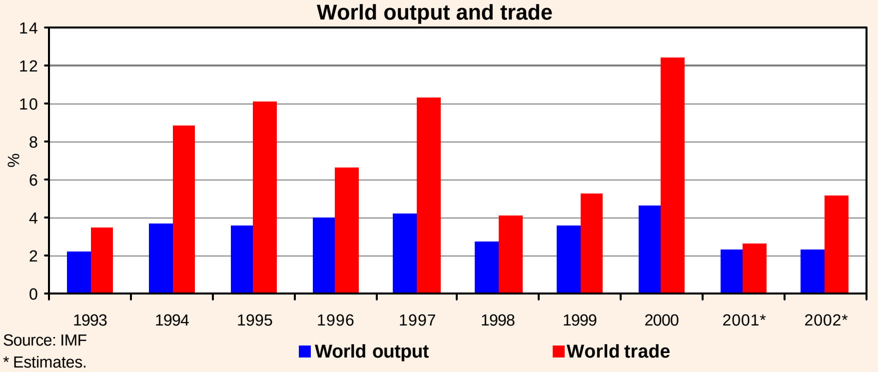
# VI

# THE INTERNATIONAL ECONOMY

## Introduction

The trajectory of the world economy in 2001 was marked by recession in the United States with strong repercussions on the activity levels of other nations. Consequently, growth in world product was practically halved according to the December 2001 issue of World Economic Outlook, which is published by the IMF. Following expansion of 4.7% in 2000, growth in world output in 2001 is estimated at only 2.4%. When one analyzes only the industrialized economies, the IMF estimates product growth in 2001 at just 1.1%, or significantly less than the 3.9% figure of the previous year. World trade was gravely impacted by the recession and, in the final quarter of the year, enormously punished by the September 11 terrorist attacks in the United States. Consequently, the volume growth in trade which had closed 2000 at 12.4% or well above product growth slipped to just 1% in 2001.

Graph 6.1
**World output and trade**




Source: IMF
* Estimates.

In the year under analysis, the United States economy interrupted a decade of steady expansion and plunged into recession as of the month of March. With the accentuated decline in the major indicators of aggregate supply and demand and the absence of inflationary pressures, the Federal Reserve reduced the basic interest rate target (fed funds) by 475 base points over the course of 2001 to a level of just 1.75% per year in December. Parallel to this expansionary monetary policy, similar measures were adopted in the fiscal area, including reductions in taxes and increases in federal outlays.

A rapid analysis of other industrialized countries shows that Japan continued mired in recession and all signs point to further reductions in internal growth, negative movement under industrial activity, record unemployment, deflation and worsening of the already grim problems of the banking sector. In its turn, growth in the Euro zone countries slowed as a consequence of the downturn in world demand. Industrial production registered negative annual growth and the tendency toward reductions in the unemployment rate was interrupted. In the major economies of the region, end-of-year indicators pointed to a scenario of stagnation. With the rate of inflation converging toward the benchmark defined by the European Central Bank (ECB), the monetary authority reduced its minimum refinancing rate by 150 base points in 2001, closing at a December level of 3.25% per year.

According to data drawn from the Balance Preliminar issued by Cepal (Economic Commission for Latin America and the Caribbean), growth in the region dropped from 4.1% in 2000 to 0.5% in 2001. Among the factors that contributed to this performance, mention should be made of both the Argentine crisis and the world economic slowdown, which had particularly strong impacts in the region as the Mexican economy accompanied the United States in its plunge into recession. The deteriorating Argentine situation worsened even further toward the end of the year, in the midst of floundering economic activity, falling income levels and deflation, as both the Minister of the Economy and the President of the Republic resigned in the face of grave institutional and social upheavals. After falling into virtual default despite an exchange of the nation’s debt papers, moratorium was declared, effectively cutting off the nation’s access to the international capital market. Cepal projects the decline in the Argentine GDP at 3.8% in 2001.

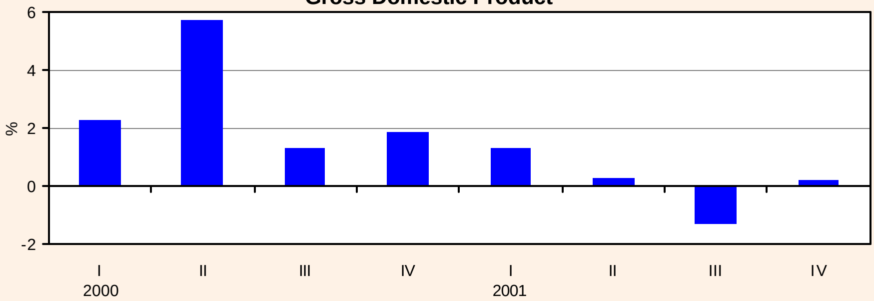
## United States

As the longest postwar growth cycle ground to a halt, the American economy was considered technically in a state of recession as of March 2001 by the Business Cycle Data Committee, an organ of the National Bureau of Economic Research. This is evident in the fact that real GDP in the United States registered declining quarterly growth in the year, dropping by 0.3% in the third quarter. In the final quarter of the year, the economy surprised most observers with positive growth of 1.4% according to a preliminary estimate made by the Bureau of Economic Analysis (BEA), which is subordinated to the Department of Commerce. Growth of 1.2% in 2001 was the lowest rate since the 1990-1991 recession, when the recent ten year growth cycle first began.

Reflecting the downturn in economic activity, the industrial output indicator closed December 2001 at a level 7% below June 2000. In its turn, the rate of installed industrial capacity fell to 74% in the month of December. This was the lowest point

Graph 6.2

**Gross Domestic Product**[1/]



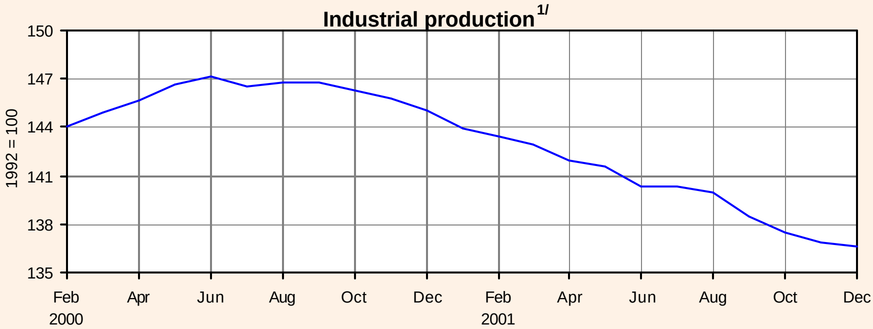

Source: Bureau of Economic Analysis

**1/** Percent change from preceding quarter, seasonally adjusted annual rate.

since the end of 1982 and mirrored the 73% utilization rate registered by the manufacturing sector. Finally, unemployment came to 5.8% at the end of 2001, as 90 thousand job positions per month were eliminated in the nonfarm sector of the economy.

Graph 6.3

**Industrial production**[1/]




Source: Federal Reserve System

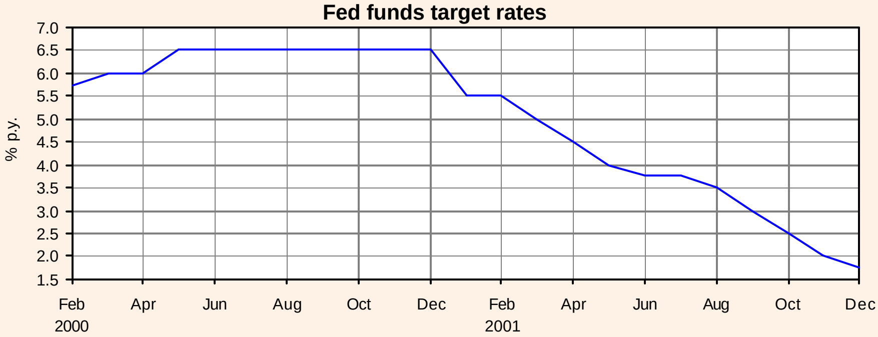
**1/** Seasonally adjusted

With the first signs of recession, the Federal Reserve made every effort to avoid a hard landing – a task that became considerably more difficult in the wake of the September 11 terrorist attacks – and, in January 2001, initiated a process of systematically cutting fed fund interest rates. Over the course of the year, a total of eleven cutbacks in basic interest rates were made as the target was chopped from 6.5% per year in December to 1.75% per year twelve months later.

