A Macroeconomic Outlook on Mercosur

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The structure of the presentation…

1) The Mercosur Countries

2) A Macroeconomic outlook on Mercosur economies from 1999-2002:

-Brazil

-Argentina

-Uruguay and Paraguay


Venezuela
Guyana
Suriname
French Guyana
Colombia
Ecuador
Brazil
Peru
Bolivia
Paraguay
Chile
Uruguay
Argentina
Falkland Islands
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Brazil

Background information…

- Brazil has had a recent history of very high inflation (chronic big inflation) until the Real plan of July 1994.

- This Plan introduced a monetary reform and between 1995-1999, a crawling peg system was established.

Background information…

- The drastic reduction of inflation since July 1994 was followed by…

  …significant external inflows, taking advantage of the country’s high real interest rates and bold reform agenda.

- But on the other hand…

Background information…

- The real exchange rate remained overvalued
- Current account deficits were increasing
- GDP growth was poor
- And the fiscal performance deteriorated along the period…

In fact, the Brazilian economy was vulnerable to external shocks.

Background information…

- The domestic currency was under attack three times…

… The Tequila effect 1995

… The Asian Crisis 1997

…The Russian Crisis 1998

- The Russian Crisis represented the final coup and the peg was abandoned in 1999.

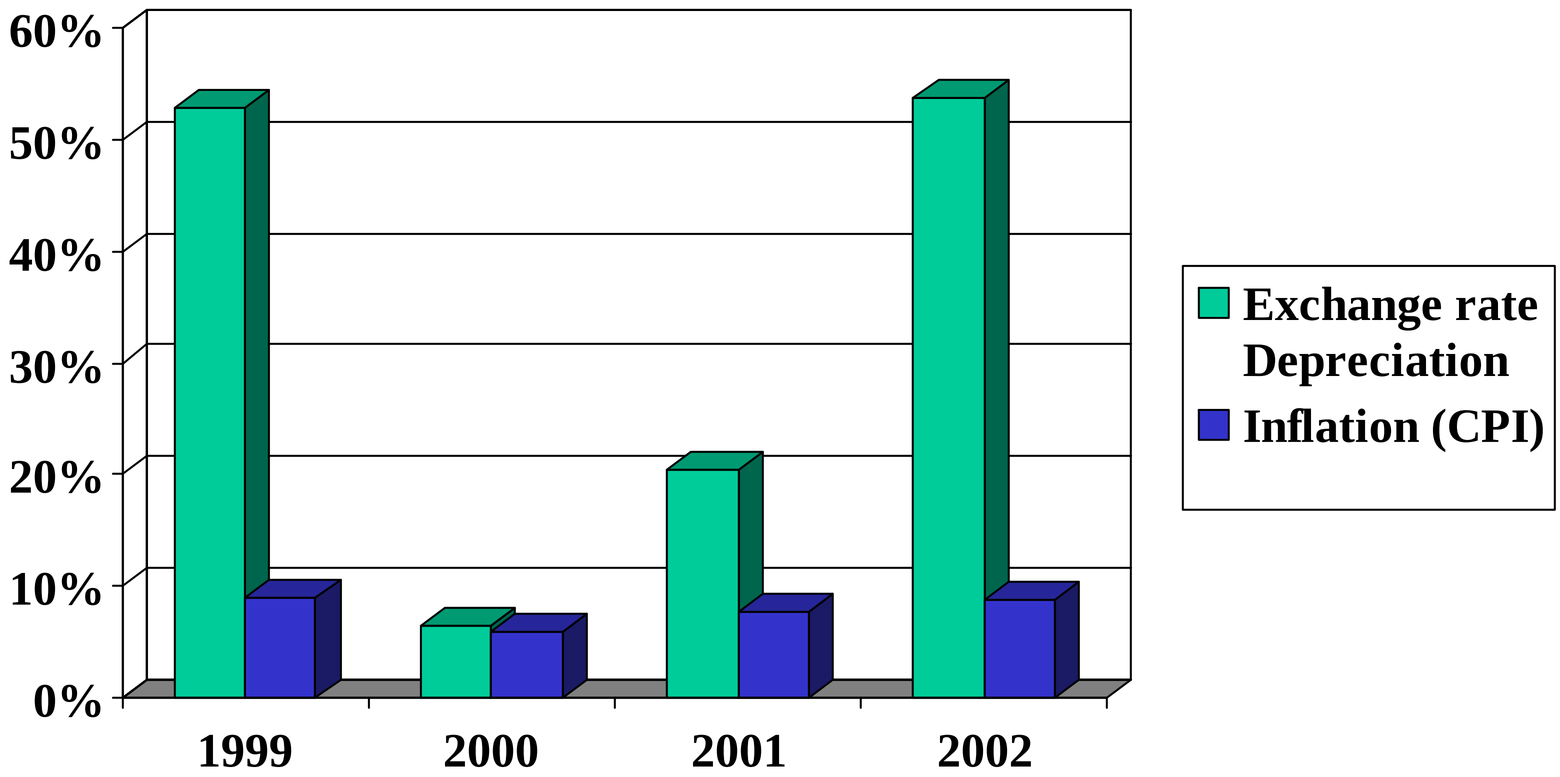
1999-2000: The beginning of the floating exchange rate experience…

- The floating exchange rate regime started in January 1999, and later in the second quarter, the inflation target regime was introduced.

1999-2000: The beginning of the floating exchange rate experience…

- In the first two years, the inflation rates were kept on target, having absorbed the initial impact of the exchange rate depreciation in 1999. ..

Inflation and Exchange rate Devaluations



1999-2000: The beginning of the floating exchange rate experience…

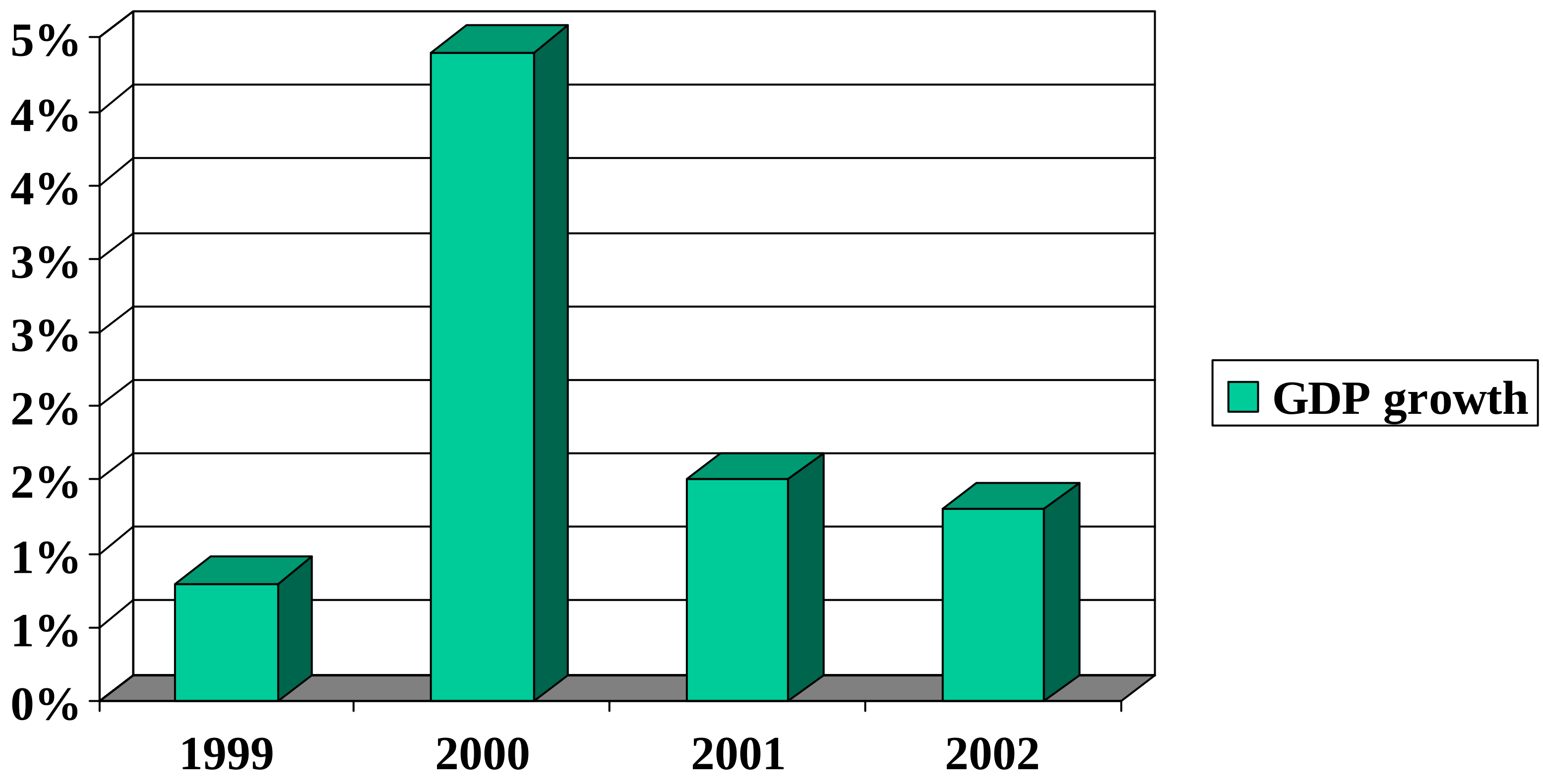
- In 1999, in spite of big devaluation and the severity of the fiscal and monetary measures the economy withstood rather well.
- **GDP** stabilized over the course of the year and the Brazilian economy grew by almost 1%.

