

Summary

Following slight declines of output in both 2001 and 2002, Latin America is now experiencing a moderate recovery. Policies are improving in a number of countries and there are signs of stronger growth in many countries, with the exception of Venezuela. The outcome will depend heavily on the external environment and whether political conditions remain supportive of policy discipline in an environment of continuing relatively low growth. Assuming that global conditions improve in the second half of the year and investor confidence strengthens, the recovery should gather momentum. Excluding Venezuela, we project real GDP growth in the region to increase to 2.4 percent this year and exceed 3 percent in 2004 (Table 1).

Deteriorating external conditions in 2001 and 2002 exposed underlying vulnerabilities stemming from policy inconsistencies and structural imbalances in several countries in South America. Countries that allowed their fiscal positions to deteriorate, that were unable to maintain competitive exchange rates with sufficient flexibility to absorb external shocks, and that were heavily dollarized were the most severely affected. Loss of access to international capital markets as their creditworthiness deteriorated forced these countries to cut government spending and tighten monetary policy, thereby amplifying the contractionary impact of deteriorating external conditions. To reduce their vulnerability, governments in a number of these countries are now engaged in implementing reforms that could, if fully implemented and if external conditions improve, generate the beginning of a virtuous circle of fiscal improvement, lower interest rates, and higher growth.

Countries that maintained strong fundamentals despite the deteriorating external environment – such as Chile, Mexico, and Peru – were able to offset the impact of weakening global demand by easing monetary policy while keeping the fiscal position under control. They were the most successful at limiting the adverse effects of the global downturn on their output growth. These are countries that have maintained relatively strong public finances for a number of years, have moderate levels of public sector debt relative to their GDP, have low inflation, and relatively low interest rates. They are now well positioned to accelerate their growth if global conditions improve.

Our baseline forecast assumes that, following a more difficult period of heightened international tension in the months immediately ahead, the external environment facing the region will strengthen in the second half of the year as global uncertainty declines and oil prices fall back to about \$25. While this will have an adverse impact on oil exporters such as Venezuela and Ecuador, it will improve the growth prospects of oil importers such as Brazil, Chile, and several smaller countries throughout the region.

Global credit conditions facing Latin America have improved beginning in the fourth quarter of 2002. The EMBI+ Latin America sub-index spread over U.S. Treasuries has declined from 1399 basis points in September to 880 basis points at present. We project a moderate recovery of net private capital flows this year from the record low of 2002.

Table 1: Real GDP
(percentage change)

	2000	2001	2002e	2003f	2004f
Latin America ¹	3.9	-0.2	-0.4	2.4	3.2
Argentina	-0.8	-4.4	-11.1	3.3	3.5
Brazil	4.4	1.4	1.5	2.0	3.0
Chile	4.4	2.8	2.0	2.8	3.5
Colombia	2.7	1.4	1.6	2.0	3.0
Mexico	6.5	-0.3	0.9	2.5	3.3
Peru	3.1	0.2	4.9	3.8	4.0
Venezuela	3.2	2.8	-8.9	-10.0	1.5

e = estimate, f = IIF forecast

¹ Excluding Venezuela.

Most countries have adopted floating exchange rate regimes and are conducting monetary policy within a framework of inflation targeting and a more independent central bank that is less exposed to short-term political forces. The shift from fixed to floating rates represents a major step forward. It has reduced vulnerability to external shocks and crises of confidence by allowing the exchange rate to share the burden of adjustment, together with the use of international reserves and changes to demand management policies.

Over the last two years, currencies of most countries in the region have depreciated. There has been limited pass-through of depreciation to domestic prices and currencies have depreciated in real as well as nominal terms. This, combined with sluggish or negative real GDP growth, resulted in a substantial decline in the region's current account deficit. The real depreciation and the effect it has begun to have on exports, imports,

and the current account are enhancing the prospects for growth in the region.

There are significant downside risks to the recovery we forecast at present. In many countries, business, consumer, and investor confidence is fragile and, in some, has yet to be established. Governments may succumb to populist political pressure and fail to implement policy to the extent needed to sustain the recovery. Prolonged conflict in the Middle East, sustained higher oil prices, lower growth of the global economy, heightened risk aversion, and renewed pressure on exchange rates and prices could force the authorities to tighten fiscal and monetary policies further and slow the recovery. The outcome in all countries will depend critically on the ability of political leadership to maintain a national consensus and broad political support for policy discipline. The balance of evidence is shifting toward the encouraging direction, but the way forward is fraught with pitfalls.

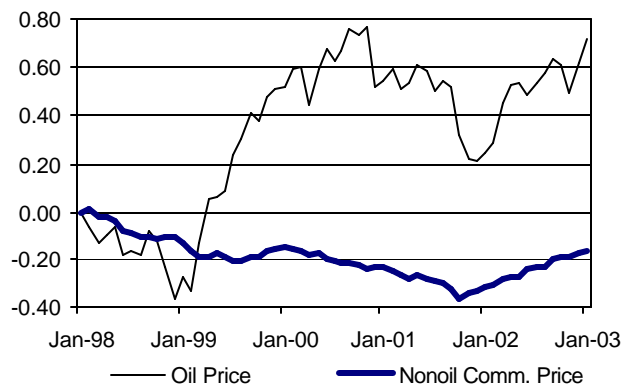
Recent Economic Developments

Reflecting deteriorating external conditions and underlying domestic difficulties in many countries, output in Latin America fell slightly in 2001 and 2002. Open unemployment is estimated to have increased to 9.1 percent from 8.4 percent in 2001. Real wages and domestic demand fell throughout the region. Declining global industrial production in 2001 and low growth in 2002 resulted in a sharp drop of demand for the region's exports (Figure 1). Prices of key Latin American commodity exports fell in 2001 with the exception of oil, and the regions' export earnings declined (Figure 2). Commodity prices improved last year, but remained below the pre-2001 level.

Figure 1
Growth of Global Import Demand Weakens
(percent change)



Figure 2
Commodity Prices
(January 1998 = 1.0)



While growth performance was weak in most Latin American countries last year, the situation differed widely across the region. In some countries, political turmoil and lack of a national consensus on the direction of economic policy contributed to a collapse of investor confidence and deteriorating economic performance. In others, where politics were more conducive to policy discipline, the decline in growth was less severe as policies were implemented with more consistency. Chile, Mexico, and Peru were successful in maintaining strong public finances, had relatively low levels of debt, and relatively high levels of international reserves. They were able to reduce their interest rates as global demand fell without weakening their creditworthiness. By doing so, they were able to cushion the impact of weak global conditions.

