

## 4 – International economy

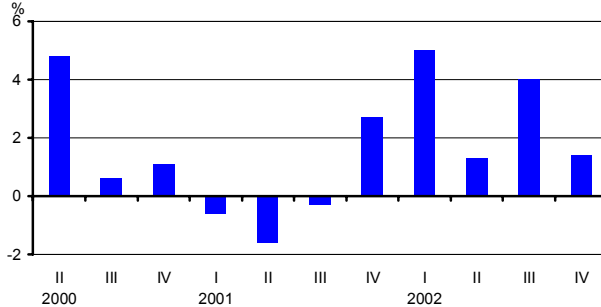
In the early months of 2003, the international macroeconomic scenario was characterized by considerable instability, generated mostly by political tensions in the Middle East. Recovery in aggregate demand became more difficult as a result of the compression of available income caused by oil price highs and rising uncertainties among businesspeople and consumers.

However, international markets expect a rapid solution to the crisis, with evidently positive impacts on the world petroleum supply and prices. According to expectations, these realities should aid in stimulating the global economy by the middle of the year. Should these expectations not be fulfilled, there is a strong possibility of new deterioration in the level of confidence and of additional aversion to risk, with undesirable impacts on capital flows, consumption, investment, output and employment.

Renewed economic growth on a global scale also depends on the performance of the United States economy, particularly since internal demand has been clearly insufficient to support the economies of the Euro zone countries and Japan. In this context, it should be noted that both monetary policy and fiscal incentives have limited effectiveness in fostering growth in the activity level of major economies.

### 4.1 Growth and employment

Based on the early results of the United States economy, world economic recovery would seem to be less imminent than initially

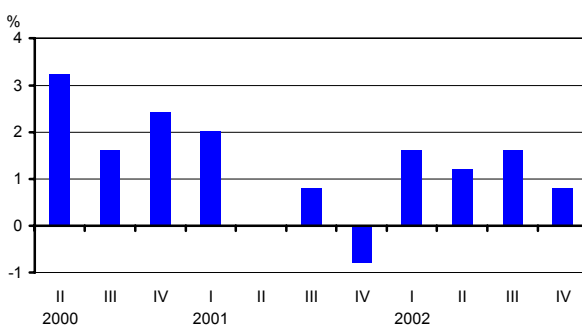
**GDP - USA<sup>1/</sup>**

Source: Bureau of Labor Statistics

1/ Quarterly change seasonally adjusted annualized rate.

suggested by the early results for 2002. United States GDP expansion slowed significantly in the fourth quarter, as annualized quarterly growth dropped to 1.4% after reaching a level of 4% in the previous quarter. Growth in 2002 GDP came to 2.4%, compared to 0.3% in 2001. The slowdown in the pace of GDP growth in the final quarter of 2002 resulted from declining private consumption and inventory investments, coupled with sharp downward movement in foreign sales.

These movements were partially offset by growth in public spending and household investments. The February issue of the Beige Book, which is a survey compiled by the Federal Reserve on the basis of reports produced by its twelve districts, confirmed the trend toward moderate consumer spending in the first two months of 2003.

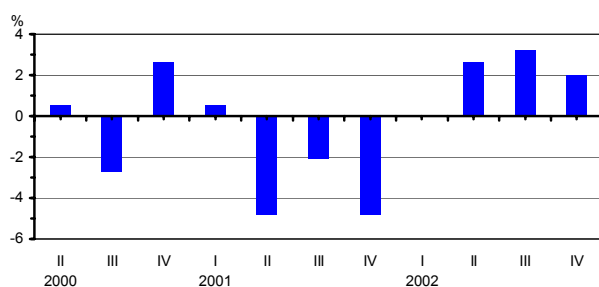
**GDP - Euro Zone<sup>1/</sup>**

Source: Eurostat

1/ Quarterly change seasonally adjusted annualized rate.