Practically at the same time in which the Federal Reserve made a rapid about-face turning its back on the contractive monetary policy of the previous year, the final year of the period of the so-called "irrational exuberance" of the market, the recently inaugurated Republican administration announced that it would make good on its campaign promise of tax cuts and increased spending to stimulate the economy. Consequently, as of the month of June, the accumulated Treasury surplus

Graph 6.4

**Fed funds target rates**

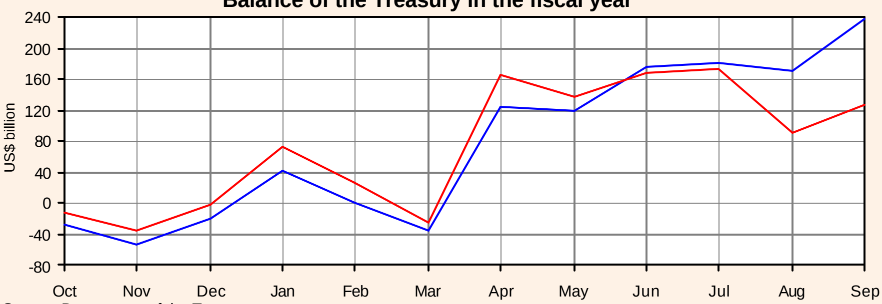



Source: Federal Reserve System

dropped below the previous year's result. This difference became further accentuated month-by-month and closed the fiscal year at the end of September at US$110 billion. Following the events of September 11, a new spending bill was sent to the Congress where, despite the divergences between Republicans and Democrats, there was no doubt as to the need for fiscal incentives. According to projections made by the Office of Management and Budget, the budget is expected to close with deficits of US$106 billion, US$80 billion and US$14 billion in the coming fiscal years.

Graph 6.5

**Balance of the Treasury in the fiscal year** 1/




Source: Department of the Treasury

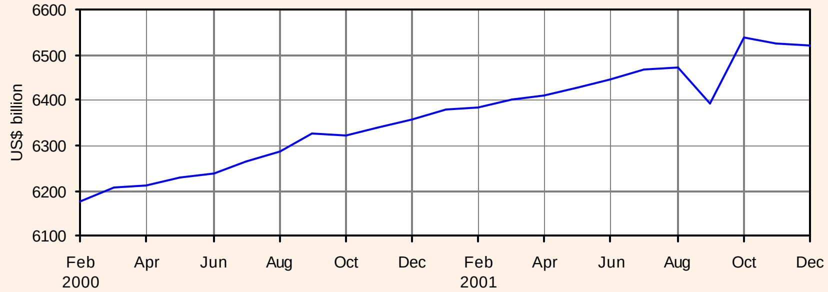
**1/** Fiscal year: Oct/t-1 to Sep/t.

A considerable share of the fourth quarter GDP result was due to zero interest automobile financing offered by several of the large manufacturers. As a matter of fact, retail sales rose by a sharp 7% in October, before dropping by 3% in the following month and then remaining practically stable through to December. In the same sense, consumer spending – the major support for sustaining aggregate demand (together with government spending) – fell abruptly in September following the terrorist attacks, before recovering sharply in October, only to drop once again in November and December, albeit at a relatively moderate pace.

With regard to gross fixed capital formation, completed construction increased in value by 3% over the previous year, though there was a sharp reversal in this trend as of February when contraction reached the peak of the growth curve started in August of the previous year. In its turn, output of business equipment dropped steadily throughout the year.

Graph 6.6

**Real consumer spending**[1/]



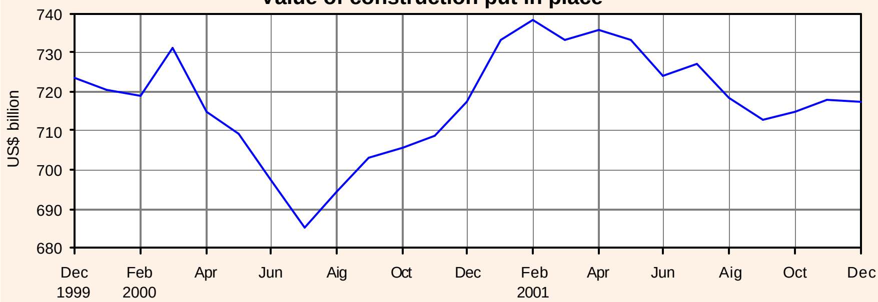

Source: Bureau of Economic Analysis

**1/** Seasonally adjusted annual rate.

As far as foreign trade is concerned, the United States deficit in goods came to US$426 billion in the year, compared to US$452 billion in 2000. Though the deficit has moved on a negative curve, both exports and imports dropped during the year. In the first case, the underlying reason was weak external demand, while the falloff in imports was caused by the internal recession.

Graph 6.7

**Value of construction put in place**[1/]



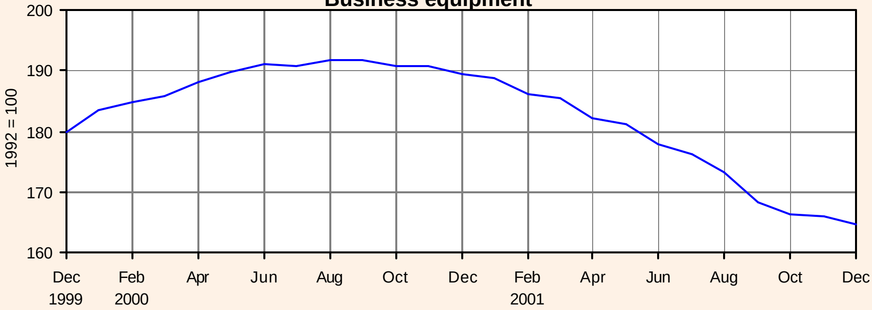

Source: Bureau of the Census

**1/** Seasonally adjusted annual rate in constant 1996 dollars.

At the end of the year, expansionary fiscal and monetary policies showed the first signs of producing the desired effects on economic activity. With this, those who were optimistic with regard to recovery in the American economy clearly carried the day over those who insisted on pessimistic predictions. The rapid measures taken by the Federal Reserve were hailed as an element of essential importance to avoiding an

Graph 6.8

**Business equipment** 1/




Source: Federal Reserve System

1/ Seasonally adjusted

even further deepening of the recession. As a matter of fact, the drop in interest rates had a powerful impact on family consumption and on business inventories. According to the optimists, the high level of consumption and an upturn in stock levels are expected to contribute to a recovery process as early as the first quarter of 2002. The pessimists, in turn, argued that the high level of family and business debt would create serious obstacles to the permanence of the recovery, once it had commenced. There is no doubt that the successive cutbacks in interest rates aided in attenuating the debt service. This factor takes on even greater importance when one observes that low and falling inflation did not aid in reducing the real value of financial charges. Furthermore, with interest at 1.75% per year, very little maneuvering room was available to the Federal Reserve for new interest rate reductions.