By contrast, difficult external conditions exposed serious underlying vulnerabilities in a number of countries including Argentina, Brazil, Colombia, Paraguay, and Uruguay. Conflictive domestic politics and adoption of misguided economic policies exacerbated the downturn in Argentina. It defaulted on its public sector debt and experienced a sharp 11 percent downturn in output. In Brazil, loss of investor confidence in the run-up to the October presidential election exacerbated an already weak fiscal position. While Brazil avoided a crisis, it did so by increasing interest rates and cutting government spending, thereby further weakening growth. Escalating political conflict including an attempted coup and inconsistent economic policies resulted in an 8.9 percent contraction of output in Venezuela. Colombia and Uruguay had been unable to mobilize political support for long overdue fiscal reforms for a number of years and were forced to retrench. Output fell 14 percent in Uruguay. Low growth continued in Colombia for the seventh consecutive year.

Reduced investment and declining output last year resulted in a sharp compression of the region's imports. As a consequence, the trade surplus for the region as a whole increased more than threefold to 2.2 percent of regional GDP. The region's current account deficit fell to 1.0 percent of GDP from 2.7 percent the year before (Figure 3). Reduced access to capital markets, especially in the third quarter when they were closed to many countries in the region, resulted in a precipitous decline of net private capital flows to less than \$28 billion, the lowest level since the 1980s (Figure 4).

Figure 3
Current Account Deficit and Trade Surplus: Latin America
Adjusts to Adverse External Conditions
 (percent of GDP)

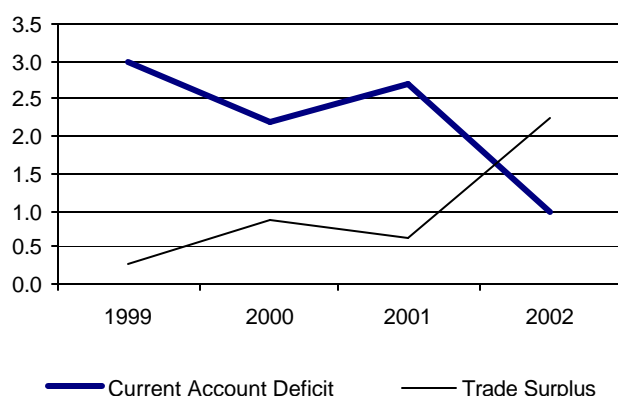
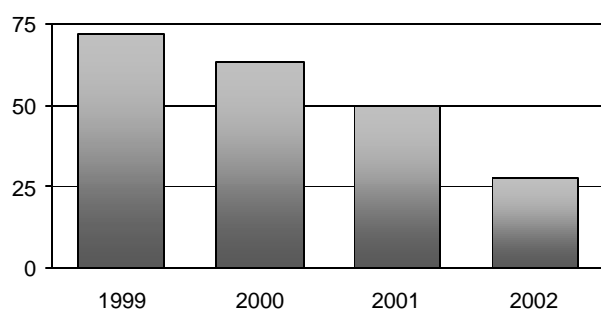


Figure 4
Net Private Capital Flows Contract
 (billions of dollars)



In 2001 and 2002 **Argentina** experienced its worst crisis since the 1930s. A vicious circle of an overvalued exchange rate, declining output, falling fiscal revenue, and rising public sector debt intensified. With the crisis deepening, politics became increasingly conflictive and consensus across the community on the direction of economic policy collapsed. The crisis culminated last

year in a massive depreciation of the peso, default on public sector debt, and collapse of the banking system. Policies adopted by the Duhalde administration such as asymmetric *pesification* of assets and liabilities of the banking system worsened the situation. With bank deposits frozen and the means of payment seriously disrupted, output collapsed (Table 2). Formal unemployment rose to 22 percent. Fifty percent of the labor force experienced some degree of employment difficulty. While the economy has started to improve and the country has entered into an arrangement with the IMF that avoided default to the international financial institutions, conflict between the Supreme Court and the executive branch over *pesification* continues to contribute to uncertainty and erode confidence. The country has yet to implement a comprehensive set of economic and financial policies that will speed recovery and normalize relations with its creditors.

Table 2: Argentina: Key Indicators

	2000	2001	2002e	2003f	2004f
	(percentage change)				
Real GDP	-0.8	-4.4	-11.1	3.3	3.5
Consumer prices	-0.7	-1.5	41.0	37.5	26.8
Real effective exchange rate ¹	120.3	128.2	55.6	57.1	64.9
	(percent of GDP)				
Current account balance	-3.1	-1.6	4.9	8.3	7.5
	(billions of dollars)				
Private capital flows, net	9.3	-10.4	3.1	4.9	-6.0

e = estimate, f = IIF forecast

¹ Index: 1990 = 100.

Despite **Brazil's** progress in recent years towards strengthening some of its economic fundamentals, growing political uncertainty in the run-up to the presidential election and deterioration of regional and global economic conditions exposed serious vulnerabilities. Investors became increasingly concerned about the sustainability of public finances. With one-third of its public debt denominated in or indexed to the dollar and over half linked to floating interest rates, fiscal sustainability is heavily dependent on market sentiment. Low growth of the economy for the second consecutive year, combined with steep increases in spreads on sovereign debt, a sharp depreciation of the *real*, and high domestic interest rates, worsened the public debt-to-GDP ratio despite a higher primary fiscal surplus. Since the elections, market concern about the policies of the new president has eased as he signaled investors that he would adopt pro-market policies and move quickly to strengthen the country's public finances and pursue orthodox

monetary policies, thereby avoiding a crisis (Table 3). International financial institutions led by the IMF, and a number of private creditors have helped to stabilize the situation with financial support.

Table 3: Brazil: Key Indicators

	2000	2001	2002e	2003f	2004f
	(percentage change)				
Real GDP	4.4	1.4	1.5	2.0	3.0
Consumer prices	5.3	9.4	14.7	11.4	7.2
Real effective exchange rate ¹	73.7	62.1	67.2	58.3	59.9
	(percent of GDP)				
Current account balance	-4.0	-4.6	-1.5	-2.0	-2.0
	(billions of dollars)				
Private capital flows, net	34.8	24.0	8.0	15.1	23.7

e = estimate, f = IIF forecast

¹ Index: 1990 = 100.

