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Latin America and the Caribbean: economic situation and outlook, 2007-2008

Summary

The favourable economic conditions and strong growth performance the Latin American and the Caribbean region has been enjoying virtually across the board since 2003 continued in 2007. The region was confronted with a worsening external financial situation, however, caused by a high level of volatility in international financial markets and rising uncertainty, both largely the result of the crisis originating in the financial market of the United States of America. Despite this, most of the region's economies continued to grow at a brisk pace thanks to strong domestic demand, which was driven by private consumption and gross capital formation. In this context, Latin America and the Caribbean registered a growth rate of 5.7 per cent in 2007; the region has thus been growing at rates in excess of 4.5 per cent for four years running.

The region continued to feel the benefits of strong external demand and of the high prices being fetched by its main export products. In regional terms, the volume of goods and services exported increased by 5.3 per cent and terms of trade were up by 2.4 per cent. These increases, combined with a rise in remittances from abroad, swelled the region's gross disposable national income in 2007 at a rate (6.5 per cent) that, like in 2006 and 2005, outstripped gross domestic product (GDP) growth.

In 2008, growth is expected to slacken slightly, with regional GDP rising by around 4.7 per cent. If these projections are borne out, the region's per capita output will have seen a cumulative increase of about 22.5 per cent in the period 2003 to 2008, equivalent to an average of 3.4 per cent per year.

* E/2008/100.

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I. Introduction

1. The economy of the Latin American and Caribbean region grew by 5.7 per cent in 2007, equal to a 4.3 per cent rise in per capita gross domestic product (GDP) (see table 1).

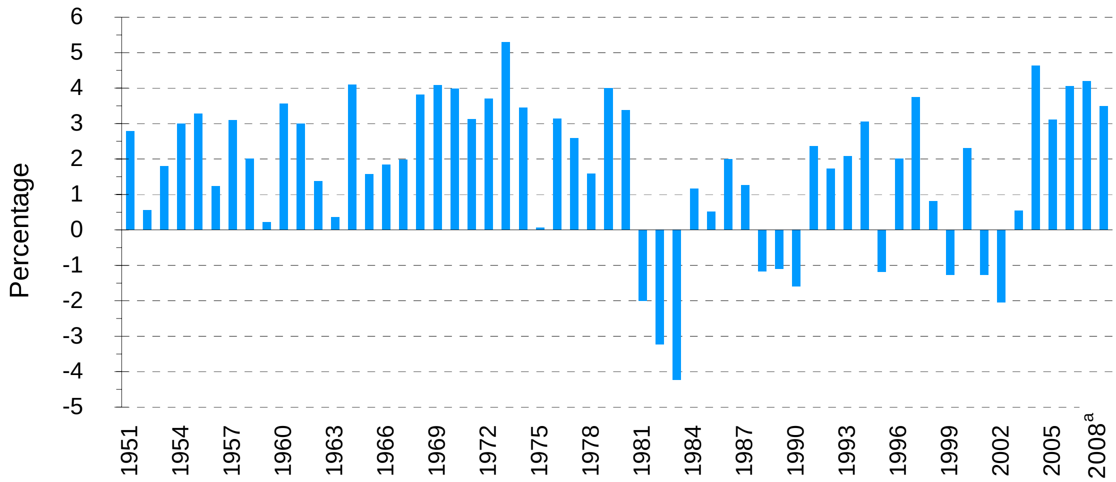
Table
Gross domestic product growth rates
(Constant 2,000 United States dollars, percentage)

Country	*2005*	*2006*	*2007*
Argentina	9.2	8.5	8.7
Bolivia	4.0	4.6	4.6
Brazil	2.9	3.7	5.4
Chile	5.7	4.0	5.1
Colombia	4.7	6.8	7.5
Costa Rica	5.9	8.2	6.8
Cuba[a]	11.8	12.5	7.5
Dominican Republic	9.3	10.7	8.5
Ecuador	6.0	3.9	2.7
El Salvador	3.1	4.2	4.7
Guatemala	3.5	4.9	5.7
Haiti	1.8	2.3	3.2
Honduras	4.1	6.0	6.3
Mexico	2.8	4.8	3.3
Nicaragua	4.3	3.7	3.8
Panama	7.2	8.7	11.2
Paraguay	2.9	4.2	6.0
Peru	6.7	7.6	9.0
Uruguay	6.6	7.0	7.4
Venezuela (Bolivarian Republic of)	10.3	10.3	8.4
Subtotal Latin America[b]	**4.6**	**5.5**	**5.7**
Subtotal Caribbean	**4.7**	**6.9**	**3.9**
Latin America and the Caribbean[b]	**4.6**	**5.6**	**5.7**

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] Data provided by the National Statistical Office of Cuba.
[b] Does not include Cuba.