1999-2000: The beginning of the floating exchange rate experience…

- In 2000 the Brazilian economy recovered with **GDP** growing by 4.2%…

…These positive results were made possible by more favourable external situation, greater freedom to reduce interest rates and an improved fiscal situation.

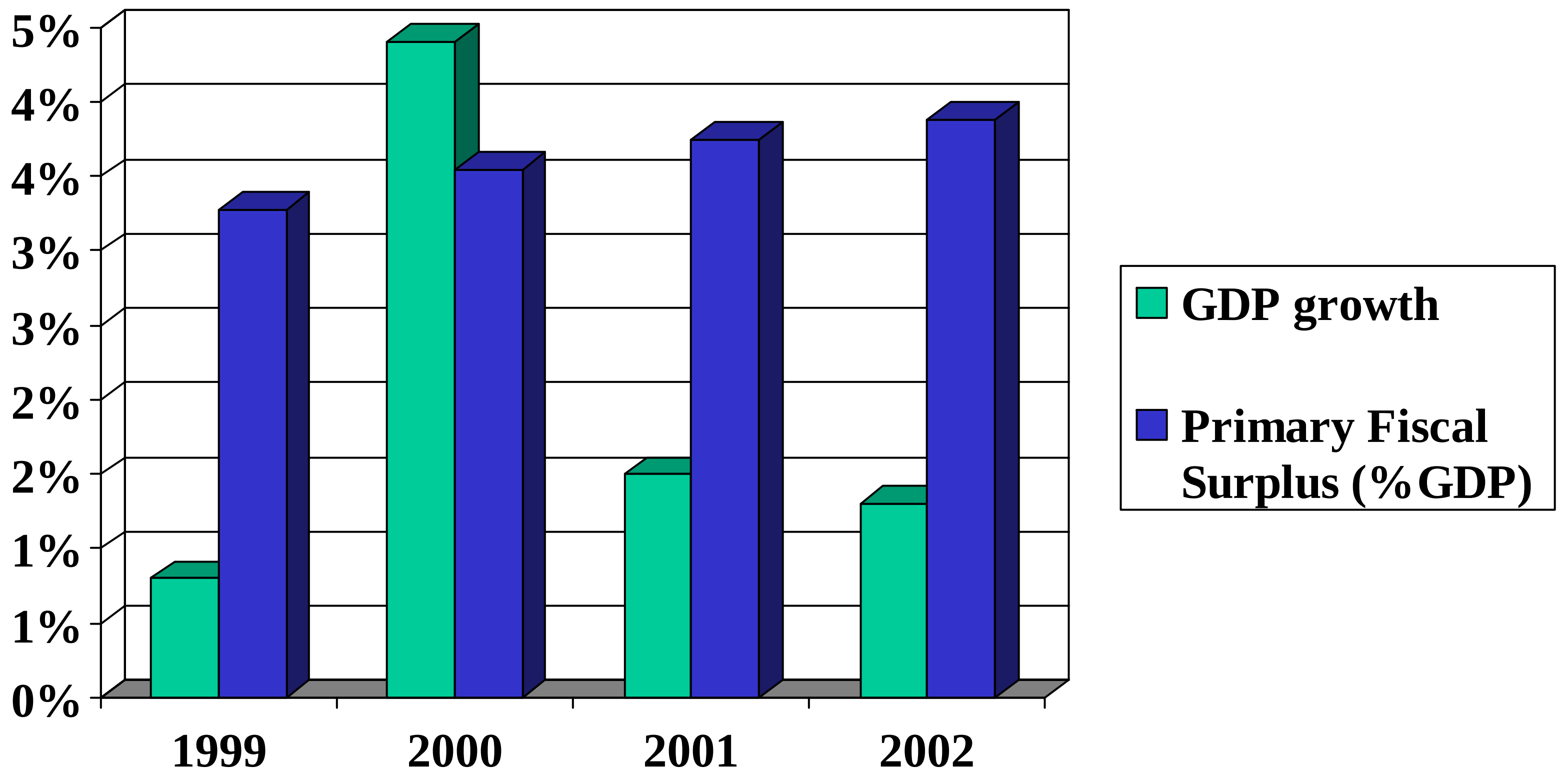
GDP growth



1999-2000: The beginning of the floating exchange rate experience…

- The successful transition was supported by a considerable fiscal improvement.

GDP growth and Primary Fiscal surplus (as % GDP)



2001-2002: An adverse international scenario

- Several external and domestic shocks hit the Brazilian economy…

- The energy crisis

- The desaceleration of the world economy

- The September 11 attacks to the United States

2001-2002: An adverse international scenario

- Argentinean Crisis

- And uncertainties related to the future Brazilian macroeconomic policies under the upcoming government.