## Japan

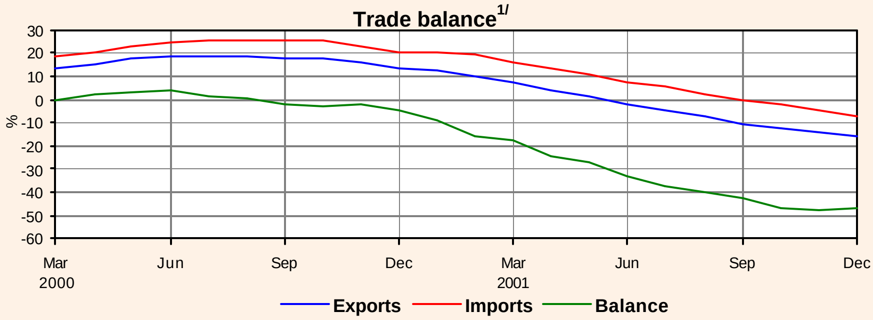
Following rather volatile growth in recent years, the Japanese economy registered a poor performance in 2001, with negative growth in two consecutive quarters. Government predictions point to a drop of about 1% for fiscal year 2001 which closed in March 2002. The scenario is one of recession in an environment of deflation caused by reductions in industrial output and the rationing of bank credits. This already somber situation was further aggravated by the sharp reduction in export revenues that followed in the wake of falling external demand. Deteriorating labor market conditions raised unemployment above the critical limit of 5% and produced adverse impacts on consumption. In its turn, the government came under the growing pressure of an internal debt equivalent to about 130% of GDP and limited its bond issues to ¥130 trillion, aimed mainly at preserving structural reform and social security programs.

Starting in April 2001, the major alternative for overcoming the crisis became that of prioritizing structural reform programs since it was decided that, without such reforms, the country would simply not be able to emerge from the deepening recession. In October 2001, the government approved ¥3 trillion (US$25 billion) in additional budget resources and, in January 2002, approved a new injection of resources totaling ¥2.6 trillion (US$20 billion), as the government sought to stimulate GDP in fiscal year 2001 by 0.9% in real terms and expand the job supply by 110 thousand positions.

External demand which has been one of the major incentives to economic activity turned in a weak performance, reflecting declines in the American and Eastern European economies. During the course of 2001, exports totaled US$402.4 billion or 16.1% less than in 2000, while imports dropped by 7.6% and closed at US$347.7 billion. Accumulated growth in the twelve month surplus followed a sharply downward curve as of June 2000 that intensified even further as of December 2000 as a result of falling demand for information technology intensive products.

Graph 6.9

**Trade balance[1/]**



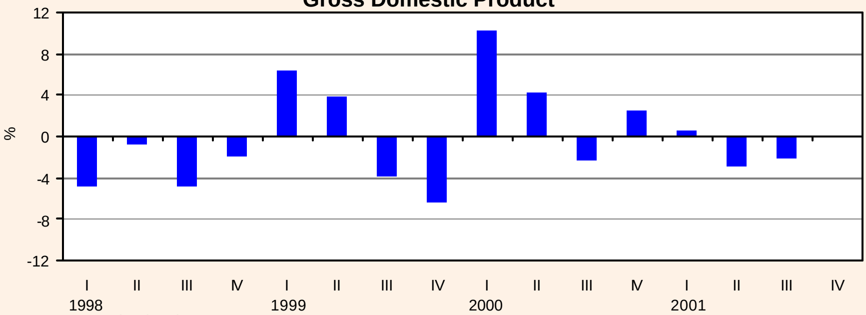

Source: Bank of Japan and Bloomberg
**1/** Accumulated variation in12 months.

Economic performance in 2001 closed far below market expectations. In the seasonally adjusted series, product dropped by 4.8% in the second quarter and 2.2% in the third quarter, following 0.5% expansion in the first quarter (annualized data). Market expectations pointed to a drop of 2% in the fourth quarter and a reduction of 0.3% in calendar year 2001. For 2002 and 2003, expectations point to -1.5% and 1.2%. According to analysts, it is essential that the deflation process be brought under control and that the problem of matured and unpaid loans be resolved for the country to reach its annual growth potential of 2% to 3%.

Industrial output expanded at increasingly higher rates up to October 2000, when it closed with growth of 5.6% in the accumulated 12 month balance. As of that moment, this tendency reversed course and closed December 2001 at -7.4%. In 2001, the reduction came to 7.9%. The weak performance of industrial production is partially explained by the falloff in external demand and such other varied factors as drops in orders for chips and other electronic goods, an area in which demand

Graph 6.10

**Gross Domestic Product**[1/]



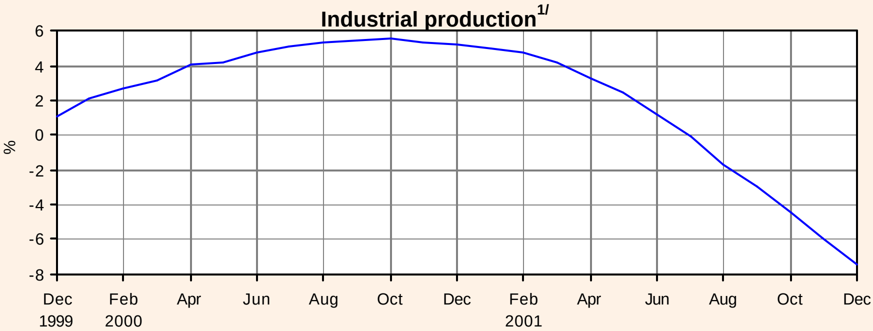

Source: Economic Planning Agency

**1/** Annualized growth over previous quarter seasonally adjusted.

in 2001 fell by 17%. These products also have to cope with competition from such other Asian countries as China, where production costs are relatively less.

Graph 6.11

**Industrial production**[1/]




Source: METI

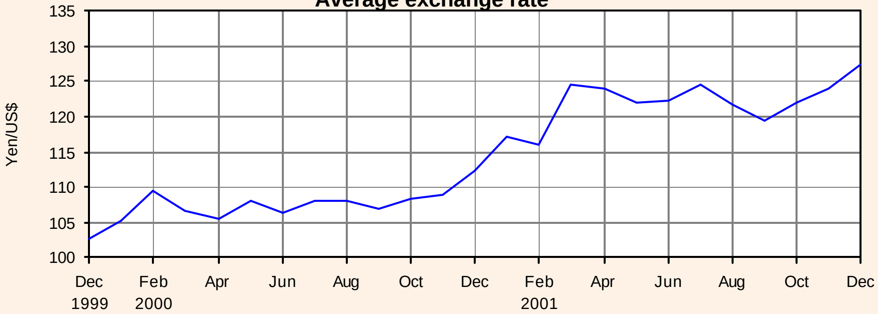
**1/** Accumulated variation in12 months.

The weak performance of the economy was mirrored in the labor market. As of August 2000, unemployment began moving upward from the relatively stable position of 4.6%, only to close December 2001 at 5.6%. The labor market situation led Prime Minister Junishiro Koizumi to create a social security network that would provide low cost credits to small and medium businesses and, in this way, attenuate the impact of unemployment.

As of October 2000, the Japanese currency, which had remained stable in the range of ¥106/US$, moved into a period of depreciation and closed December 2001 at ¥127/US$, thus further strengthening the market belief that the government desired to maintain the currency undervalued. The tendency toward depreciation raised concerns in countries like China before the possibility of losing their competitive advantages on external markets.

Graph 6.12

**Average exchange rate**[1/]




Source: Bank of Japan
**1/** Monthly average - Yen/US$.