Chile was hit hard by deteriorating external conditions last year as global demand remained weak, world copper prices were depressed, and prices of imported oil rose. Regional demand for Chile's exports fell sharply as the crisis in Argentina escalated and growth in Brazil remained low. Chile's terms of trade deteriorated 9 percent. Foreign investors grew increasingly wary of committing resources to high-risk regions such as the Southern Cone of South America, and foreign direct investment to Chile fell to one of the lowest levels in the past decade. Net private capital inflows contracted by the equivalent of over 5 percent of GDP. However, solid fundamentals, including low public sector debt, relatively high levels of international reserves, and policy credibility, made it possible for Chile to ease monetary policy to offset the recessive impact of weak external conditions. Nevertheless, output grew by only 2 percent, well below the economy's potential (Table 4).

Table 4: Chile: Key Indicators

	2000	2001	2002e	2003f	2004f
	(percentage change)				
Real GDP	4.4	2.8	2.0	2.8	3.5
Consumer prices	4.5	2.6	2.8	3.8	3.0
Real effective exchange rate ¹	99.9	93.6	88.1	80.9	84.4
	(percent of GDP)				
Current account balance	-1.5	-1.8	-0.9	-1.3	-0.2
	(billions of dollars)				
Private capital flows, net	1.3	2.6	1.9	0.6	2.1

e = estimate, f = IIF forecast

¹ Index: 1990 = 100.

The **Colombian** economy grew 1.6 percent last year, the seventh consecutive year of low growth. Increasing guerrilla violence, weakened investor and consumer confidence, deteriorating public finances, and sharply rising public sector and external debt resulted in rising country risk and higher borrowing costs. Unemployment increased further to 18 percent and domestic demand remained depressed despite efforts to boost growth by easing monetary policy. The new administration of Alvaro Uribe has overcome lack of political support for long-overdue policy reforms. President Uribe has used his strong popular support based on his hard-line stance against the guerrillas to gain congressional approval of difficult deficit-reducing measures and structural reforms, including tax, pension, and labor market reforms. This represents a major breakthrough, making it possible for Colombia to enter into a new, stronger arrangement with the IMF, and regain access to international capital markets (Table 5).

Table 5: Colombia: Key Indicators

	2000	2001	2002e	2003f	2004f
	(percentage change)				
Real GDP	2.7	1.4	1.6	2.0	3.0
Consumer prices	8.8	7.7	7.0	7.1	5.4
Real effective exchange rate ¹	82.0	78.9	79.3	69.9	68.0
	(percent of GDP)				
Current account balance	0.5	-1.9	-3.6	-2.2	-3.4
	(billions of dollars)				
Private capital flows, net	-0.5	4.5	-1.7	-1.2	-0.5

e = estimate, f = IIF forecast

¹ Index: 1990 = 100.

Mexico maintained strong policy discipline throughout 2001 and 2002 and further improved the country's economic fundamentals despite an adverse external environment and weak economic growth. A continued tight fiscal stance, skillful liability management, and relatively low public sector debt permitted the authorities to pursue a more independent, countercyclical monetary policy to offset the declining demand for exports as growth slowed in the U.S. Public finances were maintained under tight control despite lower-than-budgeted fiscal revenues. External debt declined for the fourth consecutive year, and international reserves increased to almost \$50 billion, the highest in Latin America.

Strong opposition in congress to its economic reform program has prevented the government from reducing the

overdependence of fiscal revenue on oil and liberalizing the power sector so that private investment can carry out the much-needed expansion of generation capacity. Despite this, sustained prudent demand management, a strong banking system, the high level of international reserves, and growing policy reputation earned Mexico investment-grade status in the first semester. While the country has continued to enjoy easy access to international capital markets at favorable spreads despite growing uncertainty about the global economy and rising investor risk aversion, the peso has depreciated as the U.S. economy and dollar have weakened. The pass-through to domestic prices has remained low, but the authorities proactively tightened monetary policy since late last year to keep inflation in check (Table 6).

Table 6: Mexico: Key Indicators

	2000	2001	2002e	2003f	2004f
	(percentage change)				
Real GDP	6.5	-0.3	0.9	2.5	3.3
Consumer prices	9.0	4.4	5.7	4.5	4.4
Real effective exchange rate ¹	148.1	156.2	156.3	144.5	144.7
	(percent of GDP)				
Current account balance	-3.1	-2.9	-2.5	-2.4	-2.3
	(billions of dollars)				
Private capital flows, net	15.7	20.8	15.4	16.5	20.4

e = estimate, f = IIF forecast

¹ Index: 1990 = 100.

The **Peruvian** economy grew at a rapid 4.9 percent last year following four years of relatively low growth. Export-led recovery in the first semester was complemented by expansionary fiscal and monetary policies (Table 7). Export earnings from gold rose 22 percent as a consequence of significant price and volume increases. Copper exports rose 19 percent as large export volume increases from the massive Antamina mining complex more than compensated for the decline of world copper prices. While the government has broadly complied with an economic program supported by the IMF and sustained pro-market economic policies, it has faced increasing populist pressure in congress and rising civil unrest that severely weakened the privatization program.

Table 7: Peru: Key Indicators

	2000	2001	2002e	2003f	2004f
	(percentage change)				
Real GDP	3.1	0.2	4.9	3.8	4.0
Consumer prices	3.7	-0.1	1.5	2.3	2.9
Real effective exchange rate ¹	90.3	93.7	94.0	95.6	94.2
	(percent of GDP)				
Current account balance	-3.1	-2.2	-1.9	-2.2	-2.3
	(billions of dollars)				
Private capital flows, net	0.5	0.6	2.7	1.6	2.0

e = estimate, f = IIF forecast

¹ Index: 1990 = 100.