2001-2002: An adverse international scenario

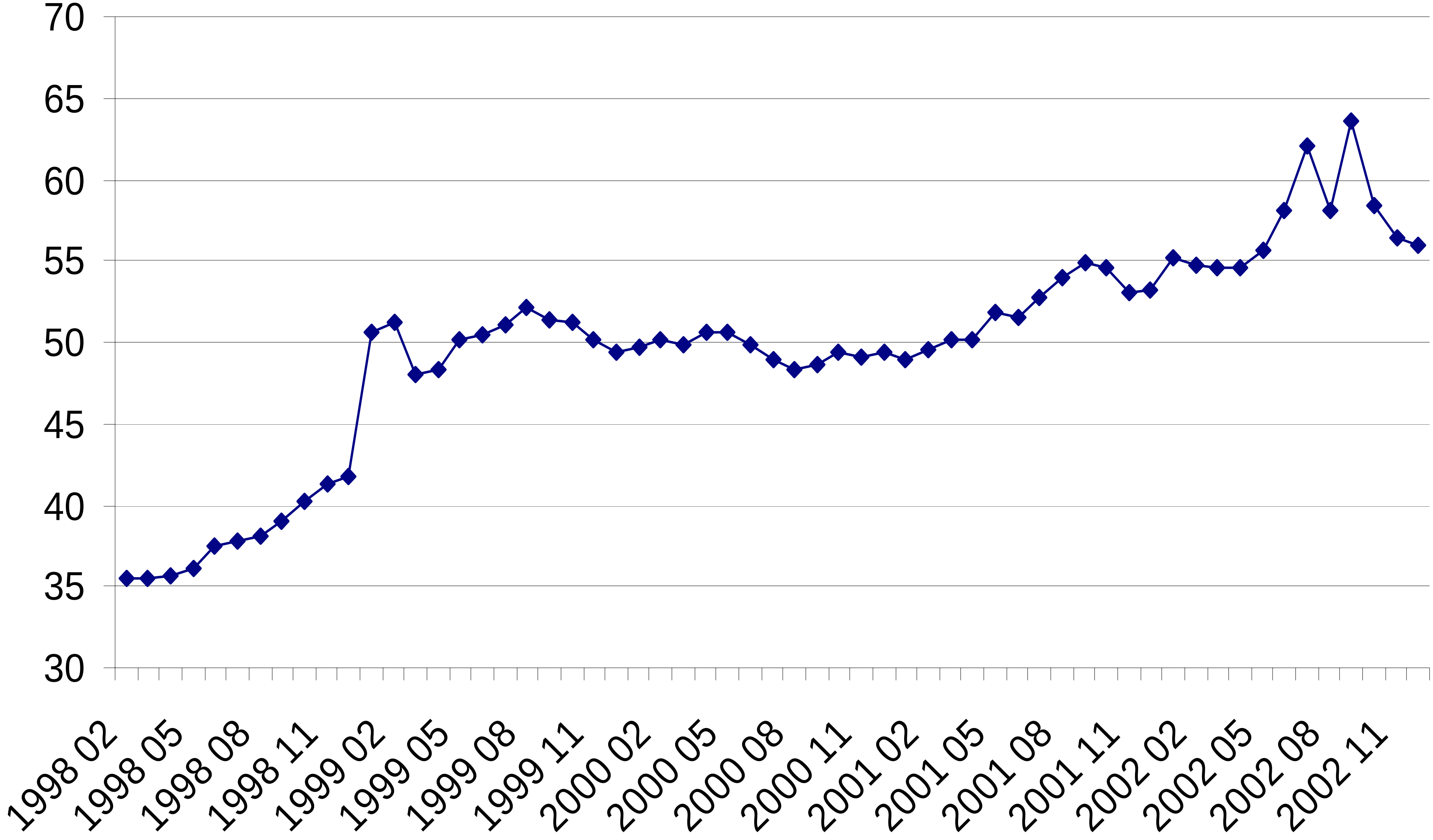
- Those shocks generated strong pressure for the depreciation of the Real.

Getting trapped by our own model…

- During the 1998-2002 period, the net public debt of the consolidated public sector in Brazil increased from 35.6% to 55.8% of GDP.

- Uncertainty about debt/GDP sustainability raised many doubts on the current economic policy mix…

Net public debt of the consolidated public sector



Getting trapped by our own model…

- Vicious cycle dynamics…

…When exchange rate devalues, public-debt-to-GDP ratio worsens (because some 30% of internal debt is US$ linked)

…Inflation Target regime requires higher interest rates to counterweight the impact on the exchange rate on inflation

Getting trapped by our own model…

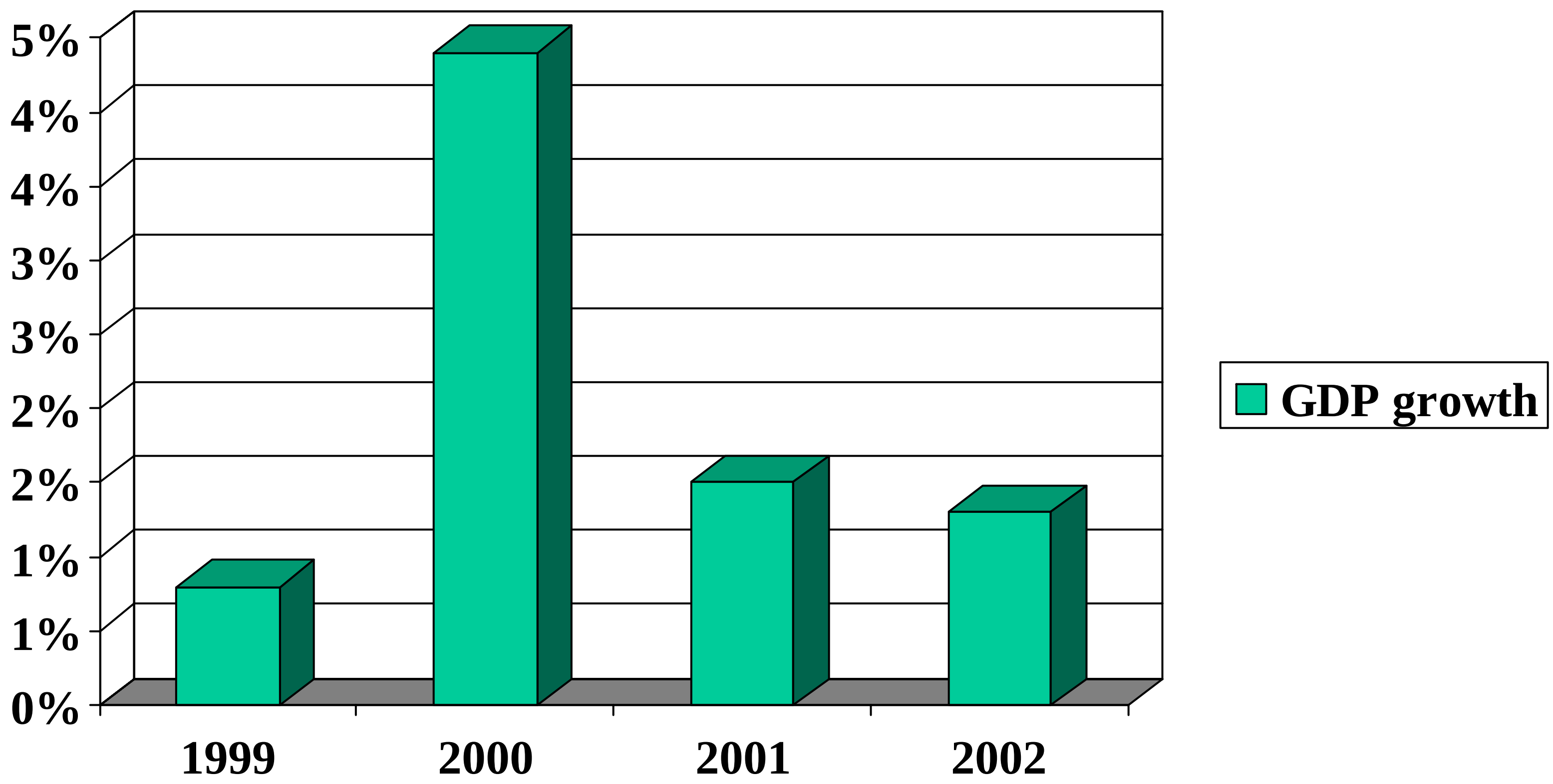
….Higher interest rates and weaker currency deteriorate debt/GDP ratio again!

- Therefore Brazil was unable to use fiscal and monetary policies as a countercyclical instrument to the adverse scenario.