In the Euro zone, there is little probability that the growth trajectory of the economy will achieve the results forecast just a few months ago for the end of 2003. Following growth of 0.8% in 2002, GDP expansion in the region is expected to close between -0.1% and 0.3% in the first quarter, and between 0.2% and 0.5% in the second quarter of 2003, according to data released by the European Commission. In the final quarter of 2002, private consumption remained sluggish as a result of the pessimism that has characterized consumer

attitudes in the face of continued high unemployment and rising petroleum prices. Exports – the component that contributed most intensely to 2002 GDP – declined in November and December, reflecting the limited pace of world economic activity and strong upward movement in the value of the euro. The trajectory of the European currency against the dollar is expected to continue in 2003, as a result of the high and growing current account deficits registered in the United States. Consequently, the contribution of trade balances to sustaining GDP growth will tend to be less important in the current year, when compared to last year.

**GDP - Japan<sup>1/</sup>**

Source: Economic Planning Agency

<sup>1/</sup> Quarterly change seasonally adjusted annualized rate.

In Japan, the recovery in private consumption that seemed to be on the horizon up to mid-2002 has not materialized, as demonstrated by data on household spending and housing starts in the final months of the year. Purged of seasonal factors, GDP registered annualized growth of 2% in the fourth quarter of 2002, following growth of 2.6% and 3.2% in the second and third quarters of the year. At the same time, the structural problems at the root of Japanese economic stagnation have persisted: deflation, which tends to inhibit aggregate demand by discouraging consumption and investment; and a high level of banking system commitment to poor quality loan operations that, combined with high levels of business debt, tends to dampen the potential role of credit in reactivating the economy.

While the United States can expect an important economic stimulus as a result of government programmed tax cuts, the possibility of other regions of the world resorting to this type of macroeconomic stimuli is quite limited. In the Euro zone countries, the demand that these nations adjust to the Stability and Growth Pact, which imposes ceilings on public debt levels, will require very significant fiscal adjustments over the coming years in the region's three major economies: Germany, France and Italy. In Japan, the fiscal situation has made it particularly difficult to resort to expansionary policies, while there is little space for adoption of monetary incentives.

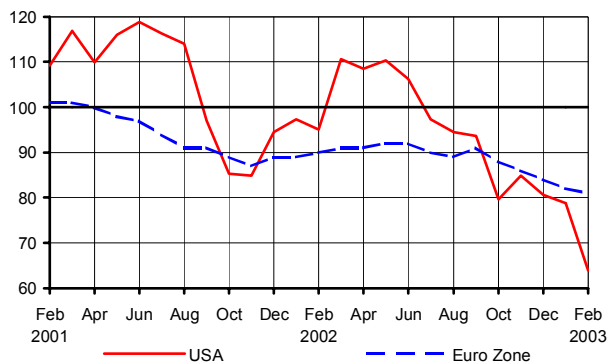
Among the emerging nations, strong positive growth has been registered in the countries of Asia and, particularly, in China and, to a lesser extent, in the nations of Eastern Europe. In 2003, the economies of China and other emerging Asian nations are expected to continue moving solidly forward, based on growing internal demand which has offset fluctuations in external demand. The Chinese economy expanded by 8% in 2002, compared to 7.3% in 2001. In 2003, growth is expected to close in the range of 8%.

In the opposite sense, the economies of Latin America and the Caribbean have tended to shrink by about 0.5% mostly as a result of the severe loss of dynamics registered in Argentina, Uruguay and

Venezuela. However, it is important to note that the other countries of the region were also unable to achieve significant growth figures in the period. Economic performance in the region was conditioned to a series of external factors, including difficulties in obtaining access to international capital flows, above all in the case of Mercosul countries, and the downturn in the pace of the United States economy, which had a particularly strong impact on the Mexican economy, as well as deteriorating terms of trade that has had a powerful impact in recent years on the economies of Peru, Chile and Brazil. The Economic Commission for Latin America and the Caribbean (Cepal) estimates that average growth in 2003 in the economies of the region will come to about 2.1%, should the signs of recovery noted since the end of 2002 be confirmed.