2. Thus, 2007 marked the fifth consecutive year of growth and the fourth at a rate of over 4 per cent. The last period of sustained per capita GDP growth of over 3 per cent per year occurred 40 years ago, in the period between the late 1960s and the first oil price shock of the early 1970s, when the region's economy expanded at comparable rates for seven years in a row (see figure I).

Figure I
Latin America and the Caribbean: per capita gross domestic product
(Annual growth rates)



Source: ECLAC, on the basis of official figures.
[a] Projection.

3. In 2008 growth is expected to slacken slightly, with growth of around 4.7 per cent in regional GDP. If this occurs, per capita GDP in the region will have increased around 22.5 per cent in the period from 2003 to 2008, equivalent to an average of 3.4 per cent per year.

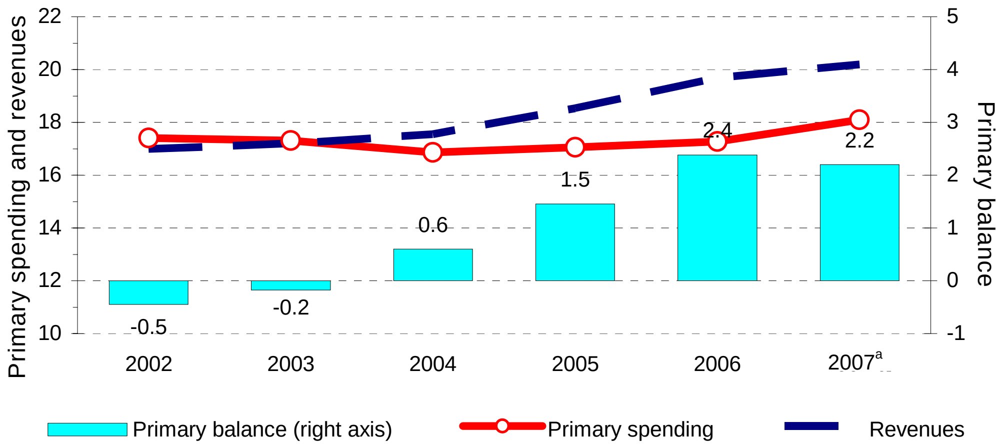
4. In the past few years, the world economy has experienced exceptional growth rates, growing at over 3 per cent annually for four years running. Thus, the performance of the Latin American and Caribbean economies is not an isolated occurrence but is taking place rather against a general backdrop of growth. In this connection, it should be noted that, while the region's growth rates are high by historic standards, they are not high by comparison with those in other regions of the developing world.

5. During 2007, many of the characteristics of the current economic growth phase continued to be observed. These features include a continuing (albeit substantially smaller than in 2006) current-account surplus, a further (although less marked) improvement in the terms of trade, a continuing positive primary balance in fiscal accounts, falling unemployment, rising international reserves and lower external debt as a percentage of GDP. However, some alterations in the trends of recent years have been observed, which undoubtedly represent an economic policy challenge. Some of the developments include a steeper increase in public spending, which represents a setback in relation to the overall fiscal balance achieved by the region in 2006; a weakened momentum of the exports of goods, whose volume grew by less than GDP for the first time in many years; a rise in inflation, which interrupted the downward trend of the past four years; and an increase in the sovereign risk of the region's countries against the backdrop of the financial market turbulence that began in May 2007.

II. Economic policy

6. Some of the characteristics of 2007 differed from those of the 2002-2006 period, since the latter was characterized by a growing primary surplus, a falling overall deficit and a sustained decline in public debt. The improvement in fiscal balances resulted essentially from revenues rising faster than public spending. While the region's countries once again achieved a large primary surplus (see figure II), it was lower than in 2006. This can be attributed to a slacker increase in revenues (which rose by 0.4 GDP points) and a faster growth in spending (which rose by 0.7 GDP points).

Figure II
Latin America and the Caribbean: central Government revenues, primary spending and primary balance (Percentage)



Source: ECLAC, on the basis of official figures.
[a] Preliminary figures.

7. At the level of central Governments, the fiscal performance of the region's countries indicated that they were running primary surpluses averaging 2.2 per cent of GDP (simple average) at the end of 2007, compared with a surplus of 2.4 per cent in 2006. Conversely, the overall balance, which includes interest payments on the public debt, worsened from 0.1 per cent to -0.1 per cent of GDP.

8. The above-mentioned average primary surplus reflects a fiscal performance that is common to almost all the countries in the region. Of the 19 countries for which information is available, 16 achieved a primary surplus in 2007 (only Haiti, Honduras and Guatemala ran a primary deficit). This is a major contrast to the situation in 2002, when just eight countries presented a surplus. Despite these results, the number of countries showing a deterioration in their fiscal balance increased. In 2007, 12 of the 19 countries analysed recorded a larger deficit or a smaller surplus. This stands in contrast to the situations in 2006 and 2005, when most of the countries recorded an improvement in their indicators. Fuller coverage of some selected countries also reveals a deterioration in the primary balance of the non-financial public sector, which fell on average from 4.1 per cent to 3.3 per cent of GDP between 2006 and 2007.