Getting trapped by our own model…

- Therefore, the external crisis and monetary and fiscal policies responses were responsible for the faltering growth in the last two years…

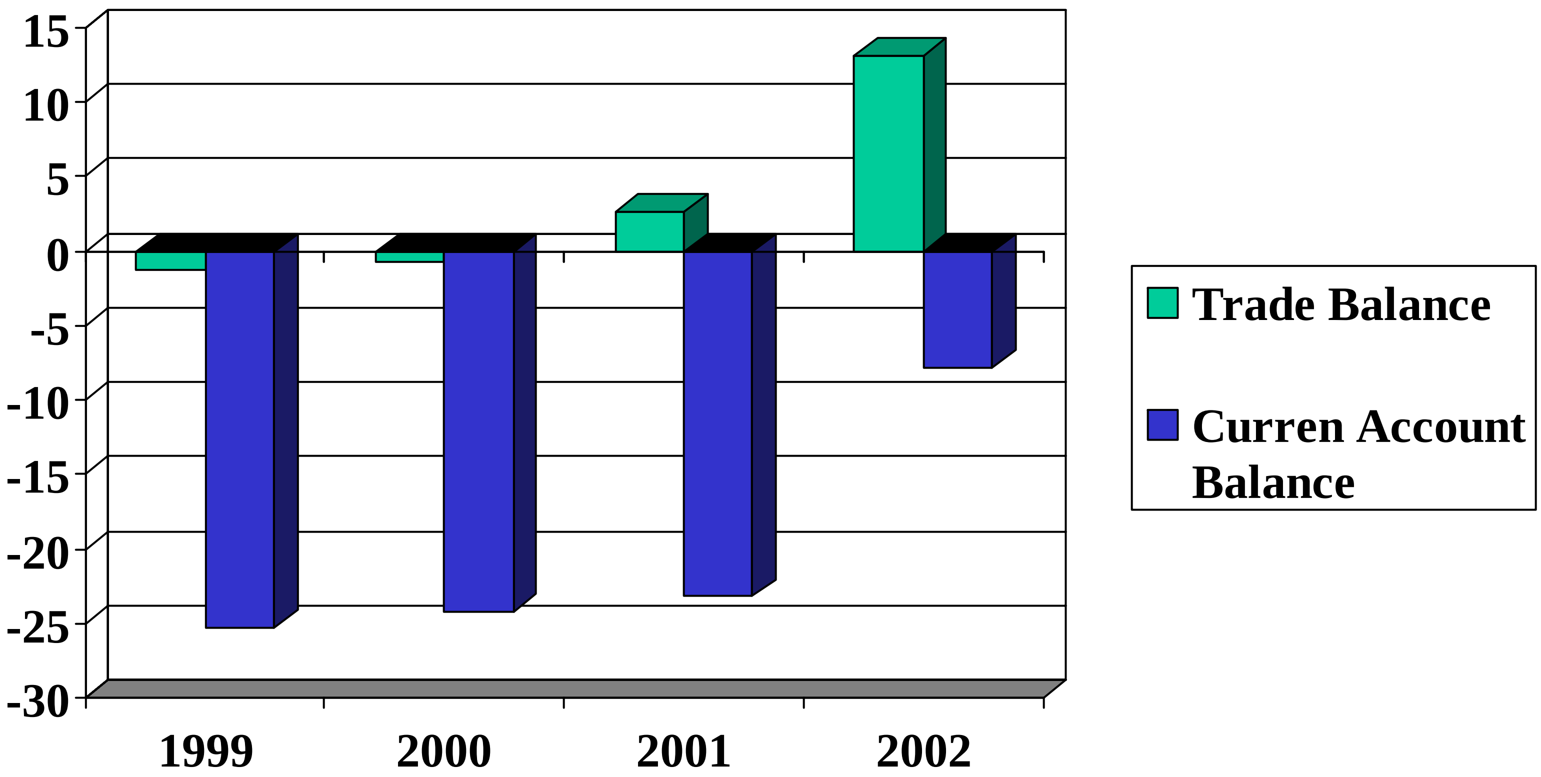
GDP growth



External Sector…

- However, lower growth and a weak Real produced substantial trade surplus…
- And finally the current account balance improved in 2002.

Trade Balance and Current Account Balance in US$ billions



Argentina…

Background information…

- By the end of 80’s Argentina had extremely high inflation rates…

- In 1991, Argentina adopted its convertibility plan, fixing exchange parity between the American dollar and the Argentinean peso (one peso = one dollar).

Background information…

- Another series of reforms was adopted in the 90s – a bold agenda was proposed ….
- And after few years, high inflation had been eliminated, and apparently the economy performed well in terms of GDP growth…

An adverse international scenario started in 1997…

- After 1997, things began not go so well:
- October/November 1997: Asian Crisis
- August/September 1998: Russian Crisis
- January/March 1999: Brazilian Crisis

An adverse international scenario started in 1997…

- These international crises have left their mark on Argentina since 1998 because …

a) Foreign capital started to decrease

b) The price of its commodities started to fall

…And the exchange rates were unfavourable to…

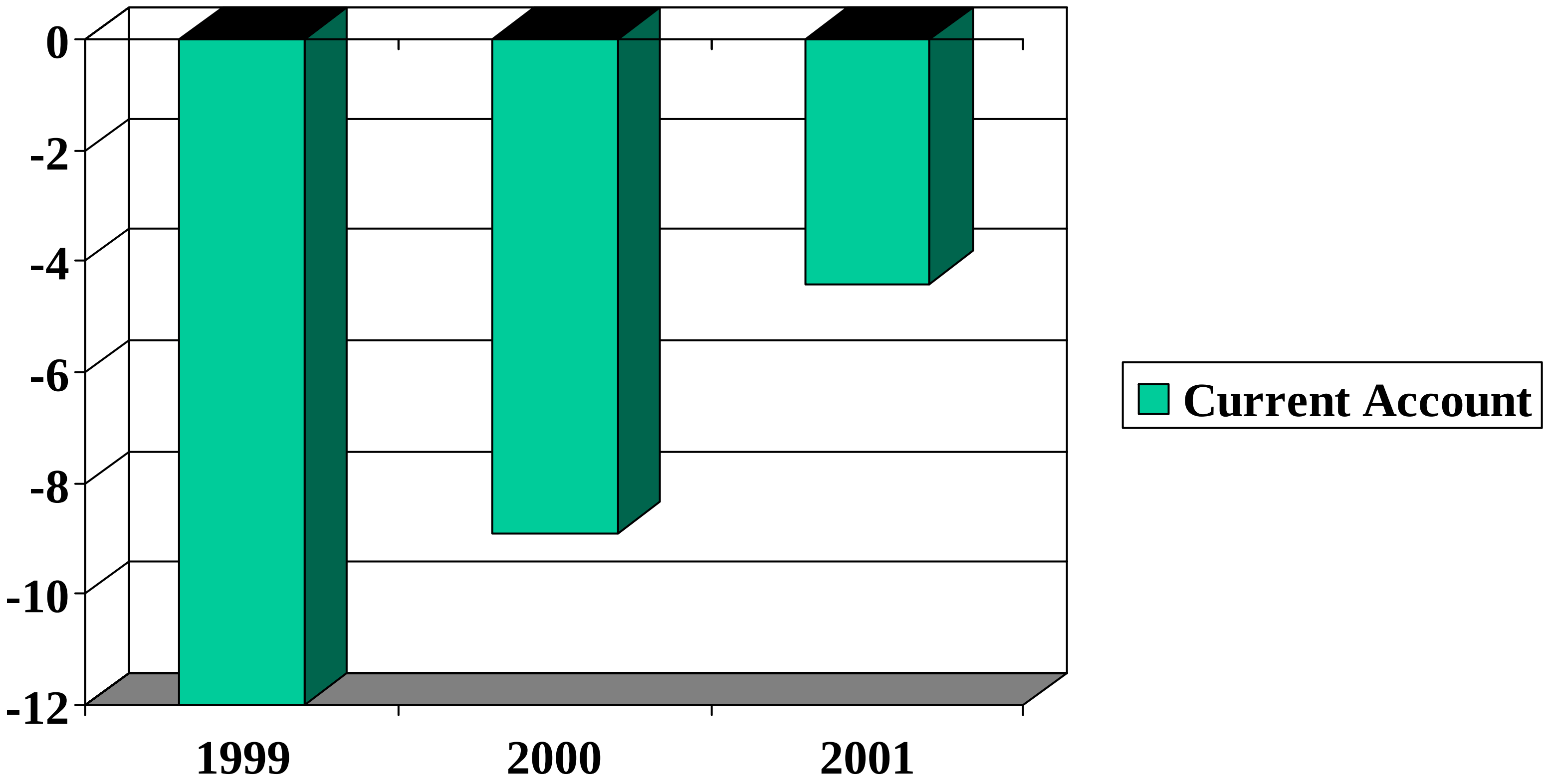
- Brazil - one of Argentina main trade partners – devalued its currency..
- European Union – another of its main partners.