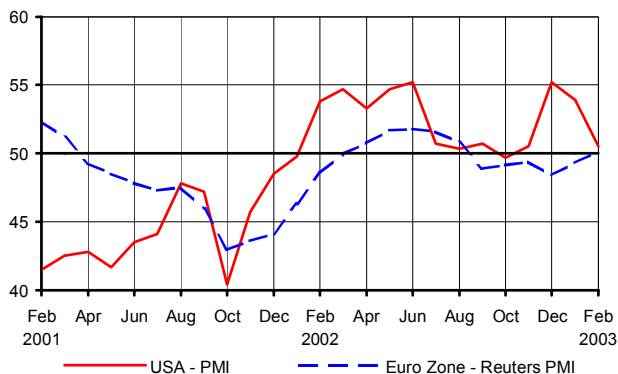
In the midst of the uncertainties that have characterized the current economic scenario, it should be noted that positive and synchronized industrial production growth has been registered in the final months of 2002 and early 2003 in several regions, including the United States, Japan and the emerging Asian nations. In countries like China, South Korea, Thailand and Turkey, growth in industrial production has remained close to or even above 10%. Positive performances have also been registered in such Latin American economies as Brazil, Chile and Peru, as well as in the economies of Eastern Europe.

**Consumer confidence**



Source: Conference Board, European Commission

Nonetheless, analysis of recent business and consumer confidence indicators in the industrialized nations does not suggest that a sustained and consistent process of recovery may be on the horizon. Quite to the contrary, expectations would seem to point toward growing pessimism as tensions in the Middle East worsen and unemployment levels creep upward in the major developed economies. This feeling is even more palpable among consumers, as witnessed by plunging confidence indicators since mid-2002. In the first two months of 2003, growth was particularly unfavorable in the United States and France.

**Business surveys**

Source: Institute for Supply Management (ISM), Reuters

Indicators used to reveal business expectations in the manufacturing sector point to less uniform but still generally downward expectations in the near future. In the United States, the Institute for Supply Management (ISM) issued its index, revealing a steady drop in the first two months in 2003. In the Euro zone, these indicators dropped to their lowest level in the year since December 2002 before turning slightly upward in the following two months. In Japan, the Tankan index has been on the rise since the first quarter of 2002, though it is still negative and clearly reveals a sense of general malaise among the businesspersons consulted.

Over the course of 2002, jobless levels remained high in the major economies, with growth in the final months of the year and in early 2003. In the United States, the rate of unemployment dropped to 5.7% in January, compared to 6% in the previous month as a consequence of hirings in the retail sector. In Japan, unemployment closed January at 5.5%, the same level registered in December 2002. Despite this stability, however, one must acknowledge that the rate is still extremely high by Japanese standards. Aside from the downturn in the world economy, the process of restructuring that has occurred in Japanese corporations and the credit restrictions imposed as a result of the difficulties faced by the banking sector have also contributed to the high jobless rate. In the Euro zone countries, unemployment hit 8.6% in January, registering a slight rise over the 8.5% December 2002 level. Among the countries of Latin America and the Caribbean, the average rate of unemployment came to 9.1% in 2002, compared to 8.4% in 2001. The situation is particularly grave in Argentina, where the rate has risen to 21%.

## 4.2 Monetary policy and inflation

The central banks of the major economies cut interest rates toward the end of 2002 and in early 2003. The United States Federal Reserve cut rates from 1.75% per year to 1.25% per year in November, while the European Central Bank (ECB) cut its basic rate from 3.25% per

year to 2.75% per year in December and 2.50% per year in March, and the Bank of England diminished rates from 4% per year to 3.75% per year in February. As a result, interest rates in both the United States and England have currently dipped to their lowest levels in the past forty years, while Japanese rates are, for all practical purposes, nil.

In the United States and Euro zone countries, recent cutbacks in interest rates were generated by a clearer perception of the general loss of economic dynamism. The Federal Reserve had held its rate firm since November, convinced that future risks were equally distributed between lesser economic activity and increased inflationary pressures. Parallel to this conclusion, the Fed came to the conclusion that monetary policy passthrough mechanisms have not completely exhausted the effects of the aggressive interest rate cutbacks of the last two years. Coupled with productivity gains, this stance could generate a positive impact on the American economic scenario. However, recent indicators suggest that the United States process of recovery is still quite fragile.