Price performance demonstrates that the country has not yet been able to emerge from the deflationary environment. The Consumer Price Index (CPI) systematically registered growth below zero in 2001 and closed December at -1.7%. The Wholesale Price Index (WPI) turned in an annual result of -0.8% in December and fluctuated through the year at levels slightly above or slightly below zero. As of March 16, 2001, the Bank of Japan made an effort to provoke a price reaction by changing the principal monetary policy goal – previously focused on the uncollateralized call rate – to controlling the Banco Central current account balance by injecting greater liquidity into the market.

To avoid the possibility of the economy plunging into recession for the third time in a decade and recover a process of self-sustained growth driven by private demand, the current reform process will not only adopt measures aimed at eliminating deflation but is projected to resolve the problem of matured and unpaid loans that totaled ¥35.7 trillion (7.1% of GDP) in September 2001. It is estimated that each 1% drop in the GDP deflator generates about ¥5.5 trillion in hard-to-recover credits. Discussions dealing with these loans were focused on determining whether the government should inject public funds directly into the banks. In this sense, the monetary policy measures cited previously represented a first attempt to recover the banking system's function as the intermediary in funding operations, providing the system with access to cash at zero cost that the Bank of Japan has made available in the form of reserves. With this, the banking system would be free to invest in more productive areas and increase the efficiency of the economy.

The climate of recession and falling prices was clearly reflected in the Tankan business confidence index, which measures short-term expectations for the manufacturing sector. Following upward movement as of March 1999, the index stabilized at level 10 in the third quarter of 2000 and then moved into a downward curve until hitting a low of -38 at the end of 2001. In the case of supply and demand conditions, this same index moved from -18 to -48 in the same period.

## Euro Zone

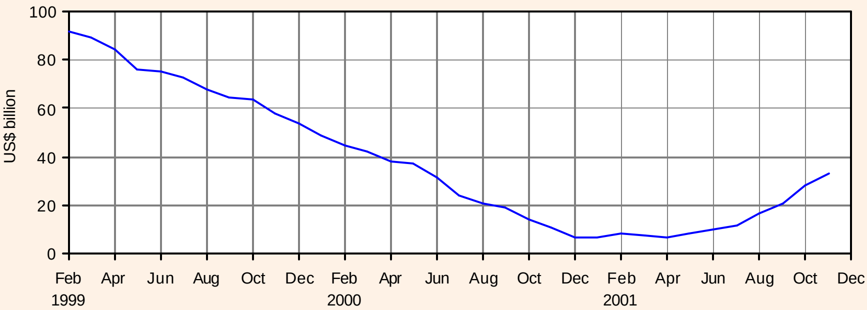
Following the trend that marked the world economy as a whole, the pace of activities in the Euro Zone countries dropped sharply during all of 2001. This behavior was evident in the falloff in industrial production at the end of the period, the rigidity of the unemployment rate, the lack of productivity gains and the low level of growth in retail sales. In its turn, inflation tended to converge with the ECB reference rate in the case of consumer prices, while registering deflation in the final quarter of the year for producer prices. In this case, the position taken by the ECB in the management of the region's monetary policy prioritized interest rate reductions as an instrument for stimulating economic recovery. Completing this scenario, business expectations dropped sharply over the year and, in December, showed some initial signs of recovery.

Retail sales declined up to the month of November in relation to the peak registered in the first quarter of the year. After hitting highs of 3.4% in January and 2.3% in March, when compared to the same months of the previous year, the indicator remained stable at a growth mark of about 1.5% between June and November. The only exception was the month of October (-0.3%), an atypical period that witnessed the September 11 events in the United States and their impact on consumption.

The Euro zone balance of trade evolved positively over the course of the year, registering an accumulated surplus of US$33.5 billion up to November 2001, a figure that was 292.5% higher than the US$7.3 billion figure registered in the same period of the preceding year. With the declining pace of economic activity throughout the globe, both exports and imports decreased in relation to the previous year. Foreign sales, which came to an accumulated total of US$865.1 billion between January and November 2001, dropped by 7.1% when viewed against the results of the same period of the previous year, while imports slipped by 9.7%. The recovery in the balance of trade, however, was not sufficient to return to the level of the 1999 surplus of US$50.3 billion, using the same basis of comparison.

Graph 6.13

**Trade balance accumulated in 12 months**

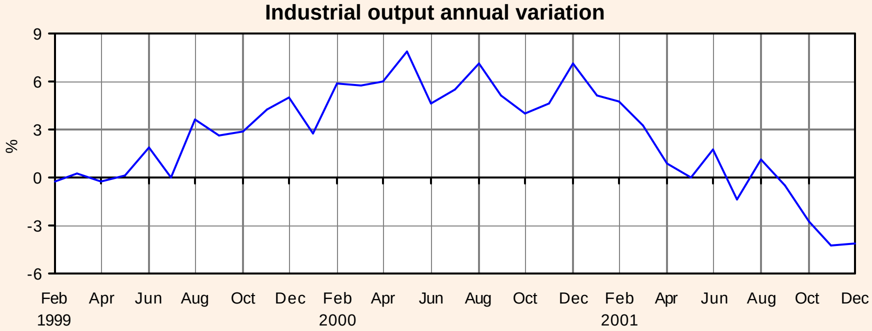



Source: Eurostat

In 2001, industrial output in the region was unable to sustain the growth levels registered in 2000, which came to more than 5% when viewed against the same periods of the previous year. In the first half of the year, there was a clear downward trend as annual expansion fell from 5.1% in January to 0.9% in April and zero in the month of May. In the second half of the year, the industrial sector turned in negative annual growth figures in five different months. In November, and December, the annual reductions came to 4.2% and 4.1%, respectively.

Graph 6.14

**Industrial output annual variation**

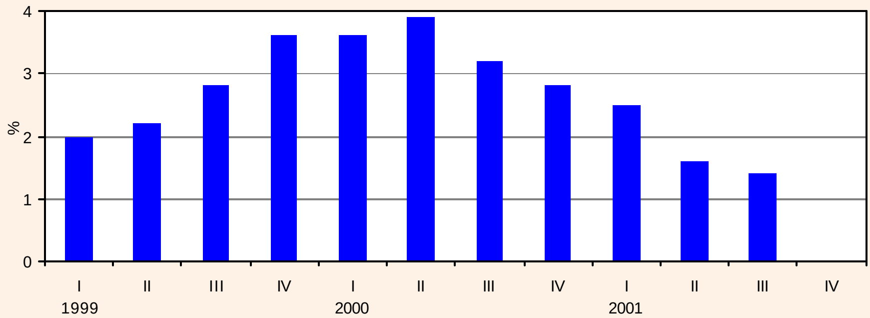



Source: Eurostat

GDP in the 12 Euro zone countries also followed a downward growth curve, albeit not as intense as that of industrial output. Growth of GDP in the region peaked in the second quarter of 2000 at 3.9% and then moved into a steady process of deceleration, closing the second and third quarters of 2001 at 1.6% and 1.4%, respectively.

Graph 6.15

**Gross Domestic Product**



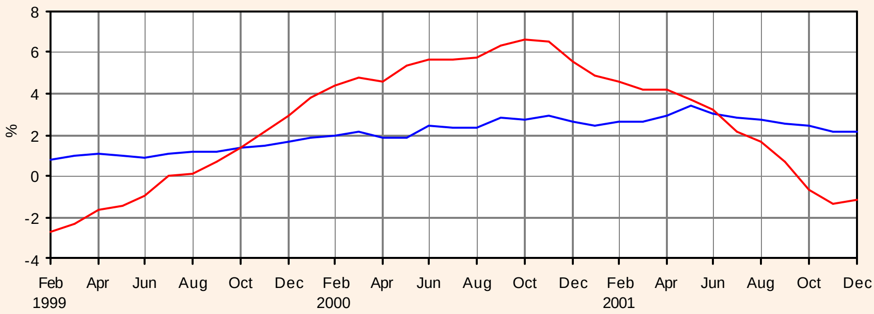

Source: Eurostat

Interrupting the downward trend that marked 2000, unemployment remained stable at 8.5% during the entire year. Labor productivity which had been losing ground since the start of the previous year remained stagnated in the second and third quarters of 2001. In the same quarters, the unit cost of labor compensation per worker increased by 2.5% in each period.