9. A number of factors have come together in the past few years to raise the fiscal revenues of the countries in the region: a substantial increase in economic activity, which has major implications for tax collections; low inflation in most of the countries; improved tax collection mechanisms; and higher prices for certain commodities, which generated larger volumes of fiscal revenues for producer countries.

10. Governments have developed a variety of fiscal mechanisms for appropriating some of these resources. In the case of agricultural products, Argentina has financed some of its spending from resources generated by export duties. A similar situation has occurred in countries that produce large amounts of non-renewable resources since their Governments have created mechanisms to capture revenue, in particular in the cases of Bolivia, Chile and Venezuela (Bolivarian Republic of).

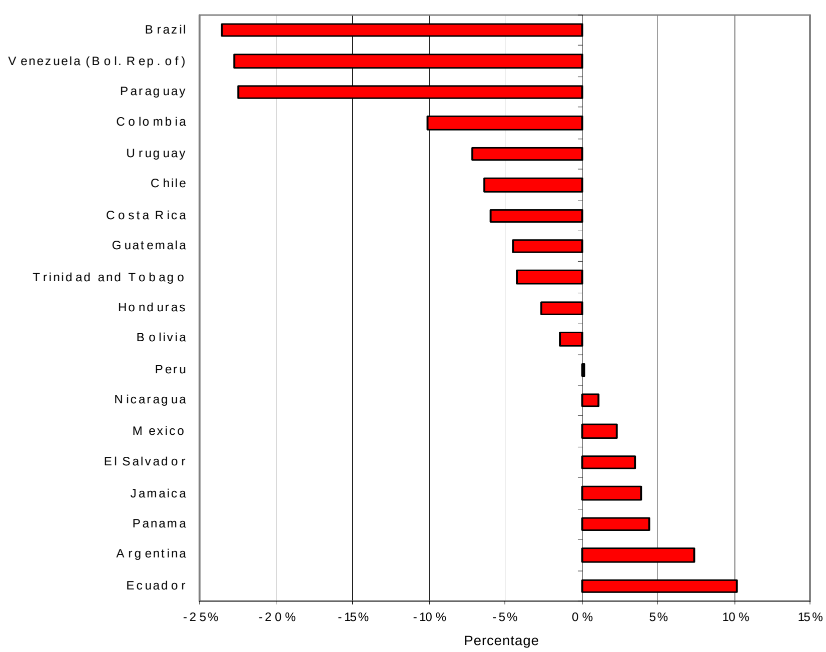
11. Expressed as a simple average of the countries of the region, the central Government public debt/GDP ratio fell to 31.8 per cent of GDP in 2007, from 37.6 per cent in 2006. The debt structure of the countries has been improving greatly in recent years as foreign currency debts have been reduced and the repayment terms of local currency debts extended.

12. In terms of exchange rate policy, the real effective currency appreciation observed in 2006 continued in 2007, in particular in South America. The extraregional exchange rate of Latin America and the Caribbean (which excludes trade among the countries in the region) appreciated by 2.7 per cent, with effective appreciations registered in 11 countries during the period. Figure III shows the evolution of total effective exchange rates since 2005 and the process of exchange rate appreciation in the region.

Figure III

Latin America and the Caribbean: total real effective exchange rate variation

(Average for 2007 compared to average for 1990-1999)



Source: ECLAC, on the basis of official figures.

13. Together, the countries of South America recorded an appreciation of 4.8 per cent, while Central America, Mexico and the Caribbean registered an effective extraregional appreciation of 0.3 per cent during the period. Currency appreciation in South America in 2007 occurred in a context where the commodities exported by the subregion were fetching high prices and a number of countries were receiving substantial capital inflows.