In the Euro zone member countries, inflation has remained persistently above the 2% per year limit, despite the weak performance of the region as mirrored in the outlook for continued recession in Germany, the largest economy of the region. This fact alone has tended to fire criticisms of the ECB monetary policy framework and the European Union Stability and Growth Pact. Both of these are considered to be instruments devoid of the flexibility required to implement the monetary and fiscal stimuli required by the region. The recent trend toward appreciation of the euro should prepare the way for possible new interest rate cutbacks in coming months.

In contrast to the cautious stance adopted by the ECB, the Bank of England opted to reduce interest in February despite a recent spike in prices. Thus, December inflation was just slightly above the central target of 2.5% per year. However, in the opinion of most members of the monetary policy committee, this rise was due mostly to temporary factors. In the absence of underlying pressures, the reduction in interest rates had the objective of offsetting the deflationary impacts of the recent rise in the value of the pound sterling.

In Japan, the so-called liquidity trap has continued draining monetary policy of what clout it may once have had. Since February 1999, when the Central Bank adopted its zero interest policy, the uncollateralized call rate, considered the basic interest rate of the economy, declined from its then current level of 0.25% per year to today's level of 0.001% per year. In this context, the Central Bank decided that the rate would be maintained in the range of zero and that significant alterations would be introduced only when consumer inflation began showing signs of upward movement.

In Latin America, the decreased dynamics of the United States economy, coupled with greater international financial market instability have led the different countries to adopt highly differentiated monetary policy postures. In those cases in which financial volatility is most severely felt, such as in the Mercosul member countries, monetary policy has followed a contractive trend and sought to offset exchange market pressures. In the opposite sense, monetary policy in the Andean countries and Mexico has tended to be somewhat more expansionary, since these nations have been impacted more intensely by sluggish growth in the United States economy.

Interest rates in Asia have been very low, with the sole exception of Indonesia, which adopted an inflation control policy based on higher interest. Growth in prices in the region has varied from one country to another, as evident in situations of deflation in China and Hong Kong, moderate inflation in South Korea and high inflation in Indonesia.

### **4.3 International financial markets**

Projections for 2003 indicate moderate recovery in private capital flows to the emerging countries. According to estimates issued by the Institute of International Finance (IIF), net capital inflows to these countries are expected to expand into the range of US\$137.1 billion, compared to US\$112.5 billion in 2002, though even this figure is seen to be rather small when compared to the second half of the 90s.

**Net capital flows to emerging economies**

Itemization	US\$ billion			
	2000	2001	2002 <sup>1/</sup>	2003 <sup>2/</sup>
Private flows	185.6	125.7	112.5	137.1
Latin America	62.6	47.8	25.2	35.5
Direct Investment, net	135.6	134.3	106.6	107.7
Latin America	60.6	54.0	35.6	33.7
Private portfolio investment, net	14.3	10.2	-4.7	8.9
Latin America	-6.2	0.7	-1.8	0.4
Commercial banks, net	-4.4	-26.3	-4.8	-2.6
Latin America	1.0	-10.1	-7.5	-4.7
Others private flows	40.1	7.5	15.3	23.1
Latin America	7.3	3.2	-1.2	6.2
Official flows	-3.0	14.7	12.2	10.4
Latin America	-6.7	22.4	14.0	17.7

Source: IIF - January 2003

1/ Estimated.

2/ Forecast.

Growth in net capital flows to the emerging countries is based on recovery in funding channeled to portfolio investments, particularly in the Asian markets, while direct investments are expected to remain stable. In the latter case, the underlying reasons for this performance are the global trend toward sharp cutbacks in transnational mergers and takeovers and a sharp slowdown in the structural reforms and privatizations that leveraged investments in several important emerging economies in the last decade. Simultaneously, bank and nonbank loans are expected to register relatively limited expansion, as a result of uncertainties surrounding the performance of the Latin American economies and the outlook for a reduction in profit levels on Asian financial markets.