With respect to prices, the Harmonized Consumer Price Index (HCPI) converged toward the ECB reference rate of 2% per year, while the Producer Price Index (PPI) closed with deflation. The reduction in inflation measured by the PPI over the course of the year was impacted both by the economic slowdown in the Euro zone and the world in general and by the drop in the prices of petroleum and derivatives. With this, the PPI, which had reached a level of 4.9% in January, 3.7% in May and 1.7% in August, turned negative in annual terms as of the month of October, closing the year with 1.1% deflation.

Graph 6.16

**Inflation - 12 month variation**



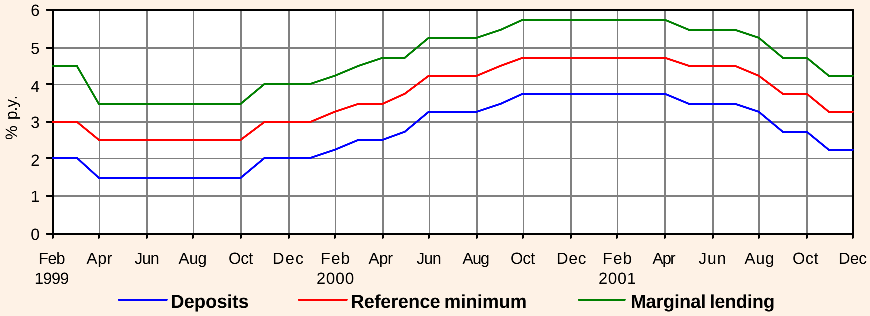

Source: Eurostat

Following upward movement between January and May when it closed at 3.4%, the HCPI reversed course under the impact of the declining pace of economic activity. In November and December, the HCPI registered annual inflation of 2.1% or slightly more than the reference rate defined by the ECB. In a manner contradictory to the behavior of consumer prices, the M3 monetary aggregate expanded in the course of 2001. One should note that M3 is one of the primary pillars of ECB monetary policy and is considered a leading indicator of the HCPI. The reference rate for annual expansion of the quarterly movable average of M3, originally set at 4.5%, was surpassed as of the month of May, when the indicator closed at 4.6%, rising to 7.8% in November.

The rate of exchange between the dollar and the euro fluctuated sharply during the year. Between January and June, the average monthly rate depreciated by approximately 10%, moving from US$0.9384/€ to US$0.8537/€. From that moment forward, the euro recovered up to the month of September, when it closed with a rate of US$0.9125/€. However, the Euro zone currency was unable to sustain this rate and gradually depreciated through to the end of the year, closing with a December median rate of US$0.8916/€.

Though less aggressive than the Federal Reserve, ECB monetary policy management kept pace with the generalized trend toward lower basic interest rates in reaction to the global economic slowdown. With this, the minimum refinancing rate came to 4.75% per year in January, dropping to 4.5% per year in May. Just shortly before the September 11 terrorist attacks in New York, the ECB lowered its basic interest rate to 4.25% per year. Following that, the ECB coordinated its operations with those of the Federal Reserve and Bank of Japan and, on September 18, cut its basic interest rate by 50 base points, a measure that was repeated in November when the minimum refinancing rate dropped to 3.25% per year.

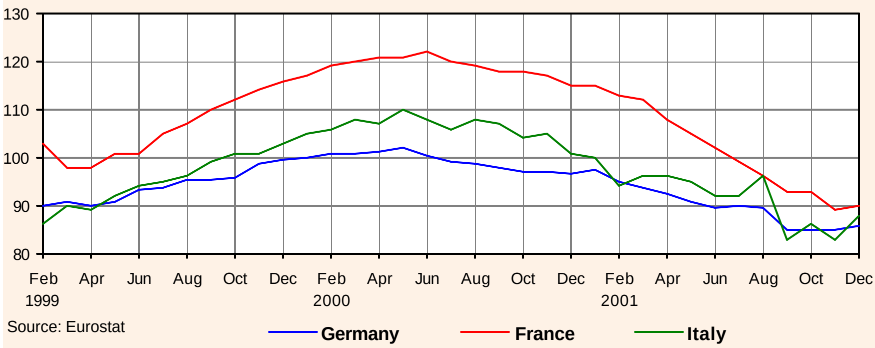
Graph 6.17
**ECB interest rates**




Source: ECB

Indicators of business expectations in the major Euro zone countries turned in negative performance throughout the year, evidently reflecting the already fragile general conditions of the economy. Here, one should highlight the accentuated drop in the indicators in the month of September as a result of the events of September 11. At the end of the year, however, all of the indicators had begun registering a small degree of recovery. In Germany, the General Business Climate Index, measured by the Institute for Economic Research (IFO) lost 11.6 p.p. between January and December, closing at 85.8 in the latter of these months. The French

Graph 6.18
**Business confidence indicators**




Source: Eurostat

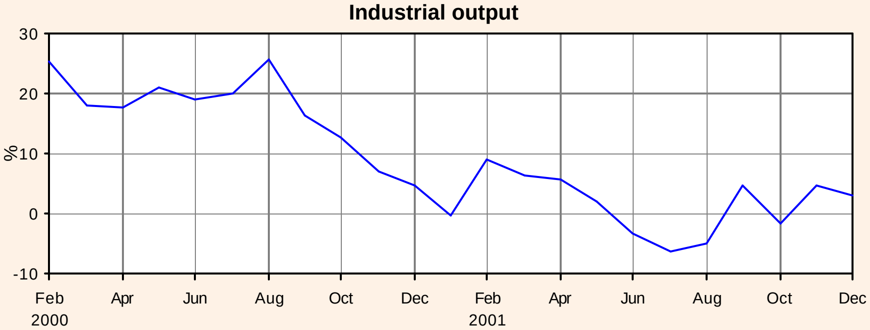
Industrial Trends Survey, which is measured by *the Institut Nacional de la Statistique et des Études Économiques* (Insee) – accumulated a loss of 25 points in the same period. though the index did register its first increase in the year in the month of December when it rose to 90, compared to 89 in the previous month. Finally, the Italian Business Confidence Indicator, calculated by the *Istituto di Studi e Analisi Economica* (Isae), remained relatively stable in the final quarter of the year, with an average of 85. However, it should be stressed that this was significantly below the 100 point level of the start of the year.

## South Korea

The Korean economy was severely impacted by the slowdown in global economic growth and in international demand for information technology-related products. During the year, however, internal demand was driven by increased government spending, which made it possible to achieve positive GDP growth rates of 3.7%, 2.7% and 1.8%, respectively, in the first, second and third quarters of 2001. Expectations of a steady recovery in the United States economy in early 2002 will certainly contribute to expansion in the Korean economy as external orders increase.