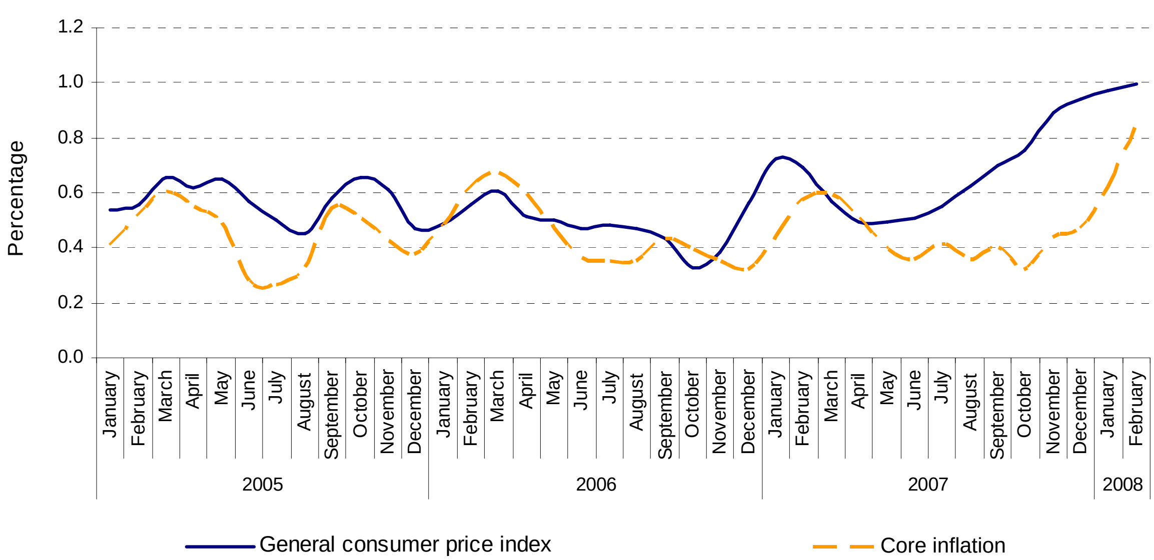
14. Although inflation in the region in 2007 was still low by historical standards, countries with an inflation target regime (including Brazil, Chile, Colombia, Mexico, Paraguay and Peru) or an inflation target range (such as Costa Rica, Guatemala and Honduras) saw consumer prices increase by more than the inflation target set by their central banks. In a number of countries, even core inflation came in over target. Most of the central banks reacted by raising interest rates. As the United States Federal Reserve lowered its monetary policy rate and the countries of the Latin America and Caribbean region increased theirs, the yield differential widened. Despite this, interest rates in the region have remained low by comparison with historic rates; this has contributed to a strong rise in bank lending, in particular consumer lending, which was the type of credit to increase the most, and mortgage lending.

15. The inflation rate in Latin America and the Caribbean was 6.4 per cent in 2007, which represents an increase over 2006 (5.0 per cent), cutting short the gradual decline in this indicator at the regional level since 2002 (see figure IV). It also reflects the sharp rise in prices for some goods and services, including food (especially cereals, oleaginous products and oils, meat and some beverages), fuels and basic services. The situation was compounded in some countries by supply constraints. In several countries, currency appreciation partially offset the effect on domestic prices of the higher prices of imported products.

Figure IV

Latin America and the Caribbean: monthly variation in consumer price indexes and core inflation

(Unweighted three-month moving averages)



Source: ECLAC, on the basis of official figures.

16. Trends in inflation and the behaviour of the exchange rate have presented the region's economic authorities with certain policy dilemmas. Further hikes in interest rates to curb inflationary pressures will contribute to further currency appreciation. This judgement is largely based on the higher level of real interest rates which, together with good country risk ratings, has helped to increase capital inflows. The capital inflows, combined with the larger currency inflows associated with increased exports, have led to increases in international reserves and hence in monetary aggregates, forcing central banks to redouble their efforts to soak up liquidity, with the resulting cost in terms of monetary policy. Whether the dilemma between inflation and appreciation continues into 2008 depends on a number of factors, in particular the monetary policy of the United States Federal Reserve and the perception of central banks concerning the causes of rising inflation.

III. Domestic performance

17. In 2007, the economic growth tendencies of earlier years continued and the expansion spread to all the countries in the region; while several countries experienced higher growth rates than in 2006, others slowed down. The following had higher growth rates: Brazil, 5.4 per cent (3.7 per cent in 2006), Chile 5.1 per cent (4.0 per cent in 2006), Panama 11.2 per cent (8.7 per cent in 2006), Paraguay 6.0 per cent (4.0 per cent in 2006) and Peru 9.0 per cent (7.6 per cent in 2006). In Mexico, economic activity slowed down, with the growth rate falling from 4.8 per cent in 2006 to 3.3 per cent in 2007. Although the rate of GDP growth in the Dominican Republic and Venezuela (Bolivarian Republic of) declined in 2007, these countries are still among those that are expanding strongly in the region. Panama and Peru had the highest growth rates, followed by Argentina (8.7 per cent), the Dominican Republic (8.5 per cent), and Venezuela (Bolivarian Republic of) (8.4 per cent). The countries with the lowest rates were Mexico (3.3 per cent), Haiti (3.2 per cent) and Ecuador (2.7 per cent). Taken together, the English- and Dutch-speaking Caribbean countries registered a growth rate of 3.9 per cent (6.9 per cent in 2006).