With regard to private capital flows targeted to the Latin American countries, IIF estimates indicate growth from US\$25.2 billion in 2002 to US\$35.5 billion in 2003, suggesting a process of gradual recovery in the confidence levels of Latin American markets, following the rather somber period of intense uncertainty that had marked the Argentine crisis and the 2002 falloff in confidence in the Brazilian economy.

In general, the international banking system has managed to maintain healthy profit and capitalization levels, though several countries have undergone domestic and foreign market losses that have jeopardized profitability levels at the national level. In the United States, the uncertainties surrounding both the overall economic situation and corporate gains reduced the profitability of banks focused on the segments of investments and insurance, while working to the benefit of retail institutions. In Europe, the foundations of the banking sector are healthy in terms of both capitalization and solidity. However, German banks have suffered the effects of low rates of profitability and only discreet economic growth, thus inhibiting expansion in the country's credit sector. In Japan, the banking system has been a constant source of uncertainties, in the absence of more effective measures aimed at resolving the problem of unpaid and matured loans. In this scenario, in the month of January, the largest Japanese

banks have been making stock offers aimed at increasing their levels of capital. However, these measures have been insufficient to eliminate the risks of a new banking crisis.

**Banks' foreign claims<sup>1/</sup>**

Distribution per regions

Period		US\$ billion					
		All countries	Developing countries	Lat. Am. & Caribbean	Asia <sup>1/</sup>	Europe <sup>1/</sup>	Brazil
2001	I	11 315.5	1 289.9	518.1	388.2	239.3	136.2
	II	11 190.9	1 285.6	521.9	375.0	245.9	139.9
	III	11 577.2	1 332.4	558.4	375.1	256.0	138.5
	IV	11 497.5	1 357.4	562.3	376.6	275.8	142.4
2002	I	11 464.6	1 327.6	528.1	387.7	270.6	134.9
	II	12 419.3	1 333.3	491.9	395.3	293.4	123.9
	III	12 519.7	1 292.0	449.2	397.8	293.7	105.1

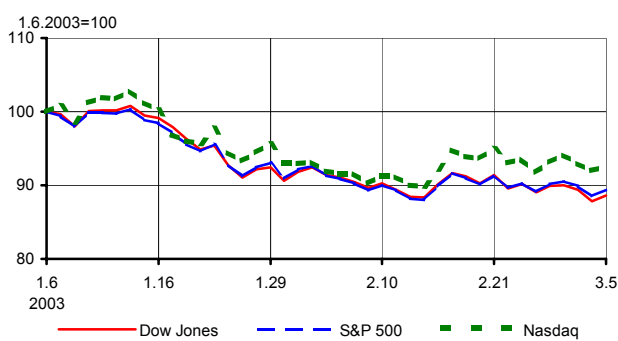
Source: BIS. Consolidated Banking Statistics

1/ Developing countries.

In 2002, international bank loans to the developed countries increased, following the trend that has been common to other modalities of capital flows. At the same time, however, flows of these operations to developing countries have declined. In this context, according to the Bank for International Settlements (BIS), total international assets from institutions that report to the BIS came to US\$12.5 trillion in the third quarter of 2002, registering growth of 0.7% and 8.8% in relation to the immediately previous period and the same quarter of the previous year. The participation of banking lines extended to the developed countries increased to 81.5% of the

total, while operations targeted to the developing countries came to 10.3%. Stress must be given to the fact that the participation of Latin America and the Caribbean in assets held in the developing countries has dropped from 41.9% in 2001 to 34.8% in the subsequent year.

**Stock exchanges - USA**



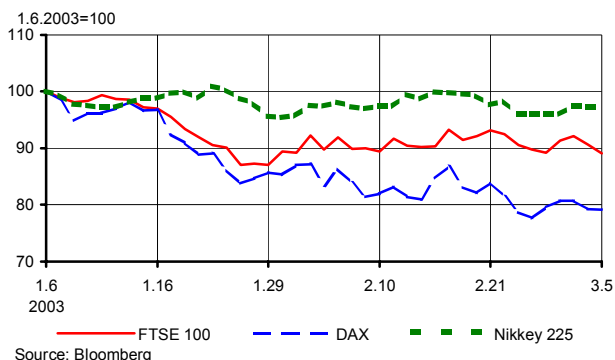
Source: Bloomberg

Global stock markets have faced fluctuations caused by uncertainties regarding the outlook for accelerated economic growth and its effects on corporate results. With regard to the performance of American exchanges, the situation is a reflection of tensions in the Middle East and the slower than expected process of economic recovery. In this context, the Dow Jones Industrial Average and the Standard and Poor's (S&P) 500, which operate at the New York Stock Exchange (NYSE), and the Nasdaq registered monthly contraction of 1% to 5% in February.