Graph 6.19

**Industrial output**

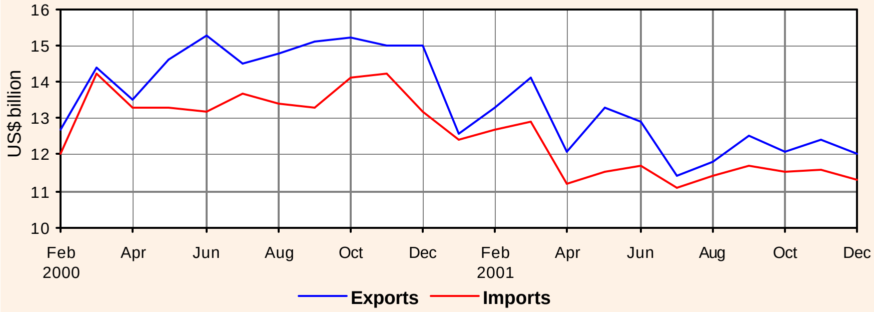



Source: Bank of Korea

The impact of the deceleration in external demand became clear as of March when exports registered negative annual growth. In the second quarter, depreciation of the yen compromised the competitive position of Korean products. At the end of the year, exports had declined by 19.6% in comparison to the previous year, while imports dropped by 14.1%. The accumulated balance of trade in 2001 came to US$9.5 billion, compared to US$11.8 billion in 2000.

The consumer price index caused some concern when growth in the month of May was measured at 5.4%. However, with the start of the second half of the year,

Graph 6.20
Trade balance



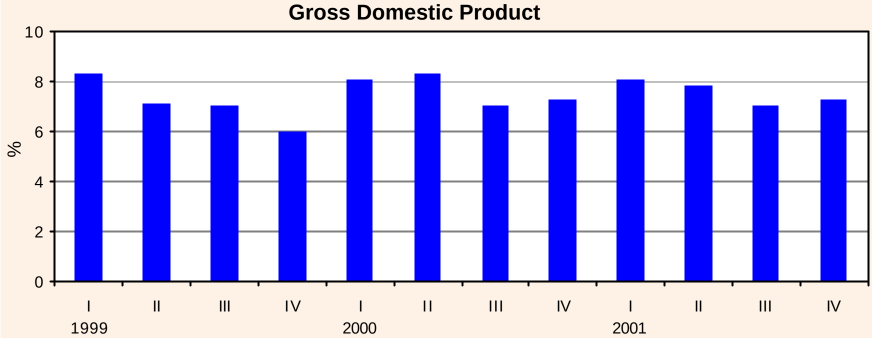

Source: Bank of Korea

demand fell at the same time as petroleum prices began dropping, making it possible to halt the rise in inflation. In December, annual growth in the consumer index closed at 3.2%. With inflation under control, the Bank of Korea was able to reduce its basic interest rate by 1.25 p.p. over the course of the year, closing at 4% per year in December.

## China

China maintained a trajectory of intense economic growth with only slight deceleration principally as a consequence of the impact of the negative international scenario. Driven by intense internal demand, GDP expansion came to 7.3% in the year, compared to 8% in 2000.

Graph 6.21
Gross Domestic Product




Source: Bloomberg

In the first eleven months of 2001, foreign sales expanded by 6.3%, in comparison to the same period of the previous year, while imports turned in expansion of 8.6%, using the same basis of comparison. With this, the balance of trade dropped by 13.5% in the period.

China remains as the emerging economy that receives the largest volume of foreign direct investment, with inflows of US$46.8 billion in 2001, for growth of 14.9% compared to the previous year.

The country's admission to the WTO in December is expected to result in acceleration of the process of economic liberalization, with reductions in tariffs and import barriers. The average nominal rate is expected to drop from 11.1% at the end of 2001 to 6.9% in five years, while the major share of the nontariff barriers is expected to be abolished. Geographic and stockholding restrictions on foreign investments should be gradually eliminated. The new context will also demand reforms in sectors that are most severely affected by foreign competition, such as farming, banking activities and the automotive sector.

On the other hand, Chinese exports will have considerably more access to the international market. The areas that will draw the greatest benefits will be labor intensive segments of the economy, such as textiles and apparel. In these two cases, their export quotas will be gradually raised until 2004 before being totally eliminated in 2005. It is estimated that the net effect of access to the WTO will be positive and will be reflected in increased growth in national output as a result of larger exports and higher levels of productivity. In the latter case, this will be possible as a result of greater technology transfers.

## Turkey

The year under analysis was marked by strong financial market instability. In December 2000, the US$7.5 billion agreement with the IMF made it possible to obtain some degree of relief in the wake of the November crisis. In February 2001, a political crisis generated a new round of instability and rapid losses of international reserves. At that point, the government opted for a more flexible exchange system, allowing the Turkish lira to fluctuate freely. The immediate impact of this measure was 28% depreciation, climbing to 50% in the first half of the year. In May, the agreement with the IMF was reinforced with an additional US$8 billion and negotiations of a new agreement began in the second half of the year. According to the Fund, the need for further strengthening the macroeconomic adjustment program became necessary as a result of the high degree of uncertainty generated by the events of September 2001.

Domestic financial instability combined with the ongoing international recession resulted in downward movement under both GDP and industrial output. In the third quarter of the year, the GDP dropped by 7.1%, following losses of 8.5% in the second quarter and 2.1% in the first. In its turn, industrial output was 8.9% less than in the previous year.

The rate of inflation remained high during the entire year and closed December at a level of 68.5%. The target for 2001 specified in the IMF agreement was 52.5%, revised upward to 58% in July. For 2002, the target was set at 35%.

The trade deficit accumulated in the first eleven months of 2001 totaled US$8.5 billion, a decline of 65.6% in relation to the same period of 2000 when the deficit came to US$24.8 billion. The reduction in the deficit resulted from a sharp 25.8% decline in imports and growth of 13.2% under foreign sales.

## Russia

Russian GDP rose at a consistent pace of approximately 5% in the first three quarters of 2001, compared to the corresponding quarters of the preceding year. The fact that the Russian domestic economy was to some extent able to segregate itself from the unfavorable external environment that marked the major part of the year transformed Russian securities into the most profitable papers on the market in 2001.

In the fourth quarter of the year, however, government estimates pointed to GDP growth in the zero range, mostly as a result of the deepening impact of the international economic slowdown. Passthrough of this impact to the Russian economy was caused mostly by downturns in international demand for petroleum, gas and metals, products that account for approximately two thirds of the nation's foreign sales.

The consumer price index remained above government targets and closed April and May at annual rates of 24.8%, dropping gradually to 18.6% in December. Over the course of 2001, the Ruble accumulated depreciation of 8.4%, or considerably less than the level of inflation. The resulting process of exchange appreciation, consequently, is expected to reduce the competitive advantage of Russian exports and jeopardize the process of economic growth. Unemployment has also been declining and closed December 2001 at 6.3%, compared to 7% in December 2000.

The trade surplus accumulated between January and November 2001 came to US$47.9 billion, as monthly exports stabilized in the range of US$8.5 billion, while imports rose sharply from a January level of US$3.2 billion to a total of US$5.1 billion in November.

In 2001, various reforms were carried out or initiated, including the social security reform, new land property laws and privatization, together with reform of the central bank. In 2002, the most important item in the area of reforms is expected to be negotiation of the country's admission to the WTO.

## Argentina

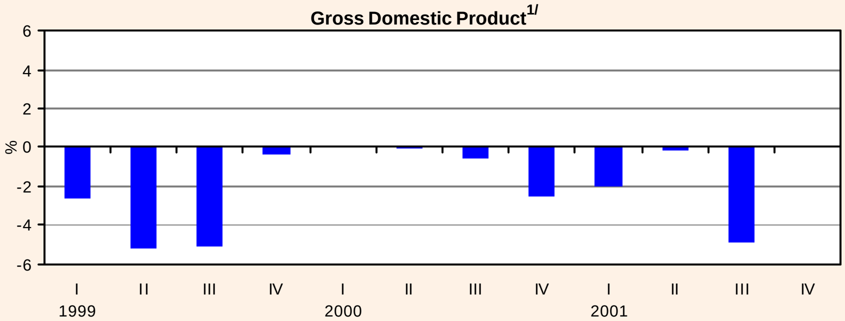
The deepening recession, the government's failure to construct a balanced fiscal environment and the worsening of political and social conflicts led to a situation of accentuated instability over the course of the year and a practically total loss of any expectations regarding the sustainability of the Argentine economy. In the month of December, the situation worsened further, pressure from the streets intensified and the absence of any sense of internal political cohesion resulted in a profound crisis that made any attempt to preserve the system of monetary convertibility totally unfeasible.