In **Venezuela**, despite favorable oil prices, escalating conflict between President Chavez and the business community, labor unions, top management of the state oil company, PDVSA, and important segments of the military continued to undermine the economy. Private investment declined sharply, capital flight accelerated, foreign exchange reserves fell and the government was forced to float the bolivar. Inflation accelerated, reflecting a 47 percent depreciation of the currency, and domestic interest rates increased sharply. Output declined 8.9 percent in 2002 and dependence on fiscal spending to shore up falling domestic demand increased. In December the opposition initiated a general strike that has pushed the economy further into crisis. The government has set the exchange rate at an unrealistically appreciated level (the bolivar is trading at a 65 percent premium in the black market) while closing the foreign exchange market in an attempt to stop capital flight, and introducing an import licensing scheme that Chavez says he will use to destroy his enemies. Imported raw materials and gasoline are in short supply. Public finances and the country's external position are being sustained by high oil prices (Table 8).

Table 8: Venezuela: Key Indicators

	2000	2001	2002e	2003f	2004f
	(percentage change)				
Real GDP	3.2	2.8	-8.9	-10.0	1.5
Consumer prices	13.2	12.3	31.2	37.6	50.0
Real effective exchange rate ¹	147.4	155.5	121.9	106.9	115.9
	(percent of GDP)				
Current account balance	10.7	3.1	8.7	10.5	7.1
	(billions of dollars)				
Private capital flows, net	0.4	4.2	-2.2	-2.7	-0.6

e = estimate, f = IIF forecast

¹ Index: 1990 = 100.

Economic Policies

Faced with a difficult external environment, low growth or recession, and rising fiscal deficits, a number of countries in Latin America were forced to tighten monetary policy last year as their currencies depreciated and inflation increased. Public sector deficits were growing rapidly and, in the aftermath of the Argentine crisis, these countries were encountering increased investor concern about their fiscal sustainability. Loss of access to international capital markets as their creditworthiness deteriorated left many of these countries with no alternative but to increase taxes, cut government spending and raise interest rates. While these policies were necessary to avoid a crisis, they reinforced the recessive impact of the global slowdown and reduced growth. Some of these countries are now reducing their fiscal deficits in an effort to reduce vulnerability to shocks and boost economic growth in the future. While these policies may reduce growth in the immediate future, they are essential if public finances are to be strengthened and interest rates can be reduced. If implemented successfully, such efforts could potentially move these countries to a more pro-growth mix of fiscal and monetary policy, supportive of a virtuous circle of strengthened public finances, lower interest rates, and increased investment.

A second group of countries – Chile, Peru, and Mexico – were able to pursue a different policy course. They had sufficient flexibility to adopt countercyclical monetary policies to offset the impact of the global slowdown. These countries were more successful in limiting the decline of domestic output without jeopardizing domestic price stability or external balance. They had successfully maintained strong public finances for a number of years and have relatively low levels of debt. Confronted with deteriorating external conditions and declining fiscal revenue, each of these countries introduced measures to reduce or limit the increase in their fiscal deficits. They now have relatively low interest rates and are well positioned to accelerate their growth when global conditions improve.

Fiscal Policy

Last year, heightened investor concern about fiscal sustainability in the aftermath of the Argentine default, combined with deteriorating public finances throughout Latin America, resulted in loss of market access for many countries, including Brazil, Colombia, Uruguay, Paraguay, and a number of other small countries. The

successful experience of Chile, Mexico, and Peru, which have continued to access international capital markets at favorable spreads despite increased global risk aversion, has underscored the importance of maintaining strong public finances. This has refocused the attention of policymakers throughout the region on deficit reduction and fiscal sustainability.

Last year almost all countries, even those that maintained low fiscal deficits and had relatively low levels of public sector debt, such as Chile, Mexico, and Peru, introduced measures to strengthen their public finances. The authorities in Mexico sought congressional approval for tax reform, but were only partially successful. They were successful, however, in retaining authorization in the budget to cut expenditures in the event of revenue slippage. The government has used this effectively in the past to control the fiscal deficit and limit growth of public sector debt. It did so again last year. Chile and Peru both raised taxes and limited spending to control their deficits. Public sector spending is set to remain tight in Brazil despite the new social initiatives being taken by the Lula administration. Temporary taxes such as the CPMF tax on financial transactions are being extended. After years of political impasse, the authorities in Colombia have gained congressional approval of key deficit-reduction measures, including structural reforms of the tax and pension systems and labor legislation. Progress is also being made in Ecuador, Uruguay and a number of small countries.

Less progress has been made in Latin America on public sector administrative reform aimed at streamlining government, increasing the efficiency of public sector spending, and reducing its level as a share of GDP. Such reforms are generally more difficult to implement because they frequently threaten to undo the results of complex negotiations, compromise, and consensus building and entail losses for powerful vested interests. In some countries such as Brazil, government spending is high and inefficient. As a consequence, tax burdens are excessively high (e.g., 33 percent of GDP in Brazil). Bloated public sectors have made fiscal balance more difficult to achieve. In Argentina, Brazil, Chile, Colombia, Paraguay, Uruguay, and a number of countries in Central America, fiscal deficits rose to high levels in 2002 as external conditions deteriorated and their growth weakened. Most of these attempted to strengthen their public finances during the course of the year, but were unable to do so given the depth and duration of the economic slowdown and failure to implement policy to the extent needed (Table 9).

Table 9: Fiscal Balance
(percent of GDP)

	2000	2001	2002e	2003f
Argentina ¹	-3.6	-5.7	-9.1	-8.5
Brazil	-3.6	-3.6	-4.6	-3.3
Chile	-0.6	-0.5	-1.4	-2.5
Colombia	-3.8	-3.8	-4.0	-3.8
Ecuador	1.7	0.6	0.7	0.5
Mexico	-1.1	-0.7	-1.2	-0.5
Peru	-3.2	-2.6	-2.3	-1.9
Venezuela	4.3	-4.5	1.0	0.8

e = estimate, f = IIF forecast

¹ Accrual basis.

Argentina failed to reduce its fiscal deficits and keep its public sector debt from rising during the three years ending in 1998 when its economy was growing rapidly. It eased spending further as its economy began to slow in the late 1990s, eroding its fiscal position further, and attempted to adjust only belatedly in 2001. Net public sector debt increased from 33 percent of GDP in 1993 to almost 60 percent in 2002. Most was denominated in dollars. Early last year, when the country was forced to abandon the Convertibility Plan and float the peso, it defaulted on its public sector debt. Including substantial interest arrears it accumulated last year (5.6 percent of GDP), the public sector deficit went up further to 9.1 percent of GDP (on an accrual basis). Uruguay experienced a similar problem after its economy began to slow in the late 1990s in response to more difficult economic conditions in Brazil and Argentina. It avoided default last year, but is now in the process of restructuring its public sector debt.