With respect to the European exchanges, expectations of recovery in stock prices have not materialized, as indices have continued along

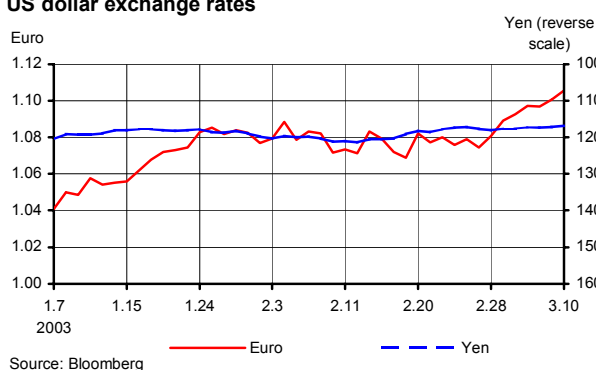
a downward curve to the extent that the threat of war has led corporations to revise their gains. In England, the Financial Times Securities Exchange Index (FTSE 100) used in the London exchange dropped by 9.4% in February while, in Germany, the Deutscher Aktienindex (DAX), used at the Frankfurt exchange, fell by 13.1%.

**Stock exchanges - Europe and Japan**



In Japan, the negative outlook regarding local economic recovery has impacted financial markets. In this sense, the Nikkei index, used at the Tokyo exchange, turned in negative growth of 3% in the first two months of 2003, following a 21% decline in 2002.

**US dollar exchange rates**



In the exchange market, the trend toward depreciation of the dollar against the euro and the yen that began at the start of 2002 deepened in the first quarter of 2003. In this sense, the American currency registered depreciation of 5.3% from January to early March, in relation to the euro, closing at a level of US\$1.105/€ on March 10, while the Japanese currency registered 1.4% appreciation in relation to the dollar in the same period. The downward movement of the dollar in international markets reflects concerns regarding economic recovery and growth in the United States current account deficit, as well as low rates of return in American fixed and variable income markets.

## 4.4 World trade

In general terms, foreign trade results for the fourth quarter of 2002 were not particularly positive for the Nafta member countries. In the United States, foreign sales declined, particularly in the month of December, reflecting the weakening of world demand. On the other hand, imports have expanded over the course of the period and have been sustained by increased purchases of consumer goods and automotive vehicles, at a rate higher than the falloff in petroleum purchases.

In Canada, after having made a significant contribution in the previous quarter, foreign trade was neutral in relation to GDP growth. The balance of trade registered some degree of decline in the third quarter, with growth in imports and reductions in exports. In Mexico, the trade deficit increased, indicating seasonal growth in imports. Exports reached the highest level of the year, despite only moderate growth, and mirrored the slow recovery of the United States economy which is the destination of 90% of the country's foreign sales.

In Latin America, improvement in the balance of trade result in 2002 was a consequence of an accentuated reduction in imports, particularly in light of the difficulties faced by several economies, particularly, Argentina and Venezuela. In Argentina, the fourth quarter result confirmed the trend toward more robust trade balance surpluses, thus guarantying maintenance of the flow of dollars to the exchange market. In Chile, the balance of trade remained relatively stable, generating an average monthly surplus of US\$250 million in the October/December quarter. The general strike in Venezuela in early December affected oil production, which declined by about 25% in the final quarter of 2002 compared to the same period of 2001. Considering that, on average, sales of petroleum correspond to 85% of the nation's exports, foreign sales declined by 29% in the quarter, while imports fell by 16.5% in comparison to the preceding quarter.