Consumption followed a downward curve throughout the year. Supermarket sales dropped by 5.5% from January to December 2001, while shopping center sales plunged by 16.4% in the same period according to the *Instituto Nacional de Estadística Y Censos* (Indec). The same Institute issued the *Synthetic Index of Construction Activity* (Isac), which reflects sales of building industry inputs, revealing a 10.8% decline in accumulated twelve month terms in the month of December. It should be noted that, in every month of the year, demand indicators declined in relation to the same months of the previous year.

According to preliminary estimates made by the *Dirección Nacional de Cuentas Nacionales* (DNCN), aggregate demand dropped by 6.5%, with reductions of 17.6% in gross fixed capital formation, 6.5% in private consumption and 2.1% in public consumption and growth of 5% in exports. In the same period of the year, GDP registered a reduction of 4.9% in relation to the same quarter of the previous year and was impacted by declines of 5.5% in the production of goods and 4.6% in that of services, following reductions of 2% and 0.2% in the second and third quarters of the year, utilizing the same basis of comparison. Once seasonal impacts are eliminated, GDP declined by 3.7% compared to the immediately previous quarter.

Graph 6.22

**Gross Domestic Product[1/]**




Source: Ministério da Economia/DNCN

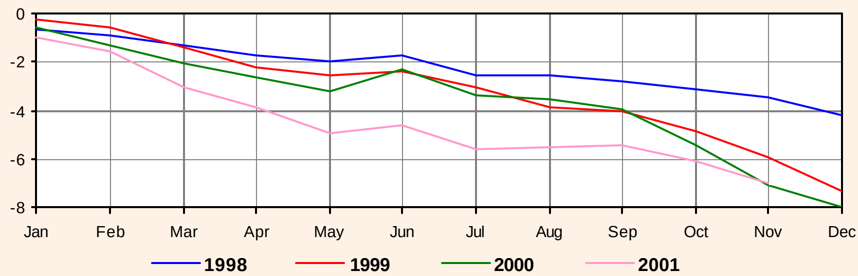
**1/** Growth over same quarter of the previous year.

Fiscal results were negative, clearly demonstrating the difficulties faced by the government in attempts to achieve a balanced fiscal environment. The overall consolidated deficit in the year came to US$9 billion, compared to the fiscal target of US$6.5 billion defined in the agreement with the IMF. Obviously, this result reflects the reduction in the annual fiscal inflow that resulted from the rapid decline in the pace of economic activity and the imbalances in the accounts of provincial governments. It should be noted that the imbalance in public accounts occurred even after fiscal packages were implemented by the government, including severe cutbacks in current accounts, based on reductions in civil service wages and retirement benefits, and in financial transfers to the provinces.

It is important to note that, during the course of the year, cutbacks in constitutional transfers to the provinces provoked a political impasse involving the federal government and provincial governments. This situation made it even more difficult to adjust national public sector accounts and generated highly negative impacts in the base of support of the government coalition. Aside from this, the reduction in federal government transfers impacted the provinces' capacity to honor their debts, including civil service wages and generated a liquidity crisis that further deepened the economic recession. By way of solution, provincial governments began issuing securities to function as quasimoney. These papers were to be accepted in private sector transactions with the public sector as well as in private sector purchase and sale operations. Consequently, at the end of the year, more than 12 provincial securities were in circulation in the market as a result of the shortage of currency.

Graph 6.23

**Financial result of the public sector[1/]**




Source: Ministerio da Economia/Secretaria de Hacienda

**1/** Accumulated per year.

In the external sector, the trade balance registered a surplus of US$6.3 billion, compared to a surplus of US$1.2 billion in 2000, according to the Indec. Exports closed at US$26.6 billion for growth of 1% over the previous year. Analysis of this figure shows growth in foreign sales of primary goods and industrial manufactured goods, coupled with a drop under exports of manufactured products originating in the farm sector and of fuels. Imports fell by 20% in relation to 2000 and were impacted by a strong falloff in the segment of capital goods and intermediate goods as a result of the overall economic slowdown. Insofar as Mercosul is concerned, foreign sales declined by 11% in relation to the preceding year and imports kept pace with the general tendency, falling by 18% using the same basis of comparison. Up to the third quarter of the year, the balance of payments registered a current account deficit of US$825 million, corresponding to 0.3% of GDP and a surplus of US$857 million in the capital account. The latter figure was impacted by loans from multilateral organizations in the framework of the August renegotiation of the IMF agreement.

Keeping step with the downward slide in the pace of economic activity, output of the industrial sector plummeted. In December, output measured by the Monthly Industrial Estimator (EMI) fell by 18.4% in comparison to the same month of 2000. In the year, the reduction came to 6.2%. The automotive, metal-mechanics and textile industries were the headings that turned in the sharpest reductions in industrial activity.

Price indicators reaffirmed the downward movement that marked the last three years. The *Índice de Precios ao Consumidor* (IPC), measured by Indec, accumulated deflation of 1.54% in the year, while the *Índice de Precios Internos al por Mayor* (Ipim), which measures price changes at the wholesale level, closed with 5.37% negative growth.

Expectations regarding the Argentine economy were impacted by political happenings and deteriorated steadily during the year. In April, following the resignation of two predecessors, Domingo Cavallo assumed the position of Minister of the Economy with exceptional powers granted by the Legislative Branch. Cavallo's period in office was characterized by the pursuit of balance in the nation's public accounts, as evinced by creation of the Tax on Banking Credits and Debits and renegotiation of the public debt with internal and external creditors. In the latter case, the highpoint was the security exchange operation carried out in June, involving US$29 billion in short-term papers exchanged for long-term securities.

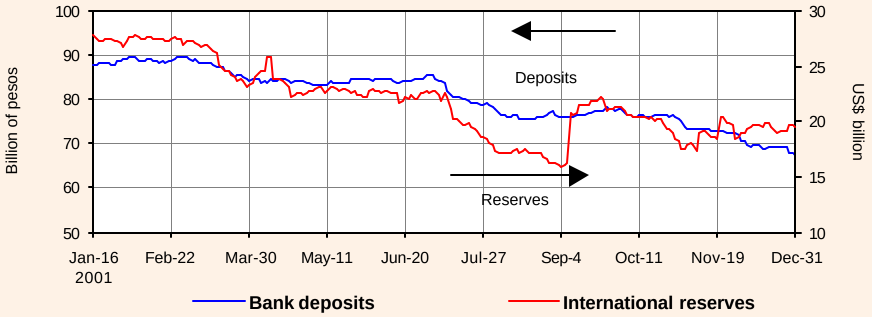
However, the security exchange operation did not produce the desired impact on investor expectations. In the month of July, increasing funding costs – as demonstrated by the 14.01% per year rate in the 91 day Treasury Bill auction – signaled that this standard of financing could no longer be counted on and that the country was facing serious access restrictions to foreign credits. In this context, the government introduced a fiscal adjustment program that included severe cutbacks in the wages and retirement benefits paid to active and retired civil servants. This measure had the objective of achieving a zero deficit target in the coming months.

