of 2004 when long-term interest rates on Treasuries shifted upward.

Graph 6.17

Emerging markets currencies

Flexible exchange rates – Dollar exchange rates



Source: Bloomberg

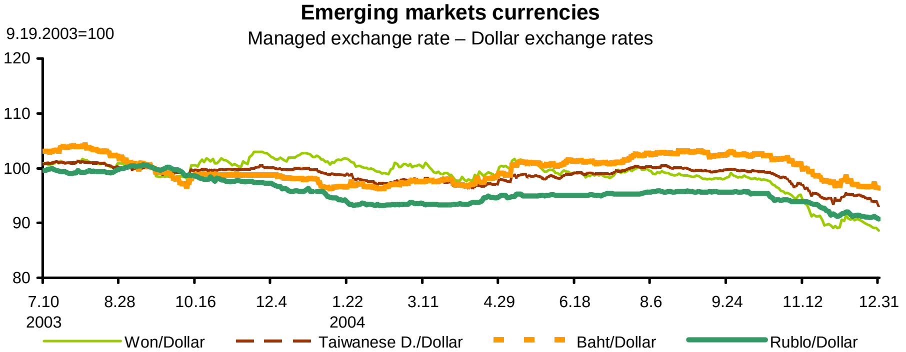
Even the currencies of such countries as Russia and the nations of southeast Asia, which have considerably more rigid exchange systems, appreciated against the dollar as of the month of October. This was a clear indication of the continued ample supply of international funding and short-term capital flows.

A comparison of average exchange rates in December 2004 and 2003 shows that the currencies of Thailand, Korea, Singapore and Taiwan appreciated at respective rates of 1.3%, 13.5%, 4.2% and 5.8%, against the dollar. Basically, this movement resulted from the upward trajectory in currency values between September and December, when these currencies appreciated by 5.7%, 9.3%, 3.3% and 5.3%, in that order.

Graph 6.18

Emerging markets currencies

Managed exchange rate – Dollar exchange rates



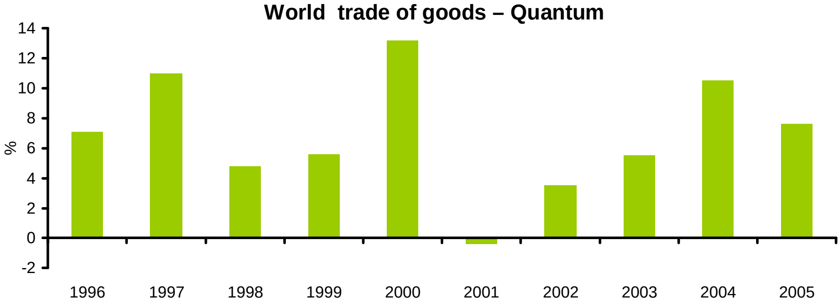
Source: Bloomberg

It is important to emphasize that depreciation of the American currency did not restrict financing of the nation's external debt, since growth in the flow of private foreign capital, including foreign direct investment, and government capital originating in purchases of United States securities by Asian central banks was sufficient to finance the 25.5%, or US$135.2 billion, increase in the country's current account deficit, together with the rise in United States investments abroad.

World trade

According to IMF estimates, the volume of world trade in goods registered growth of 10.5% in 2004. This was the best result in the last four years and reflected across-the-board growth in the world economy as of the second half of 2003. Parallel to these figures, the World Bank and WTO projected annual increases of 10.2% and 8.5%, respectively, in the volume of 2004 trade.

Graph 6.19
World trade of goods – Quantum



Source: IMF
2004 = Estimate.
2005 = Forecast.

Increased trade flows in 2004 were a consequence of more intense economic activity, particularly in the United States and China, the major driving forces underlying expanded world demand. Though practically all of the world's economies registered foreign trade growth, the developing countries turned in rates that were higher than those of the developed world. Recovery in manufacturing activity resulted in increased purchases of capital goods and raw materials for the industrial sector. At the same time, commodity demand remained strong, primarily as a consequence of Chinese economic vitality, which guaranteed continued high prices for these products. Greater energy demand caused by consolidation of world economic expansion was reflected in the volatility of international oil prices throughout the year. Pressures intensified in the final six months of the year, when prices set new nominal highs, generating negative impacts on world trade growth.

In the United States, despite some degree of loss in the dynamics of the economy in the second half of 2004, domestic demand remained high, leading to more rapid growth in imports when compared to exports. In a context of strong economic growth and higher oil prices, increased outlays on energy played an important role in raising the level of imports. Consequently, the balance of trade in goods registered a deficit of US$666.2 billion in the year, mirroring an increase of 21.7% compared to 2003.

Intra and extrabloc trade flows intensified in the Euro Area countries. With regard to extrabloc flows, exports accelerated in the early months of the year, resulting in a larger trade surplus. In the following period, foreign sales declined simultaneously to a rise in imports, resulting in trade balance deterioration. Strong appreciation of the Euro, particularly in the final months of the year, diminished the competitiveness of the bloc's exports which had already been curbed as a result of falling external demand. In Germany, the region's major economy, output was adversely impacted by the behavior of trade flows in the second half of the year. As a result, the external sector contribution to GDP in the third and fourth quarters was negative, in contrast to the four previous quarters. In France, an upturn in export flows in the final months of the year was sufficient to avoid excessive trade balance deterioration. In the case of the United Kingdom, appreciation of the pound sterling hampered the export flow. As a result, the sharp rise in imports led to a record 2004 trade deficit.