Brazil's public sector deficit rose to 4.6 percent of GDP last year despite introduction of additional revenue measures, tight control of spending, and an increase of the primary surplus to 4 percent of GDP. Interest payments on the government's debt, much of them dollar-indexed and at variable-rates, rose sharply as market sentiment deteriorated in the run-up to the presidential election. While the country overachieved its primary surplus target, its public sector debt continued to increase as a share of GDP, further eroding investor confidence, pushing up borrowing costs, thereby contributing to Brazil's adverse debt dynamics.

Brazil's new government appears to be committed to fiscal adjustment and has announced a higher primary surplus fiscal target (4.25 percent) for this year. It has also identified improved liability management as a key objective and is working to reduce dependence on dollar-indexed and variable-rate debt. The government is now

seeking congressional approval of key structural reforms, especially pension reform, that will strengthen public finances over the medium term.

Mexico has successfully maintained low public sector deficits since its 1994-95 crisis. Public sector debt has remained relatively stable since that time and is currently 44 percent of GDP. Most of the government's debt is owed to Mexican residents. The country's total external debt is only 26 percent of GDP, one of the lowest ratios in Latin America. Some 40 percent of this is private sector debt. Mexico continued to control its fiscal deficit as the economy failed to recover from the 2001 recession and fiscal revenue declined. It did this primarily by cutting government spending. The 2002 fiscal deficit target of 0.65 percent of GDP would have been achieved had it not been for expenditures associated with the liquidation of a bankrupt state-owned bank that had required increasing subsidies from the federal government for a number of years. Public finances were strengthened by the closure of the bank.

Peru has been reasonably successful controlling its fiscal deficits over the past decade. Public debt-to-GDP ratio is a moderate 46 percent. Peru reduced the fiscal deficit last year by cutting spending and strengthening tax collections throughout the year. The fiscal deficit was reduced to 2.3 percent of GDP from 2.6 percent and 3.2 percent in 2001 and 2000, respectively. It has successfully accessed international capital markets on favorable terms.

Exchange Rate Policy

Since the mid-1990s, exchange rate policy has been modified in every Latin American country. All major countries have shifted from fixed or intermediate regimes to floating rates. Brazil, Chile, Colombia, Mexico, and Peru floated their currencies in the 1990s. Last year, Argentina, Paraguay, Uruguay, and Venezuela floated their currencies as large capital outflows and declining international reserves forced them to exit from the peg. Their fixed exchange rates were clearly out of line, and their fiscal sustainability was in doubt.

The shift to floating rates represents a major step forward as fixed rates have been a major cause of recurring crises throughout the region. Fixed rate regimes with local currencies pegged to the dollar were adopted by a number of countries in Latin America in the late 1980s and early 1990s to serve as nominal anchors. While this was initially successful in reducing inflation, it increased vulnerability to destabilizing shocks. Fixed

rates also encouraged dollarization of financial systems and government debt. In the face of external shocks, governments experienced serious debt problems when they were forced to exit the peg and depreciate their currencies.

Adoption of floating exchange rate regimes has introduced greater flexibility to macroeconomic policy while reducing the danger of a currency crisis. Floating rates have also reduced unrealistic expectations of exchange rate stability and have weakened incentives that promote foreign currency borrowing and dollarization. They have also reduced the region's reliance on volatile short-term capital flows. Less volatile foreign direct investment is now the major source of private external capital flows to the region. But floating rates are not a panacea, particularly in countries with large external debt or high degree of dollarization. Sound macroeconomic policies and vigorous structural reforms need to be pursued to create conditions conducive to a meaningful role played by exchange rate flexibility as a shock absorber and an instrument of adjustment.

Real exchange rates of countries in Latin America have been realigned over the past two years and now more accurately reflect underlying fundamentals and external conditions (Table 10). The currencies of countries that adopted floating regimes earlier and had the strongest underlying fundamentals – Chile, Mexico, and Peru – generally were the most stable in 2002. Those of Mercosur countries in which fundamentals were weaker – Argentina, Brazil, Paraguay, and Uruguay – depreciated by the greatest amount in percentage terms last year as they were forced to float their currencies. Pass-through to domestic prices has been moderate as domestic demand in these countries was depressed. As a consequence, exchange rates depreciated in both nominal and real terms. Escalating political conflict and a collapsing economy resulted in a massive devaluation of the Venezuelan *bolivar* as the authorities were forced to float. In an attempt to halt capital flight and control inflation, the authorities have recently re-pegged the currency at an appreciated rate. A black market has emerged in which the *bolivar* is trading at a substantially depreciated rate.

Table 10: Exchange Rate Developments¹
(percentage change)

	2000		2001		2002	
	Official Rate	REER ²	Official Rate	REER ²	Official Rate	REER ²
Argentina	0.0	-0.9	0.0	6.6	-208.0	-56.6
Brazil	-0.9	6.9	-28.8	-15.7	-23.9	8.2
Chile	-5.2	-2.0	-18.6	-6.3	-8.5	-5.9
Colombia	-18.9	-9.7	-10.1	-3.8	-8.9	0.5
Mexico	1.1	7.8	1.2	5.5	-3.4	0.1
Peru	-3.2	-0.5	-0.5	3.8	-0.3	0.3
Uruguay	-6.7	-2.0	-10.1	1.5	-59.6	-1.7
Venezuela	-12.3	2.0	-6.4	5.5	-60.4	-21.6

¹ - = increase of the exchange rate (depreciation).

² Real effective exchange rate.

Monetary Policy

The shift to floating exchange rate regimes has been accompanied by changes in the way central banks operate throughout the region. The authorities in most countries are now conducting monetary policy within a framework of inflation targeting. Many have or are in the process of establishing a more independent central bank that is less exposed to political forces. Over the last several years, inflation has declined throughout the region, thereby helping to establish policy credibility. Inflation remained low in most countries in 2002 with the exception of those in Mercosur and Venezuela that were forced to abandon fixed exchange rate regimes and experienced large currency depreciations (Table 11).