Getting trapped by their own model…

- As the **financial capital** cease to flow in, and the **terms of trade** got worse, international reserves started to fall.

- As a consequence a reverse of the current account deficits was necessary.

Current Account (USD Billion)

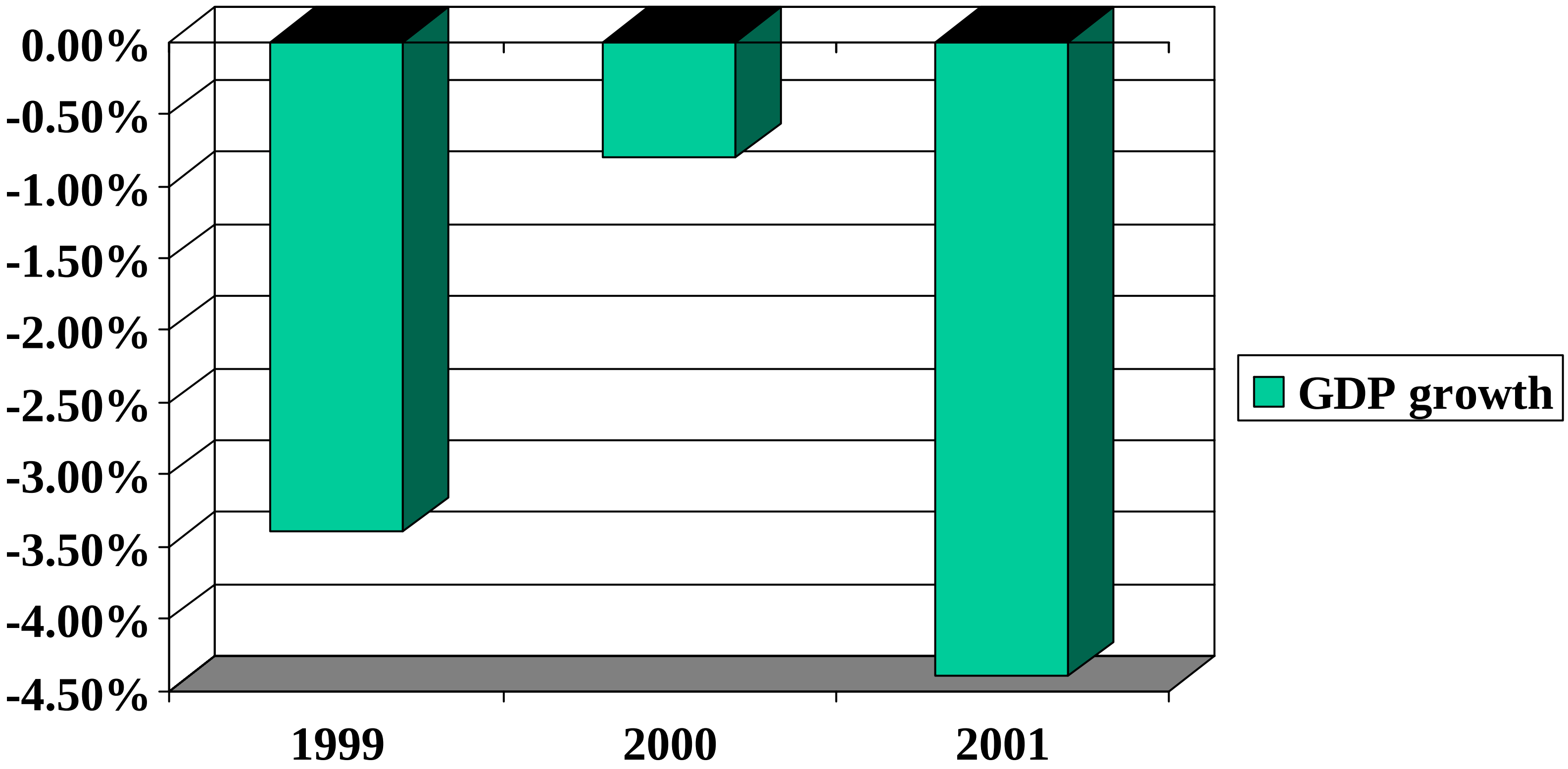


Getting trapped by their own model…

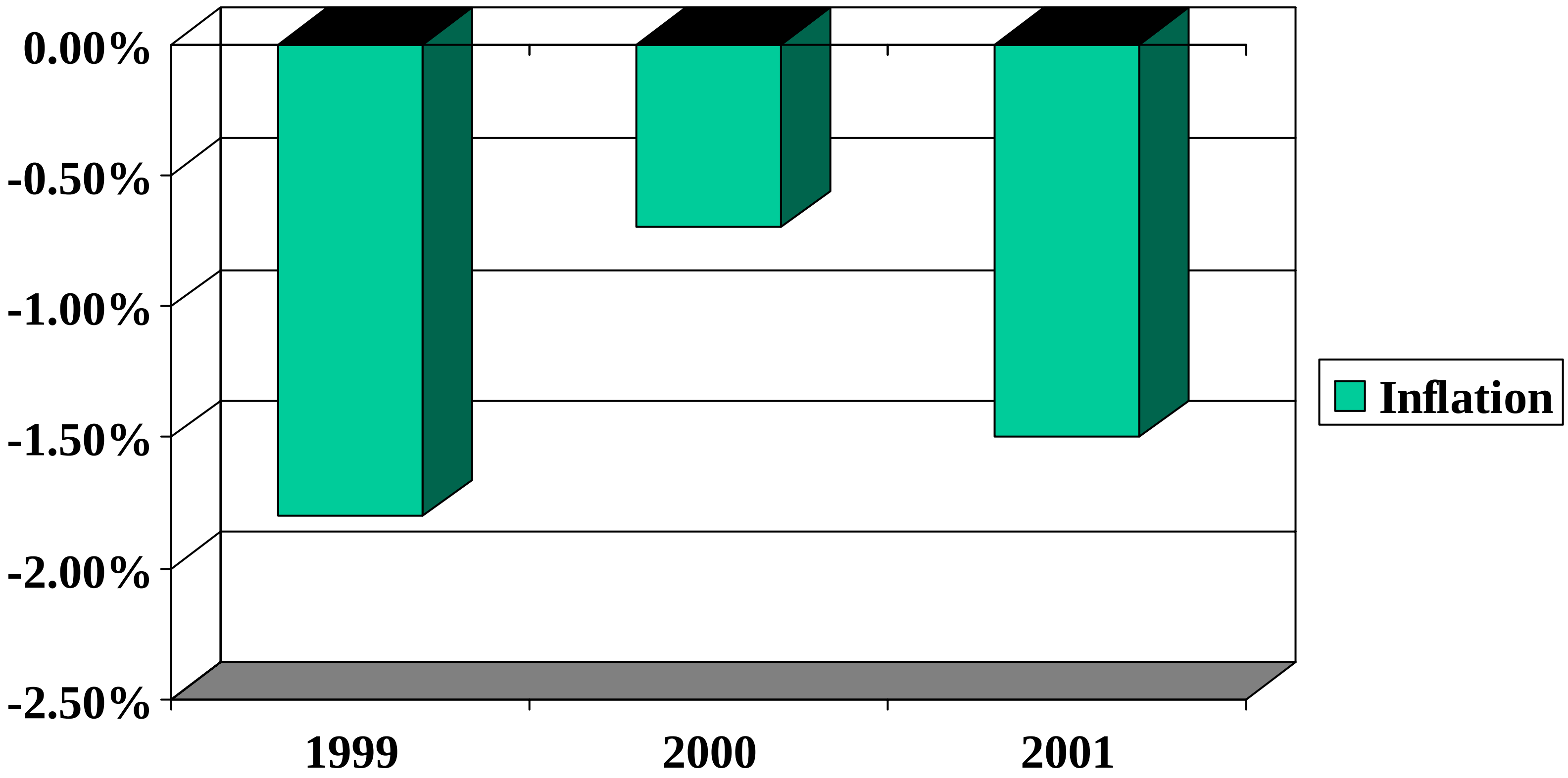
- And the contraction on the current account deficit leads to a drop in employment and production.