Japanese exports benefited from strong demand in China and the United States, as the trade surplus for the first six months of the year expanded. However falling external

Table 6.2 – International trade of goods

US$ billions

Countries/ Regions	Exports			Imports		
	2003	2004 [1/]	Percentage change	2003	2004 [1/]	Percentage change
USA	713.1	807.6	13.2	1 260.7	1 473.8	16.9
Canada	288.7	334.2	15.8	246.0	279.9	13.8
Euro Area [2/]	1 208.6	1 433.2	18.6	1 128.4	1 339.5	18.7
Germany [2/]	757.1	915.5	20.9	608.3	721.3	18.6
France [2/]	368.7	424.2	15.1	366.3	433.9	18.5
Italy [2/]	153.8	177.1	15.2	152.0	178.1	17.1
United Kingdom	310.1	350.5	13.0	388.3	456.3	17.5
Japan	472.9	567.7	20.1	383.9	455.8	18.7
Latin America and the Caribbean	376.3	460.7	22.4	333.0	398.8	19.8
China	438.4	593.4	35.3	412.9	561.4	36.0
South Korea	193.8	254.2	31.2	178.8	224.5	25.5

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

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

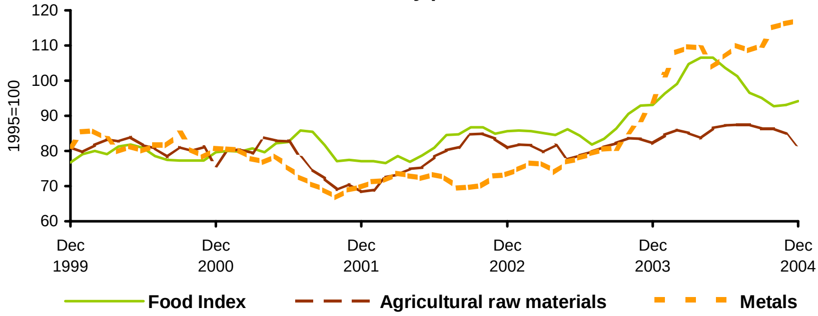
demand, appreciation of the yen and a new oil price spiral, coupled with real growth in imports, provoked deterioration in the trade balance through the end of the year. Consequently, the foreign trade contribution to GDP was negative in the third and fourth quarters.

In China, trade flows expanded sharply in 2004. Increased exports reflected rising world economic activity and enhanced competitiveness, partly as a result of the exchange system alterations adopted by that country. Imports grew at a pace above the previous year, clearly ratifying the vigor of the Chinese economy despite the measures taken by authorities in 2003 to dampen the pace of economic expansion. Chinese economic performance had a powerful impact on the trade sectors of the Asian economies, as a result of the verticalization of the region's productive chain, as well as on trade by the Latin American countries, since they are major suppliers of raw materials and commodities.

The accelerated pace of world economic growth, particularly in the United States and China, had important impacts on Latin American foreign sales. In the Mercosul framework, an important share of the increase in exports was due to sales of manufactured goods to the United States by Brazil, while the exports of the Andean countries benefited from sales of basic products and, to a lesser extent, manufactured goods. Export growth not only generated increased import capacity, but also made it possible for the region to maintain a surplus balance in the trade of goods for the third consecutive year. Parallel to this, the current account balance remained positive for the second consecutive year, increasing from 0.5% to 1.1% of GDP.

Though the international prices of major farm commodities turned downward toward the end of the second quarter of 2004, primarily as a consequence of an increased world supply of such crops as soybeans, corn and cotton, the prices of these goods remained at levels well above those in effect in past years. On the other hand, the prices of the major metallic commodities continued on a steady upward curve.

Graph 6.20
Commodity price index

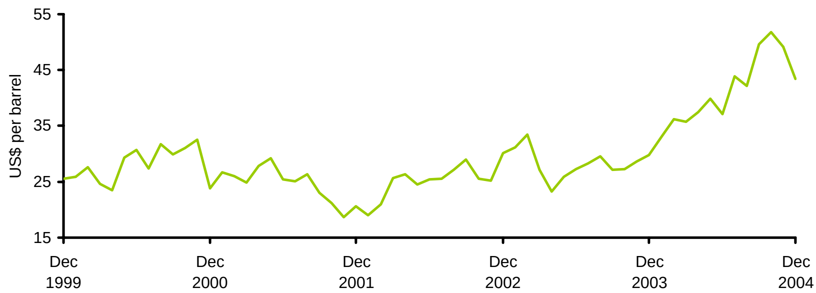


Source: IMF

The international petroleum market was highly volatile in 2004, as a result of sharply rising prices, coupled with such other factors as futures market speculation and uncertainties regarding the possibility of maintaining an adequate supply to meet growing demand, particularly in the United States and China. The doubts raised with respect to the evolution of supply took due account of the rather slow recovery of production in the region of the Gulf of Mexico, hit by hurricane Ivan at the end of September, and of conflicts in the Middle East and Nigeria and uncertainties regarding Russian output. These were the major factors responsible for the spikes that occurred in the daily prices of this commodity. Another factor that helped to maintain oil prices at very high levels was depreciation of the dollar on the international market.

In this context, the price of Brent-type oil negotiated on the London market reached an October maximum of US$50.95, closing 2004 at US$40.24, representing a rise of 35% compared to the price in effect one year previously. West Texas Intermediate (WTI) negotiated at the New York Commodities Exchange set a record of US$55.50, also in October.

Graph 6.21
Brent oil – Spot market



Source: Bloomberg

It is important to note that the volatility that marked the per barrel price of petroleum occurred parallel to a shift in overall price levels. In other words, the price of Brent-type oil increased from annual averages of US$25.02 in 2002 and US$28.87 in the following year to US$38.32 in 2004, corresponding to a cumulative rise of 53.2% in the period. This increase occurred despite the measures taken by the Organization of the Petroleum Exporting Countries (Opec) to raise supply of the product to 25.5 million barrels/day (mbd) as of July, adding another 0.5 mbd on August 1.