18. Despite growing turmoil and increased volatility in the international markets during 2007 and uncertainty about developments in the economy of the United States of America, the region's economies continued to perform well. Their expansion occurred against the backdrop of trends in the other economic regions during the last few years, specifically a general pattern of growth, high liquidity and easy access by emerging economies to international capital markets. High external demand for the region's export commodities and high international prices for them have led to a considerable rise in export receipts, which in most of the countries has also meant an increase in fiscal revenues. Growth has also been occurring within the context of renewed domestic demand in a number of the countries, driven by higher disposable national income and a recovery of previous levels. In a number of countries, it was not until 2005 (Panama and Venezuela (Bolivarian Republic of)) or 2006 (Argentina, Brazil, Dominican Republic and Peru) that gross fixed capital formation returned to earlier levels.

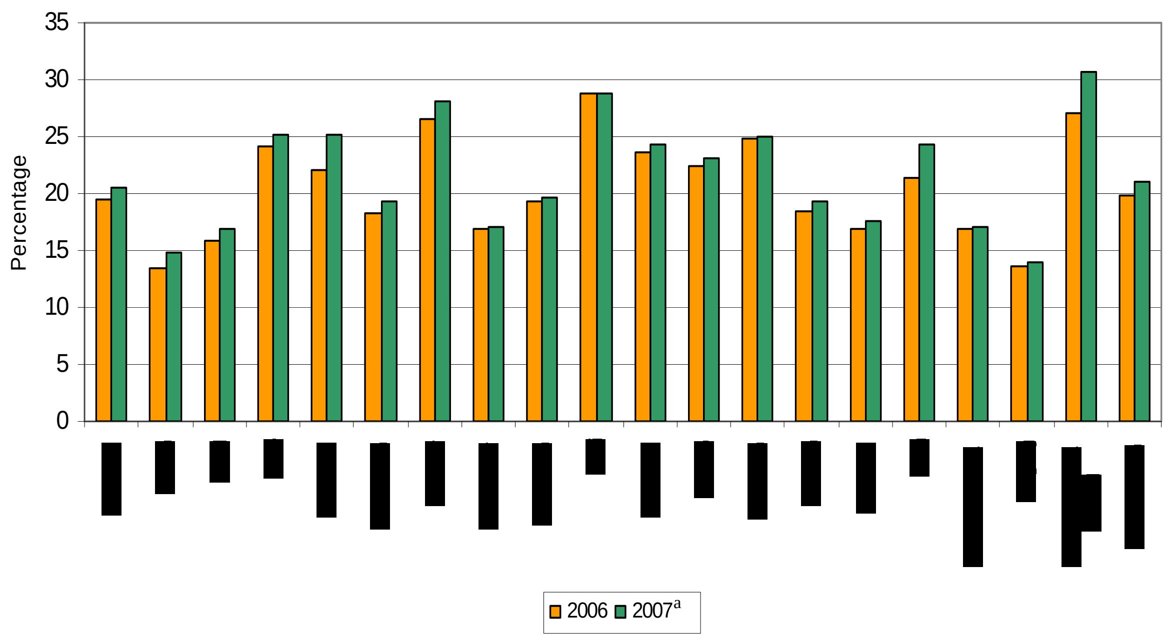
19. The volume of goods and services exported by the region continued to expand in 2007 (5.3 per cent), although that growth has slowed during the past three years. Meanwhile, domestic demand continued to grow at high rates (7.7 per cent) owing to a substantial increase in private consumption (6.8 per cent), driven by improved employment indicators, a modest rise in real wages, persistently low interest rates in

a number of countries, which provided a stimulus to consumer lending, and currency appreciation, which brought down the prices of imported final consumption goods.

20. The rate of expansion in 2007 in gross fixed capital formation (12.2 per cent) was similar to the rate in 2006 (12.9 per cent), making this the component of demand that had grown the most over the past four years; indeed, regional gross fixed capital formation grew by a cumulative 59 per cent between 2003 and 2007. The rise in regional fixed capital investment is due mainly to the rapid growth of investment in plants and equipment, most of it imported, a development due in part to the appreciation of most of the countries' currencies against the United States dollar and by rising domestic and external demand. Meanwhile, the construction sector slowed slightly.

21. Regional gross fixed capital formation, expressed as a percentage of GDP and in constant dollars, continued to increase, reaching 21.1 per cent in 2007, as compared to 19.9 per cent in 2006. This is still considerably lower than the levels reached in the 1970s but it represents a substantial increase over the lows of 2002 (16.8 per cent) and 2003 (16.4 per cent). The regional total is heavily influenced by the figures from Brazil, which accounts for about 30 per cent of the region's gross fixed capital formation and has one of its lowest investment ratios (16.9 per cent), along with Bolivia, the Dominican Republic, El Salvador, Paraguay and Uruguay (see figure V).

Figure V
Latin America: gross fixed capital formation as a percentage of GDP[a]
(Constant 2000 United States dollars)



Source: ECLAC, on the basis of official figures.
[a] Estimate.