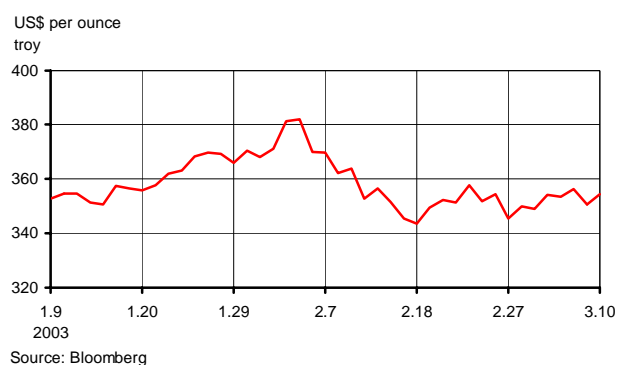
The growth curve followed by foreign trade in the Euro zone countries was interrupted in the final two months of 2002, as exports dropped more sharply than imports, resulting in a fourth quarter trade surplus reduction of 17%, when compared to the previous period. In Germany, foreign sales expanded, albeit at a much more moderate pace than in the previous quarter, and resulted in a lesser trade surplus. In France, both imports and exports turned downward.

Recovery in external demand as of the third quarter of 2002 had a positive impact on Japanese foreign trade, generating particularly strong export growth in November. Simultaneously, imports dwindled and, consequently, had the effect of raising the trade surplus to US\$22.5 billion in the fourth quarter of the year.

In China, exports accelerated over the course of the final quarter of 2002, with intense expansion in the month of December. Chinese participation in the United States electric-electronic goods market has been expanding, threatening the leadership position of products made in Japan and Southeast Asia.

## 4.5 Commodities

### Gold



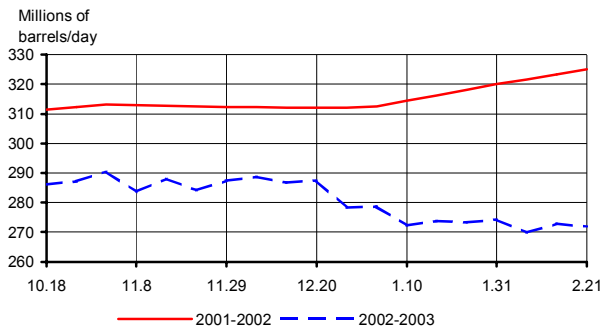
In early February, gold prices moved into the range of US\$382 per troy-ounce and fell to a level of US\$330 per troy-ounce in the final week of March, following rather intense fluctuation in the period. In early 2002, the price of gold fluctuated in the range of US\$300 per troy-ounce. The increase in the price of this metal was due mostly to uncertainties on the world political scene, plus the downward slide in United States stock market and depreciation of the dollar.

In February, the announcement made by the Bank of Portugal that it would sell 30 tons of its gold reserves was not sufficient to push prices downward. Expectations are that prices will remain volatile as long as the uncertainties of the international scenario persist. Other precious metals, such as silver and palladium, and base metals, like copper, aluminum, nickel and zinc, have also registered sharp improvement in international market prices.

## 4.6 Petroleum

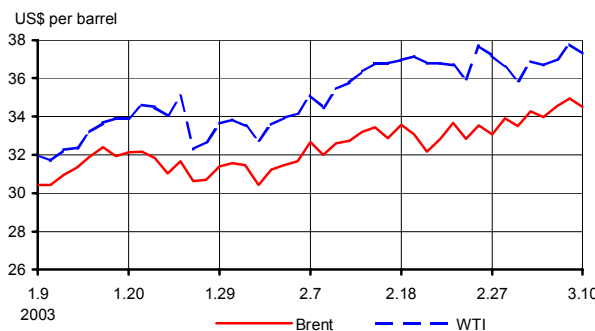
At its January 12 meeting, the Organization of Petroleum Exporting Countries (Opec) analyzed the situation of supply and demand for the first quarter of 2003 and decided to increase the production target from 23 million barrels per day, defined in December 2002, to 24.5 million barrels per day, as of February first. Product prices rose by more than 40% from December to March as a consequence of the strike by Venezuelan oil workers that jeopardized exports of the product to the United States. Going beyond this, the petroleum