- Consistently, the domestic prices in this period fell.

GDP growth


0.00%
-0.50%
-1.00%
-1.50%
-2.00%
-2.50%
-3.00%
-3.50%
-4.00%
-4.50%
1999
2000
2001
GDP growth

Inflation (CPI)



Getting trapped by their own model…

- **In the the public sector**, the situation was not going well either.

- Govern sovereign bond were strong predominant over total public debt at the end of the 90s.

Getting trapped by their own model…

- **The financial sector was especially vulnerable**…

- In August 2001, facing imminent devaluation people began to withdraw their dollar deposits provoking a crisis in the financial sector.

The Argentinean Crisis in 2001

- At the end of 2001, a moratorium was declared on the external debt and the Convertibility plan came to an end.

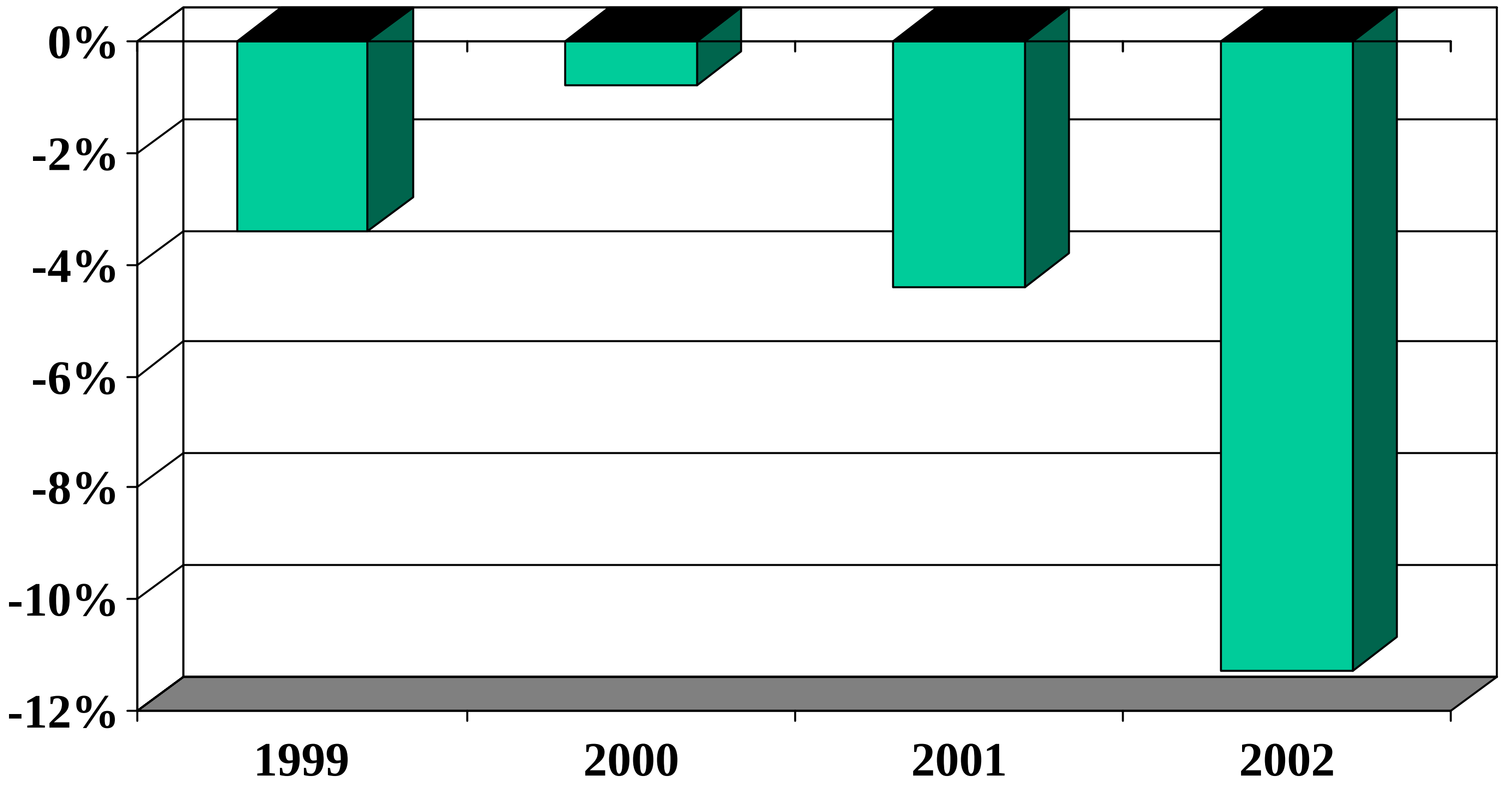
- Also, the *corralito* was implemented, which consisted of imposing a maximum limit on saver's withdrawals.

The Argentinean Economy in 2002

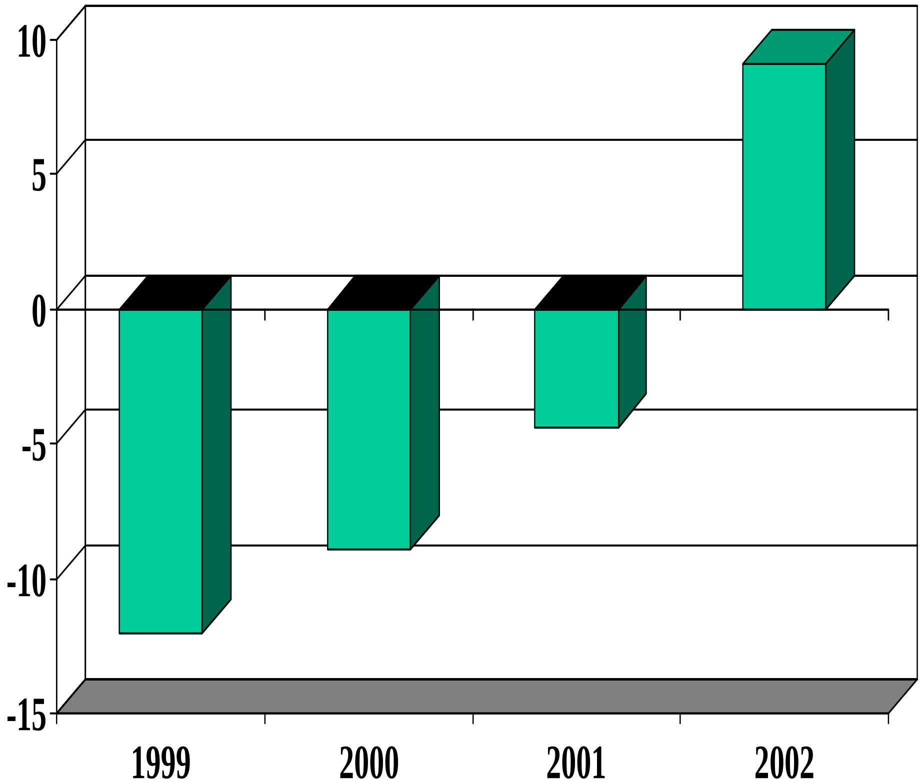
- In January 2002, Argentina adopted the floating exchange rate regime…