Table 11: Consumer Prices
(percentage change, end of period)

	1999	2000	2001	2002e
Argentina	-1.8	-0.7	-1.5	41.0
Brazil	8.4	5.3	9.4	14.7
Chile	2.3	4.5	2.6	2.8
Colombia	9.2	8.8	7.7	7.0
Ecuador	60.7	91.0	22.4	10.5
Mexico	12.3	9.0	4.4	5.7
Peru	3.7	3.7	-0.1	1.5
Uruguay	4.2	5.1	3.6	26.0
Venezuela	20.1	13.2	12.3	31.2

e = estimate

Chile, Mexico, and Peru, countries with low inflation, solid public finances, and a strong external position, were able to sustain an expansionary monetary policy stance throughout most of 2002 without weakening their currencies or experiencing a deterioration of the market assessment of their country risk. Policy interest rates were cut, bank reserve requirements were reduced, and higher limits were placed on central bank rediscount facilities. Chile and Mexico have experienced some exchange rate volatility and price pressure in recent months as the external situation has deteriorated further and risk aversion has increased. Mexico has already started to tighten monetary policy. Chile is expected to do so in the near future. Chile met its inflation target last year. Inflation in Mexico exceeded the target by 1.2 percentage points.

A second group of countries, including Brazil and Venezuela, that had weaker fundamentals, were unable to sustain expansionary monetary policies last year as they lost international reserves, their currencies depreciated, and inflation rose. Brazil and Uruguay have tightened monetary policy in recent months and their interest rates are likely to remain high for some time to come. In Argentina, despite the central bank pumping liquidity into the banking system to keep banks afloat, interest rates remained high through the first half of 2002. Rates came down after July as pressure on the exchange rate and prices began to subside and the outflow of deposits from the banking system halted. Rates are expected to move up gradually as the central bank absorbs liquidity by increasing its sale of short-term paper (*Lebac*s) under the new IMF arrangement (Table 12).

Table 12: Interest Rates¹

	1999	2000	2001	2002
Argentina	7.0	8.1	22.6	41.4
Brazil	26.3	17.6	17.5	19.1
Chile	7.8	9.4	6.4	3.8
Colombia	21.3	12.2	12.4	8.9
Ecuador	64.4	13.2	16.4	14.6
Mexico	21.4	15.2	11.3	7.1
Peru	14.9	12.7	8.6	3.2
Uruguay	66.4	57.3	71.7	31.6
Venezuela	38.0	38.0	37.0	40.0

¹ Short-term policy rates.

Outlook

We project a moderate recovery of the regional economy this year and next. With the exception of Venezuela, we expect all countries in the region to participate as global conditions improve. Economic

policies have been strengthened in a number of countries and there are signs of better growth prospects in every major country. While the prevailing unfavorable external environment is likely to become more difficult in the weeks ahead, we anticipate an improvement of external conditions in the second semester that will strengthen exchange rates and reduce inflationary pressure in most countries in the region, thereby setting the stage for an easing of monetary policy and acceleration of the recovery. Excluding Venezuela, we project real GDP to increase to 2.4 percent this year and 3.25 percent in 2004 (Table 13).

Table 13: Latin America Forecast Summary¹

	2000	2001	2002e	2003f	2004f
	(percentage change)				
Real GDP	3.9	-0.2	-0.4	2.4	3.2
Domestic demand	4.5	-0.9	-1.8	2.1	2.7
Consumer prices	6.2	5.2	13.6	10.4	7.2
Goods exports volume	9.7	1.6	-0.2	3.0	5.3
Goods imports volume	14.6	-1.6	-3.8	1.4	4.8
Terms of trade	5.4	-2.0	3.6	0.4	-0.7
	(percent of GDP)				
Current account balance	-3.1	-3.1	-1.6	-1.3	-1.2
	(percentage of exports)				
Total external debt	190.9	194.6	202.4	191.1	171.6
Gross interest payments due	14.5	14.6	13.5	12.9	13.1

e = estimate, f = IIF forecast

¹ Latin America excluding Venezuela.

While growth of the global economy eased in the fourth quarter of last year, investment in some of the industrial countries appears to be slowly recovering, thereby paving the way for a mild improvement of the world economy later this year. The consensus forecast is for acceleration of growth in the second semester that supports a significant increase of world trade growth this year. This would provide a favorable base for a pickup of growth in Latin American countries as almost all of them have experienced real depreciation and now have stronger competitive positions. Countries with more efficient, open economies, such as Chile and Mexico, with the strongest trade linkages to the outside world and whose exports are especially sensitive to changes in growth of the global economy, will benefit the most. The strengthening in prices of the region's nonoil exports that is projected will also help if it materializes.

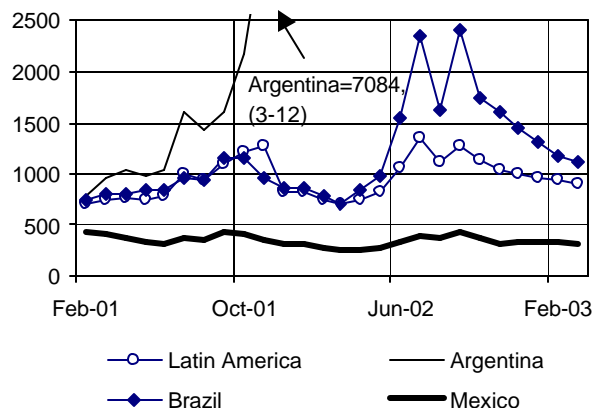
While we expect almost all countries in the region to benefit from improving global conditions later in the year, some are better positioned to do so than others. Countries such as Chile, Mexico and Peru that had floated their

currencies earlier and had maintained strong macroeconomic fundamentals despite the deteriorating external environment will experience more rapid growth than most other countries in the region this year and next. These countries have strengthened their public finances and have relatively low levels of debt. While they have experienced some recent increase of inflationary pressure and have either increased their interest rates or are about to do so, they still have low inflation and low interest rates compared to most other countries in the region. They are able to borrow in world capital markets at moderate spreads over U.S. Treasuries and enjoy the highest credit ratings in Latin America.

Net private capital flows are projected to recover only moderately this year to \$36 billion from a historic low \$28 billion last year (Table 14). Despite an increase in global uncertainty, equity market weakness, and increased risk aversion in recent months, bond issuance by Latin American countries has recovered strongly from the level of the third quarter of last year when market access was sharply curtailed. While there was a drop-off of issuance in February, spreads on Latin American sovereign debt have declined since the third quarter and have remained lower and stable (Figure 5). Recent bond offerings of higher-grade Latin American countries have been oversubscribed.