22. In current dollars, regional investment has also continued an upward trend. Expressed as a percentage of GDP, gross fixed investment rose to 20.7 per cent in 2007, from 20.2 per cent in 2006. As in earlier years, the levels of investment were financed entirely out of national saving, given the persistence of negative external saving in the region. The national saving rate in the region was 21.2 per cent in 2007 (21.8 per cent in 2006), while the negative external saving, which has been a feature of the region since 2003, narrowed from -1.7 per cent of GDP in 2006 to -0.7 per cent. The sharp rise in domestic demand in the region was reflected in a rising volume of goods and services imports (13.4 per cent). Given that this aggregate has been consistently rising faster than the volume of goods and services exports since 2004, net exports have been making an increasingly negative contribution to regional GDP growth.

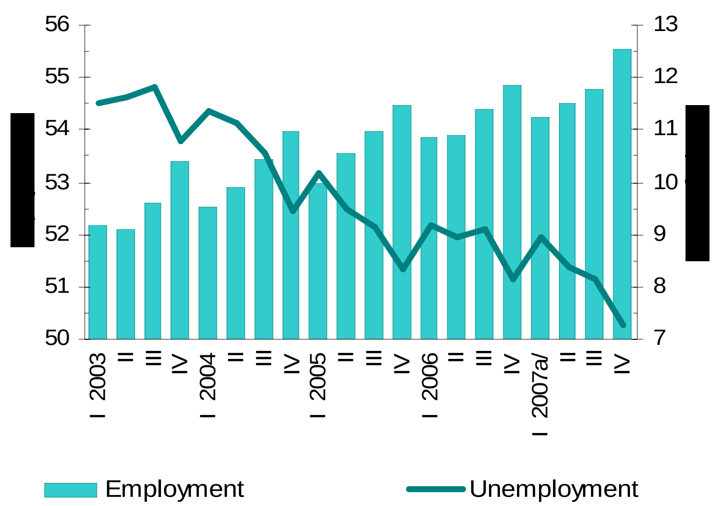
23. Growth in demand had its counterpart in the performance of the various sectors of economic activity. Regionally, the most dynamic sectors were transport and communications, construction, trade, and financial and business services. Greatly improved cereal harvests (Argentina, Paraguay) and the growing of export crops (Costa Rica, Honduras, Panama) resulted in a substantial expansion of the agricultural sector; in other countries, poor weather conditions affected performance (Bolivia, Chile). Mining expanded only very modestly in the region as a whole, although output in Chile rose as new workings came on stream. The industrial sector continued to grow at about the same rate as in 2006, owing to rising domestic and external demand. At the regional level, the performance of the construction sector was uneven. Argentina, Colombia, Chile, Costa Rica, Ecuador, Guatemala, Honduras, Mexico, Nicaragua, Paraguay, Uruguay and Venezuela (Bolivarian Republic of) saw a marked slowdown in this sector, although some of them posted double-digit growth rates (Colombia, Costa Rica, Dominican Republic, Panama, Peru and Venezuela (Bolivarian Republic of)). At the same time, the upswings in domestic credit, financial transactions and domestic economic activity were reflected in the expansion of financial and business services. The momentum of the international economy and the stronger growth in general in the Latin American countries helped to drive an increase in recreational and business travel. In 2007, tourist arrivals were up by 10.3 per cent in Central America and 8.1 per cent in South America and down by 1 per cent in the Caribbean. Sharp rises in commodity prices and in the export revenues of the region’s countries meant that, region-wide, the terms of trade effect remained favourable in 2007. Although many imported products rose in price, in particular food and energy, the prices of manufactures increased only very slightly, so that the purchasing power of the region’s exports continued to grow. The trade gains resulting from the improvement in the terms of trade amounted to 3.7 per cent of GDP in 2007 (3.1 per cent in 2006), the main beneficiaries being the South American countries and Mexico.

24. This situation, combined with a slight drop in net factor payments to the rest of the world (although these are still high) and a steady increase in net current transfers from the rest of the world, meant that gross disposable national income in the region’s countries rose by more than GDP for the fifth year running, increasing by 6.5 per cent in 2007 (7.1 per cent in 2006). In terms of the subregional picture, however, this aggregate expanded at a slower rate than economic activity in the Central American countries, owing to slower growth in emigrant remittances and the negative impact of the terms of trade.

25. The need to create sufficient high-quality jobs continues to be one of the main concerns in the region. Job creation remained high in 2007, with the regional employment rate rising by 0.5 percentage points, from 54.1 per cent to 54.6 per cent of the working-age population. The labour participation rate edged up from 59.4 per cent to 59.5 per cent; the rise in the employment rate was thus reflected in a further fall in the unemployment rate, from 8.6 per cent to 8.0 per cent (see figure VI). The unemployment rate not only fell again in the region as a whole but also in 16 out of the 18 countries for which information was available. In the past five years, unemployment in the region has dropped by three percentage points, coming close to the levels of the early 1990s. The number of urban unemployed fell by about 800,000 in 2007, leaving the total of urban unemployed people at a little less than 17 million. This reveals a continuing situation of very serious unemployment, closely linked to high, though falling, levels of poverty.