**USA - Commercial stocks**



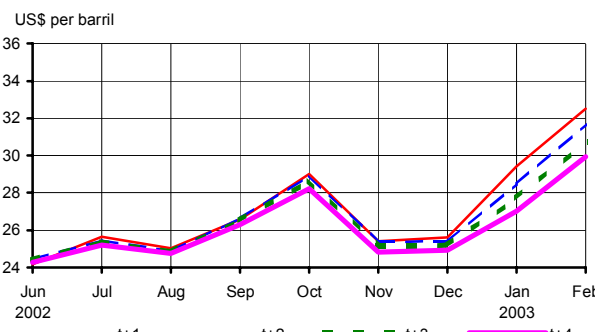
Source: US Department of Energy

**Oil market**



Source: Bloomberg

**Oil- Future market**



Source: Bloomberg

market was further pressured by the imminence of the war on Iraq, coupled with increased demand for fuel for purposes of heating during the upcoming winter in the northern hemisphere. Taken together, Venezuela and Iraq are responsible for 7% of overall petroleum output.

In early March, crude prices reached their highest level since the Gulf War in response to a declaration released by the United States Department of Energy with regard to reductions in American stocks of petroleum, refined oils and gasoline. American reserves diminished by one million barrels to a level of 271.9 million barrels in the week of February 21, which was 14% less than on the same date of the previous year. In the wake of military operations in Iraq, oil prices declined even further, dropping more than 20%.

At the end of December, Brent type petroleum was negotiated at US\$29.99, rising to US\$31.45 at the end of January and approximately US\$35 in early March and dropping to US\$26.60 in March 26. In New York, WTI type petroleum was negotiated at US\$31.37 per barrel at the end of December, US\$33.51 at the end of January and US\$37 at the beginning of March, decreasing to US\$26.60 in March 24. On the futures market, Brent type petroleum prices moved downward for subsequent delivery periods.

## 4.7 Farm commodities

On average, farm commodity prices registered upward movement in early 2003. Despite the fact that current estimates indicate additional price increases for cotton, corn, citrus fruits and other commodities,

an overall analysis for the year does not indicate any sustained rise in international prices. Should the world geopolitical scenario stabilize, there may even be a price decline before the year is out.

In the case of the sugar market, prices are expected to remain high over the medium term, partly due to the outlook for increased production of alcohol in detriment to sugar in the next Brazilian harvest. In the case of wheat, world production in the 2003/2004 period is expected to come to 595 million tons or 30 million more than in 2002/2003.

## 4.8 Conclusion

World economic performance has yet to regain the dynamism that would indicate the start of a process of solid recovery. Quite to the contrary, the pessimism implicit in the confidence indicators of the major developed economies would seem to suggest a worsening of the activity level in coming months, despite positive recovery in industrial output in the early months of 2003. It should be emphasized that the signs of shrinking private consumption in the United States not only call into question the recovery of that country's economy, but also raise concerns regarding the recovery of the world economy as a whole.

Low levels of inflation in the major economies represent a favorable scenario for additional monetary policy incentives aimed at stimulating growth. Thus, since recovery over the medium term does not seem likely, one can expect further interest rate cuts in the United States and the Euro zone countries. The United States economy can also count on further fiscal incentives already programmed by the government. The emerging economies, such as those of Latin America, will continue suffering restrictions on utilization of fiscal policies, given the need for more sustainable public debt structures, and on application of expansionary monetary policies, as a result of their dependence on international capital flows. On the other hand, once the problems of the Middle East are behind us, one can expect some degree of renewed confidence on the part of international investors, coupled with additional reductions in the level of aversion

to risk. The coming together of these elements should facilitate access to international financial markets, particularly among the emerging economies.

Should expectations of a rapid solution to the Middle East crisis be confirmed, this fact alone will act as a shot in the arm to the world economy, accompanied as it surely will be by declining uncertainties and lesser oil prices. If all of this were to result in an abrupt about-face in the United States economy, the results would bring a rapid ripple effect for economic recovery on a global scale.