Figure 5
EMBI+ Spreads

(basis points over U.S. Treasuries)



Gross cross-border bank lending to Latin America is beginning to recover. We project net lending of -\$4.9 billion this year compared to -\$7.8 billion in 2002. We expect foreign direct investment to remain sluggish this year and make a delayed rebound only in 2004 as the region's recovery becomes more robust. Despite this lagging performance, we project equity investment to cover the region's sharply lower current account deficit

by almost three-fold. Compression of imports in 2001-02 as the regional economy contracted resulted in a decline of the current account deficit from 3.1 percent of GDP in 2000 to a record low 1 percent last year. We project the deficit to decline further this year to 0.8 percent of GDP. Official flows are projected to remain roughly stable at about \$16 billion.

Table 14: Latin America External Financing
(billions of dollars)

	2000	2001	2002e	2003f	2004f
Current account balance	-40.2	-47.0	-16.5	-11.9	-13.0
External financing, net	56.7	72.2	43.1	52.1	41.4
Private flows, net	63.4	50.0	27.9	35.7	41.7
Equity investment, net	55.2	56.1	34.2	32.8	40.1
Direct investment, net	61.7	56.2	36.3	33.5	40.1
Portfolio investment, net	-6.5	-0.1	-2.1	-0.7	-0.1
Private creditors, net	8.3	-6.2	6.3	2.9	1.7
Commercial banks, net	1.5	-9.9	-7.8	-4.9	-4.2
Nonbanks, net	6.8	3.7	1.5	7.8	5.8
Official flows, net	-6.7	22.3	15.2	16.4	-0.3
IFIs	-2.8	22.0	14.0	17.6	-0.2
Bilateral creditors	-3.9	0.3	1.2	-1.3	-0.1
Resident lending/other, net	<u>-15.6</u>	<u>-26.2</u>	<u>-23.5</u>	<u>-21.6</u>	<u>-14.1</u>
Reserves (- = increase)	-1.0	1.0	-3.2	-18.6	-14.3

e = estimate, f = IIF forecast

The outlook for **Brazil** remains highly dependent on implementation of policy and structural reforms that the new government has announced. If policy discipline is maintained and congress supports reforms, including greater autonomy of the central bank and strengthening of the pension system, the stage will be set for a gradual strengthening of growth in the second half of the year when the external environment is projected to improve. The outcome in Brazil will have an important bearing on policy and performance of other countries in the region. Declining risk aversion, lower oil prices, a firmer *real* and reduced inflationary pressure will provide scope for lower interest rates. We project growth of 2 percent this year and about 3 percent in 2004.

Three factors will prevent more robust growth this year: the direct demand effect of fiscal austerity, a tight monetary stance (throughout much of the year), and a difficult external environment in the first semester. The cohesiveness of the President's legislative coalition will be tested in the coming months as the government pushes its reform agenda forward. If support does not materialize to the extent necessary and policy begins to veer off

course, we believe the recovery could stall. Another downside risk is a prolonged conflict in the Middle East since this would produce heightened international tension, sustained higher oil prices, and lower global growth. Such an outcome would put pressure on the *real* and prices, force further tightening of fiscal and monetary policies, and weaken the recovery.

Despite a more difficult external environment in the months ahead, we expect the **Mexican** government to continue to pursue policies that maintain the strong fundamentals that earned the country investment-grade status last year. Tight control is being kept on government spending, and the Fox administration plans to press forward with fiscal reform following the July congressional elections. Monetary policy was tightened at the end of last year in response to increased price pressures coming from weakening of the *peso*. However, the external environment improves in the second half of the year, we expect the *peso* to stabilize, inflationary pressure to ease, and interest rates to begin to come down. In these circumstances, we project the Mexican economy to grow a moderate 2.5 percent this year, and between 3 and 4 percent in 2004.

While the economy is set to recover this year, it remains vulnerable to a prolonged unfavorable external environment and slippage of structural reforms. Failure of the U.S. economy to recover in the second semester, continued global risk aversion, and reduced flows of foreign direct investment to Mexico would clearly weaken the recovery. In the absence of reform of the power sector, economic growth will be constrained over the medium term by electricity shortages. This is, as well as tax reform aimed at reducing the government's overdependence on revenue from petroleum exports, is high on the reform agenda of the administration. While there are reasonable prospects for gaining congressional approval of tax reform later in the year, failure to do so could jeopardize fiscal stability and growth in the event of a deep, prolonged decline in the price of oil.

If the government elected in **Argentina** next month is committed to reform and is able to gain significant support in October's legislative election, we believe the mild recovery currently underway will be sustainable. The economic program supported by the new IMF arrangement includes fiscal and monetary measures aimed at stabilizing the macroeconomic situation. While it encourages the government to undertake preliminary measures that could lead eventually to structural reforms, no firm target dates for implementation are included in the agreement. With no new money included in the

arrangement and the timing of implementation of many of the most important reforms yet to be defined, there is little to suggest that there will be serious progress improving Argentina's relationship with its private creditors any time soon. The recent Supreme Court decision declaring *pesification* unconstitutional, has worsened the situation by inflicting substantial additional costs on the already very weak banking system and further increasing uncertainty among depositors and investors.

The underlying obstacles to sustained recovery are the country's fractious politics and lack of a national consensus regarding the need for orthodox economic and financial policies. Much will depend on the next government. If it adopts a populist approach to economic and financial policy similar those of the first year of the Duhalde administration, institutional conflicts among the executive, judicial and legislative branches continue, or if the new administration fails to win adequate support in the October election, we believe that sustained recovery is unlikely. If the government fully implements the existing program supported by the IMF and can reach agreement on a new arrangement that includes additional money and accelerates implementation of long overdue policy and structural reforms, the way could be paved for satisfactory negotiations with private creditors that create the basis for sustained recovery.