- And in the end of 2002 the main macro indicators were…

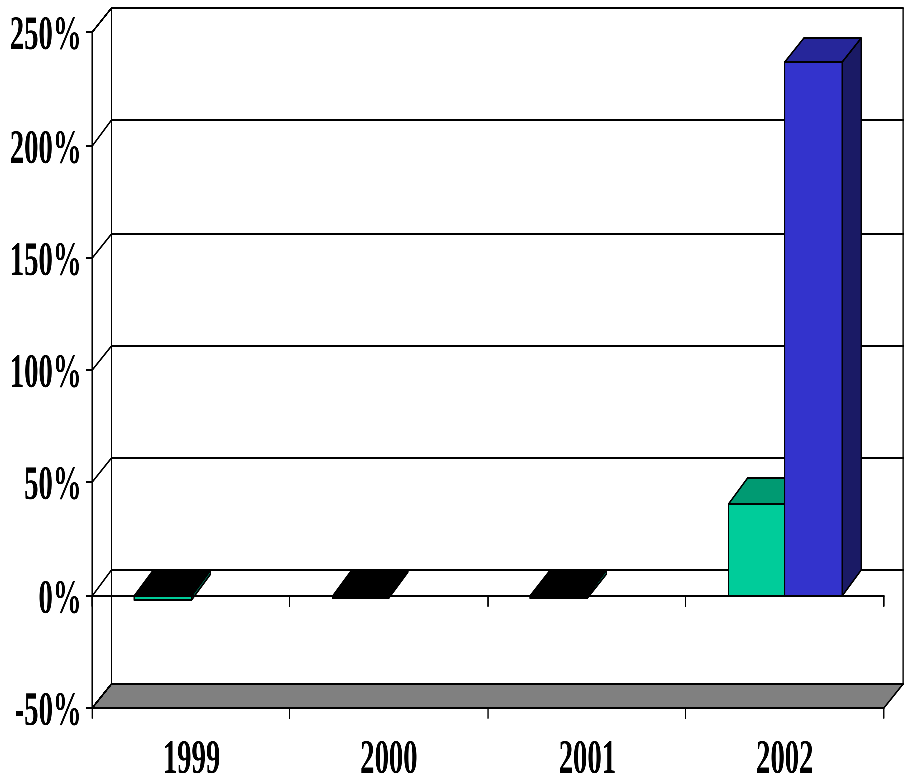
GDP growth



Current Account (USD billion)



Inflation and Exchange Rate Depreciation



Spillovers of the Argentinean Crisis in Uruguay and Paraguay

- Bank stampedes
- Credit mechanisms were falling apart
- **Steep devaluations**

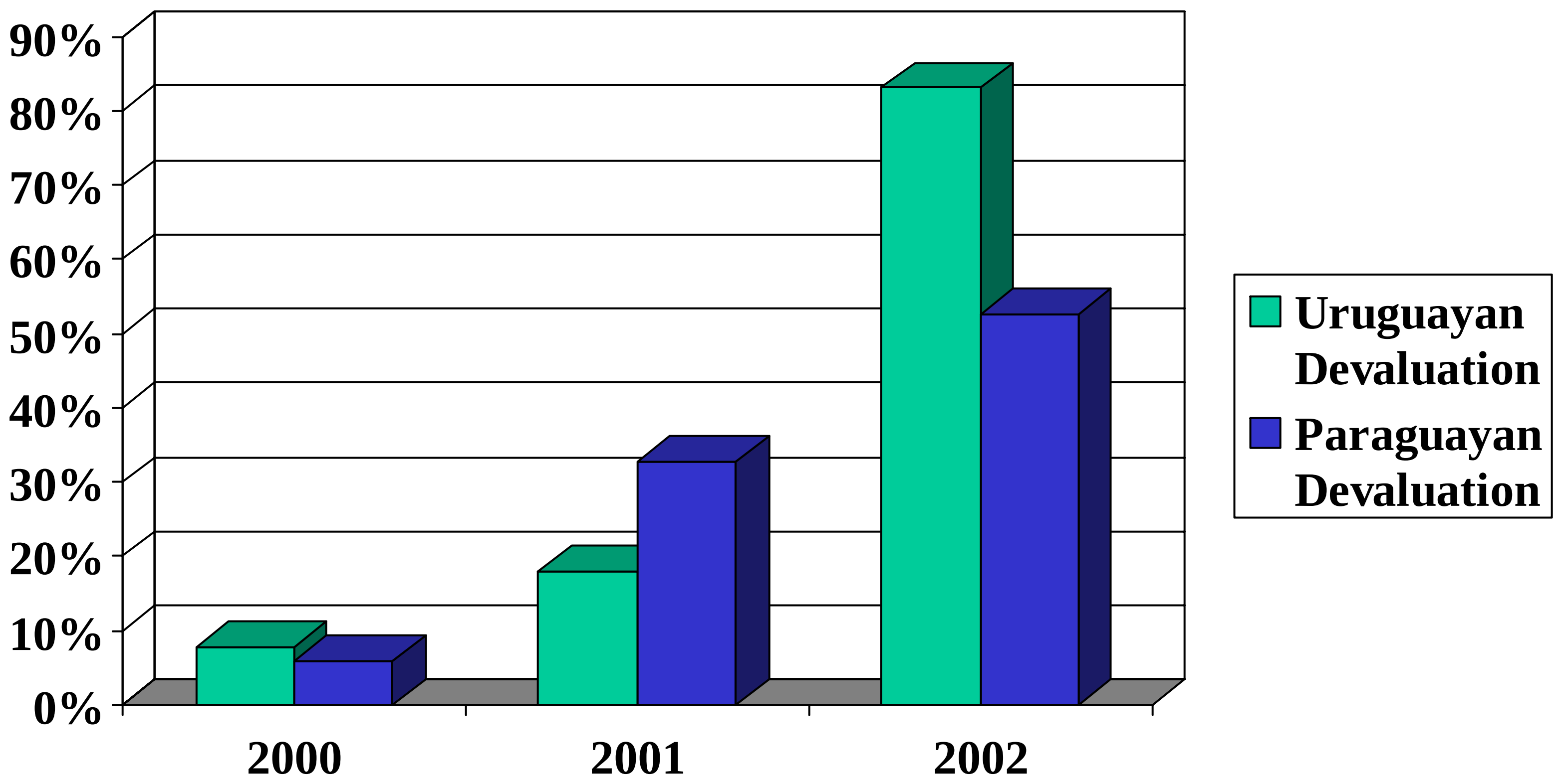
…in **Uruguay** and to some degree in **Paraguay.**

Spillovers of the Argentinean Crisis in Uruguay and Paraguay

- In particulary, Uruguay was forced to adopt a floating exchange rate regime.

- At the end of 2002, the Uruguayan and Paraguayan currencies devalued about 83% and 50%…