26. Real wages showed only a slight increase in most of the countries, continuing the tendency observed in the current period of economic growth for labour dynamics to be reflected in job creation, but to a much lesser extent in wages.

Figure VI
Latin America (9 countries): Quarterly employment and unemployment rates
(Weighted average, percentage)



Source: ECLAC, on the basis of official figures.

27. Developments in labour supply were uneven. While labour participation rates rose in a number of countries, they fell in Argentina, Mexico and Venezuela (Bolivarian Republic of). In most of the countries that posted a rise in labour-market participation, the increase was, as in earlier years, related to increased participation by women; while the rate for men, however, continued its slow decline, mainly as a result of young men staying longer in the education system.

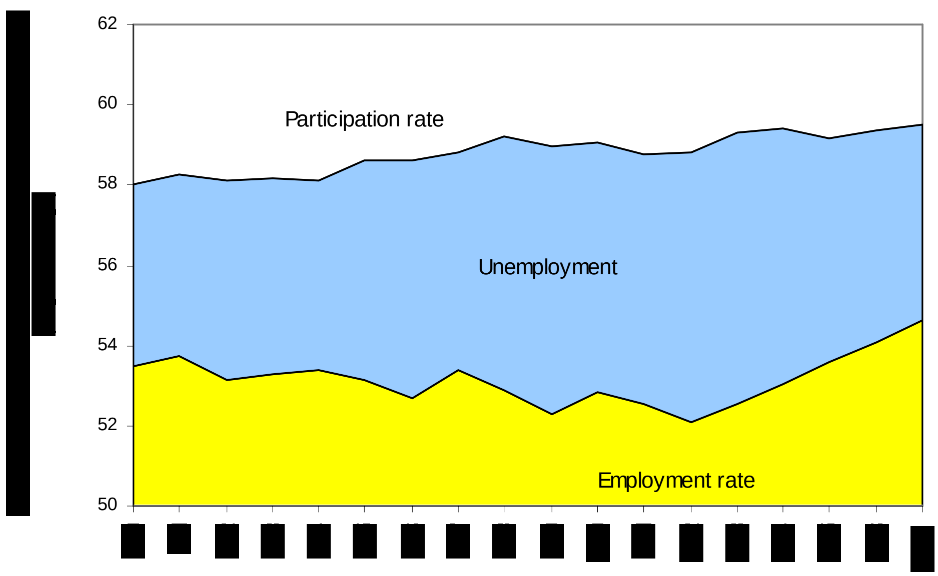
28. In contrast with the uneven figures for labour-market participation, the employment rate rose in almost all the countries; it fell only in two: Honduras and

Trinidad and Tobago. In the past five years, the employment rate for the region has risen by 2.5 percentage points. This not only has made up for the earlier fall but also represents an increase of 1.5 percentage points over the region's average employment rate for the 1990s (see figure VII).

29. The most notable characteristic of the rising employment rate in the 2003-2007 period of growth is that the significant increase in job numbers is concentrated in waged employment. The main exceptions were Brazil and Peru, where there were notable increases in self-employment. This does not mean, however, that the labour demand had weakened in those cases, in particular since waged employment, especially formal waged employment, continued to increase strongly.

Figure VII

Latin America and the Caribbean (16 countries): participation, employment and unemployment rates, as a proportion of the working-age population



Source: ECLAC, on the basis of official figures.

[a] Preliminary figures.

30. Employment as a whole rose by 2.8 per cent in 2007 (similar to the previous year's figure) and waged employment by 4 per cent. The strong upward trend in formal waged employment also continued in 2007. As in previous years, high rates of increase suggest that the upturn is due not only to new job creation but, in part, to the formalization of pre-existing jobs. The combination has boosted the size of the formal sector, measured by the indicator of registered employment or by the number of those contributing to social security systems. In the past five years, formal employment has risen by about 17.5 per cent in Mexico, 25.3 per cent in Brazil, 31.2 per cent in Chile, 26.9 per cent in Peru, 29.3 per cent in Costa Rica, 47.6 per cent in Nicaragua and 49.5 per cent in Argentina.