We project the **Chilean** economy to recover at a modest 3 percent this year and 3.5 percent in 2004. Investors remain cautious due to a mix of adverse external and domestic events. Chile is heavily dependent on copper exports and oil imports. Prices of these products moved against Chile in recent years and the country's terms of trade deteriorated sharply. This could worsen in the months immediately ahead. Pro-market reforms have come to a halt and the left-of-center Lagos administration has implemented measures that have increased business costs. The investment to GDP ratio has fallen to 21 percent in recent years from 25 percent in the second half of the 1990s with adverse implications for future growth. Recent scandals in the financial sector have compounded this. While macroeconomic fundamentals remain strong, we believe investors are unlikely to increase their stake in Chile in the foreseeable future. The moderate recovery envisaged here would be cut short by a prolonged conflict in the Middle East, higher oil prices, lower copper prices, and increased investor risk aversion.

We expect **Colombia** to begin to emerge this year and next from a long period of low growth. We project

GDP to grow 2 percent this year and 3 percent in 2004. The new Uribe administration has made considerable progress gaining congressional support for key structural reforms and this has helped Colombia regain access to international capital markets in recent months. We believe that investor confidence will gradually be restored as the country implements reforms. Progress will be constrained by the likely escalation of guerrilla violence in the near term and the difficult social problems the country must overcome in the longer term.

We project the **Peruvian** economy to grow about 4 percent annually this year and next. Peru has relatively strong fundamentals and the Toledo government has maintained a pro-market stance. Our projection of lower growth this year than in 2002 is based on growing investor concern that the newly created regional governments will destabilize public finances and the negative impact of growing populist pressure in congress on privatization and investment.

Venezuela is locked in a situation of escalating political violence and an imploding economy. No end is in sight. In the aftermath of the failed general strike, Chavez seems more determined to crack down on opposition leaders and avoid early elections. He has ordered the arrest of two prominent opposition leaders and several executives of the state oil company (PDVSA) on charges of treason. His supporters have bombed the offices of the Spanish and Colombian governments in Caracas and have killed opposition activists. Outlook for the economy is grim. Real GDP growth fell 8.9 percent in 2002 and we expect the economy to contract 10 percent further this year, reflecting collapse of investment, sharply reduced consumption, and diminished oil production. Former oil workers put current oil production at about 65 percent of pre-strike levels. The government has stated that production will return to normal by end-March, but the recovery is being hampered by damage to machinery and lack of manpower and funds to restore older fields. Sharply lower oil prices following the conflict in the Middle East would compound existing problems and increase the probability of restructuring government debt.

* * * * *

Despite serious political and economic problems in some countries, the outlook for recovery in the region as a whole is generally favorable. With few exceptions there are hopeful signs in almost every country. The key issue is whether those signs are simply pointing to a cyclical up-turn, or should be seen as a precursor of an improved

longer-term performance. While economic challenges the region faces are daunting, the strength Latin American countries have gained by living through the tumultuous time of the last few years provides a basis for some hope. Institutions and policies are stronger. Economic teams are more technically capable and experienced. There are a growing number of independent central banks free from the destabilizing pressures of daily politics. Vulnerability to external shocks and confidence crises has been reduced by the adoption of more flexible foreign exchange regimes. Also, there is greater understanding of the need to strengthen public finances in order to lower interest rates, increase medium-term growth and achieve sustainable debt dynamics.

Throughout the downturn of 2001-02 the region demonstrated growing resilience to adverse external conditions. We believe it is now better equipped to deal with unforeseen difficulties than at any time in the past. External positions are stronger as indicated by the improvement in a wide range of creditworthiness indicators. External debt is declining to a projected 186 percent of exports this year from 227 percent in 1999. The interest service ratio has fallen steadily to a low 13 percent. The trade surplus is expected to exceed \$40 billion this year, over 2.5 percent of GDP, and the current account deficit is falling to under 1 percent of GDP. International reserves are projected to reach \$163 billion this year (the equivalent of five months of imports), the highest level ever.

While adjustment policies over the past two years have been pragmatic, flexible and generally well suited for dealing with the more difficult external conditions, there remain a number of weaknesses that need to be overcome if the region is to make lasting progress restoring sustained growth. Current account deficits have been scaled back, but this has been done more by cutting investment than by increasing domestic savings. If growth is to accelerate, investment must be increased without jeopardizing external balance. This requires increased domestic savings. Foreign direct investment is also an indispensable part of this because of the additional resources it contributes and the key role it plays in accelerating technological change and access it provides to the international economy. For this to occur, it is essential that countries strengthen their creditworthiness and maintain access to international capital flows.

The most immediate way to increase aggregate domestic savings is to raise government savings by cutting fiscal deficits. With lower deficits and higher domestic savings, interest rates will be lower and

crowding out of the private sector can be eliminated. Most Latin American countries had difficulty achieving this in 2001-02 in an environment of low growth. As growth recovers, their efforts must be redoubled. For countries that have a high ratio of tax revenue relative to GDP, such as Brazil, the optimum way of reducing deficits is by cutting expenditures. If this can be achieved, tax burdens can be reduced and international competitiveness of the economy can be enhanced. While a number of countries in the region were successful in cutting expenditures over the last two years, few did so in a way that will achieve this permanently. For this, far-reaching reform is necessary. Essential elements of this include reform of local government, rationalization of intragovernmental revenue-sharing systems, pension reform, and privatization.

Excessively large public sectors have made fiscal balance more difficult to achieve in some countries and have had an adverse impact on their international competitiveness. It is one of the reasons a number of these economies have had difficulty opening their economies, achieving productivity gains and increasing growth. Reducing the size of the public sector and carrying out reforms aimed at liberalizing domestic markets, getting rid of excessive government intervention,

reducing barriers to international trade, and enhancing the role of the private sector are the best way to achieve this.

The most effective way to increase domestic savings and channel it to the best use is through development of a well-functioning financial sector without which efficient resource allocation is hard to envisage. Development and maintenance of a strong banking system is essential. Banking systems throughout Latin America have become stronger and more global in recent years as both local and international banks have carried out major investments that have resulted in a rapid transition to modern banking systems. But as the experience of Argentina illustrates, even strong banking systems cannot survive in the absence of prudent fiscal and monetary policies.

Capital markets also need major strengthening. For this, pension reform is a central element. The underlying constraint faced by capital markets in almost every country in Latin America at present is lack of flows of private savings into those markets. Creation of an institutional environment that instills confidence in small savers is essential for overcoming this barrier. Pension reform, including the creation of private pension funds along the lines that exist in Chile, is a very effective way to achieve this. Much remains to be done in most countries to carry this out.