However, the government's fragile political support in the provinces, the Congress and among the population in general became evident in the opposition victory in the October legislative elections, making it even more difficult to achieve the proposed targets, including those set down in the IMF agreement renegotiated in August and involving an assistance package totaling US$8 billion.

In this framework, uncertainties in relation to the nation's capacity to sustain its exchange system and honor its external debts were mirrored internally in voluminous withdrawals of bank deposits and a steady drop in international reserves. From January to November, bank deposits fell by US$18 billion, equivalent to a full 20% of deposits in local banks at the start of the year. Parallel to this, the international reserves held by the Central Bank (Banco Central de la Republica Argentina – BCRA) registered a loss of US$8 billion. On November 30, the nation's reserve position stood at only US$14.2 billion, a level insufficient to sustain the free convertibility of local currency to the dollar.

Graph 6.24

**Bank deposits and international reserves**




Source: BCRA

In their turn, financial system indicators became extremely volatile. The Bailbor interest rate for 30 day operations in pesos came to 132.5% per year on November 30, and sovereign risk, as measured by the EMBI+ Index published by JP Morgan closed above 4,000 base points, transforming Argentina into the country with the highest risk level among all nations analyzed.

The gravity of the situation provoked new efforts to restructure the public debt with internal creditors, soon shown to be insufficient to reestablish confidence in the economy. Facing a situation in which bank deposits and international reserves were rapidly dwindling, the government adopted another series of measures targeted at restricting withdrawals of bank deposits and savings accounts and remittances of funds abroad.

The impact of the restrictions imposed on withdrawals on the general population was disastrous. In the midst of protests in the streets and a worsening of social conflicts, Minister Domingo Cavallo and, soon afterwards, President Fernando de la Rúa, resigned from office as the country plunged into a grave institutional crisis. The absence of any political cohesion generated a turbulent process of presidential succession and, following the resignation of Adolfo Rodriguez Saá, who had been chosen by the National Congress to replace De la Rúa, the Congress called another extraordinary assembly and indicated Peronist Senator Eduardo Duhalde to the position of President until 2003. Among the first measures taken by the new administration, President Duhalde ratified the suspension of foreign debt payments that had been decreed by his predecessor and announced an end to the system of free convertibility of the Argentine currency to the dollar.

## Chile

Following sharp recovery in 2000 when the economy achieved GDP growth of 5.4%, the Chilean economy came under the sway of adverse external factors and lost a good deal of momentum in 2001. More specifically, GDP expanded by 3.6% in the first quarter, 3.5% in the second and 2.6% in the third quarter, when compared to the corresponding periods of 2000. With respect to the immediately previous quarter, the GDP results were 3%, 4.5% and -1.8%. Among the adverse factors, the world recession and the fact that Chile was the country most seriously affected by the Argentine crisis, outside Mercosul, deserve mention.

Consequently, the Chilean peso devalued in nominal terms by 17.3%, compared to annual inflation of 3.6%, while the monthly indicator of economic activity (Imacec) followed a downward trajectory throughout the year, slipping from 4.1% in January to 1.5% in November in accumulated 12 month terms. In its turn, industrial output registered rates of -3.8%, 15% and -5.5% in the first three quarters of the year with an estimate of -1.5% for the final quarter. However, employment statistics were not overly impacted by these events, as average unemployment dropped to 8.9% in the October/November period, after reaching a high of 9.2% in the previous year.

The major external accounts suffered no significant alterations in the course of the year as the trade surplus, current account deficit and international reserve position closed at respective levels of US$1.4 billion, US$1 billion and US$14.2 billion, respectively. Foreign sales dropped from US$18.2 billion in 2000 to US$17.7 billion in 2001, while imports fell from US$16.7 billion to US$16.3 billion.

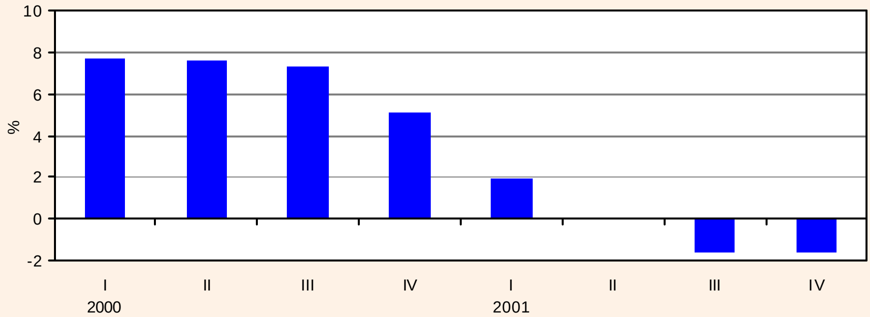
In the first half of the year, monetary policy was clearly expansionary, with seven interest rate cuts that brought the basic rate down from 5% at the end of 2000 to 3.5% in July. In the month of August, however, the rate was raised by 300 base points and remained at that level to the end of the year.

## Mexico

Growth in the Mexican economy ground to a practical halt as the recession took hold in the United States. Consequently, the first three quarters of the year registered GDP growth rates of 1.9%, 0% and -1.6%, respectively. The fourth quarter confirmed the Mexican recession, matching the -1.6% result of the previous quarter.

Graph 6.25

**Gross Domestic Product**

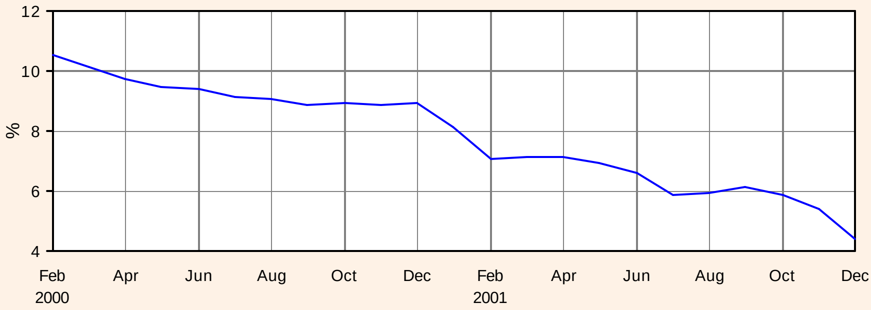



Source: Inegi México

The impact on industrial output was even harsher, as the sector closed with growth rates of -1.4%, -3.6% and -4.7% in the first, second and third quarters, when compared to the corresponding periods of the previous year. In November, the industrial output indicator turned in 3.7% negative growth in relation to the previous year. The sector most seriously impacted by the American recession was that of the maquiladoras, with a November decline of 18.5% when compared to the same month of the previous year. In the first eleven months of 2001, the drop in this segment of industrial output came to 15.2%. In this scenario, open unemployment also moved upward, rising from an annual average of 2.2% in 2000 to 3% in 2001.

Graph 6.26

**Inflation - 12 month variation**




Source: Banco de México

The consumer price index registered a sharp downturn, dropping from 9% in 2000 to 4.4% in 2001. Consequently, the country easily complied with the 6.5% per year inflation target. In much the same way, accumulated growth in the producer price index – excluding crude oil for the export market – which had reached 7.4% in 2000 closed with a reduction to 2.6% in 2001.

The trade deficit grew to US$9.7 billion or 21.6% more than in the preceding year. Imports totaled US$168.3 billion or 3.6% less than in 2000, and exports totaled US$158.5 billion, for a reduction of 4.8% due to the recession that had taken hold in the United States economy.

Just as in the case of the Federal Reserve, the Mexican central bank announced a series of interest rate cuts. Thus, at the end of the first half of the year, interest rates had dropped by 6 p.p., closing at the same level as in 1994. With this policy, interest rates on 91 day Treasury Certificates (Cetes) fell to 7.42% on July 31 and remained at that level through to the end of the year.