Exchange Rates Devaluations
-Uruguay and Paraguay-



Spillovers of the Argentinean Crisis in Uruguay and Paraguay

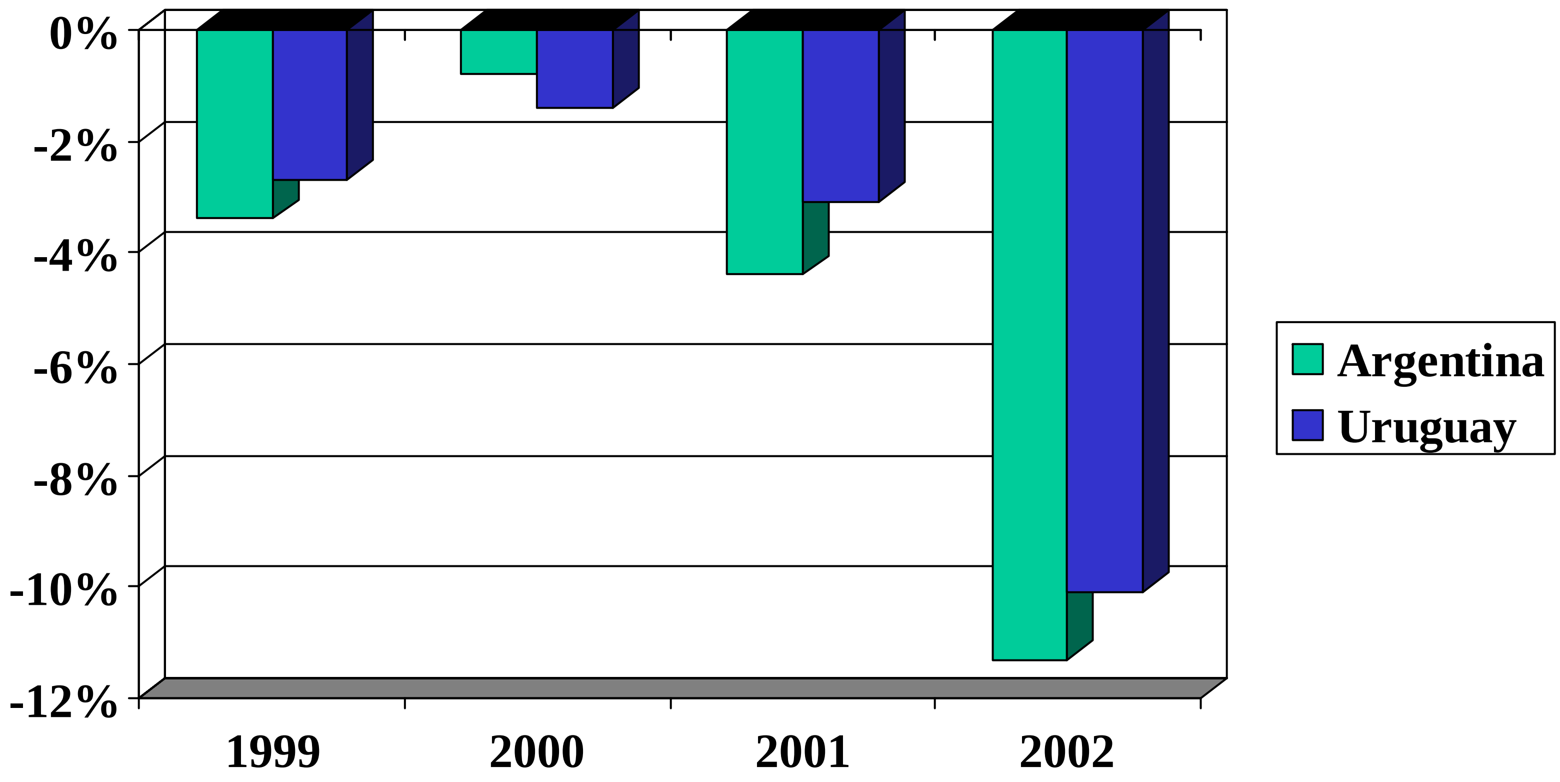
And unfortunately, this adverse international scenario was reinforced by pro-cyclical fiscal and monetary policies in both countries…

Spillovers of the Argentinean Crisis in Uruguay and Paraguay

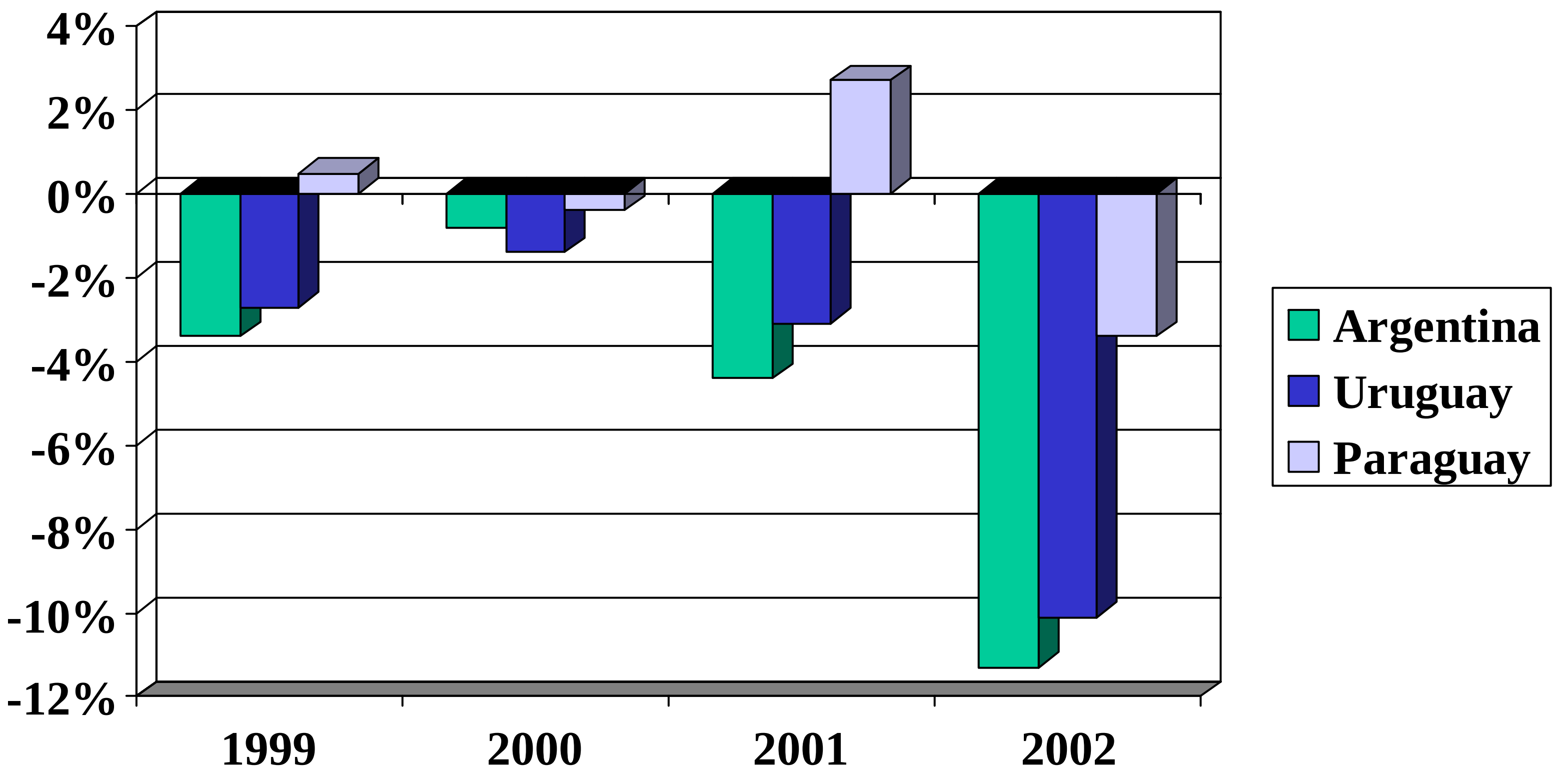
- The Argentinean crisis struck Uruguay particularly hard.

- The Paraguayan economy was also affected in a lesser way.

GDP growth
-Argentina and Uruguay-



GDP growth
-Argentina, Uruguay and Paraguay -



BRAZIL				
	1999	2000	2001	2002
GDP growth	0.80%	4.40%	1.50%	1.20%
Inflation (CPI)	8.94%	5.97%	7.67%	12.50%
Exchange Rate Depreciation	52.96%	6.45%	20.36%	53.66%
Fiscal Surplus (%GDP)				
(Primary)	3.28%	3.55%	3.75%	3.88%
Current Account				
USD Billion	-25.33	-24.22	-23.21	-11.1
%GDP	-4.77%	-4.08%	-4.61%	-2.69%

ARGENTINA				
	1999	2000	2001	2002
GDP growth	-3.40%	-0.80%	-4.40%	-11.30%
Inflation (CPI)	-1.80%	-0.70%	-1.50%	41.00%
Exchange Rate Depreciation	0.00%	0.00%	0.00%	236.50%
Current Account				
USD Billion	-12.00	-8.90	-4.40	9.10

URUGUAY				
	1999	2000	2001	2002
GDP growth	-2.70%	-1.40%	-3.10%	-10.10%
Inflation (CPI)	4.10%	5.10%	3.60%	27.00%
Exchange Rate Depreciation		7.75%	17.97%	83.14%
Current Account				
USD Billion	-0.5	-0.6	-0.5	-0.1

PARAGUAY				
	1999	2000	2001	2002
GDP growth	0.50%	-0.40%	2.70%	-3.40%
Inflation (CPI)	5.40%	8.70%	8.30%	15.70%
Exchange Rate Depreciation		5.95%	32.75%	52.71%
Current Account				
USD Billion	-0.2	-0.3	-0.2	-0.4