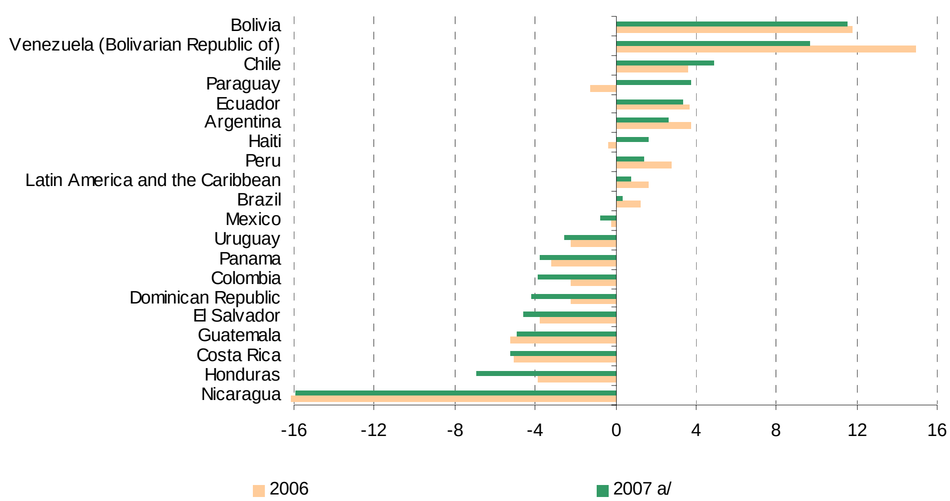
31. This does not mean, however, that there has been a general improvement in employment quality. Although the indicators relating to the volume of employment improved fairly generally, as tends to be the case when open unemployment is falling, when other indicators are used, performance appears more uneven. One

matter for concern is the growing lack of stability in formal contracts, reflected in a rise in fixed-term contracts (in Colombia and Mexico, for example). Real wages in the formal sector showed only a slight increase or even a decrease in most of the countries and, considering the region as a whole, real wages increased by 1.5 per cent as a weighted average. There has thus been a continuation of the pattern of the past few years, in which rising labour demand has had a strong impact on job creation, but much less of an impact on wages.

IV. The external sector

32. Despite worsening turmoil in the financial markets during 2007 and uncertainty over the performance of the United States economy, external conditions remained favourable for the region's countries throughout the year, thanks to robust international demand for their export commodities and an increase in intra-regional trade. The region posted a current account surplus for the fifth year running in 2007, amounting to $24.41 billion (0.7 per cent of GDP). This is around half of the 1.7 per cent of GDP surplus ($48.01 billion) recorded in 2006. Two thirds of the region's countries recorded a deterioration in the current account balance. The reduced surplus in the region is due almost exclusively to a large drop in the merchandise trade surplus (see figure VIII).

Figure VIII
Latin America and the Caribbean: current account balance
(Percentage of gross domestic product in current United States dollars)



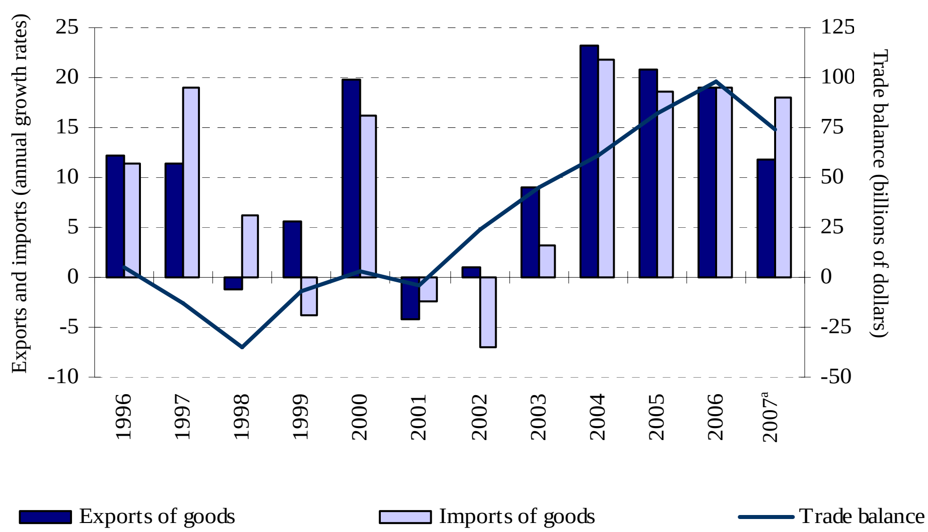
Source: ECLAC, on the basis of official figures.
[a] Preliminary figures.

33. In 2007, total Latin American exports rose by 12.2 per cent to reach $752.26 billion. Imports, however, grew more quickly, at a rate of 18.2 per cent, to reach US$ 677 billion. Although the region registered a positive merchandise trade balance for the sixth year running, equivalent to 2.2 per cent of GDP, the upward trend that had been in evidence since 2002 was reversed in 2007 (see figure IX). The increase in merchandise exports had as much to do with higher prices (6.3 per

cent) as higher volumes (5.3 per cent). The higher prices of the region's exports were due largely to rises in commodity prices, which continued to climb throughout 2007. Despite the rise in export volumes in the region as a whole, the volumes fell in some petroleum-producing countries (Ecuador, Mexico, and Venezuela). The countries that have posted the largest increases in export volumes are Paraguay (26.7 per cent) (thanks to high soybean sales), Panama (13.6 per cent), Guatemala (9.6 per cent) and Costa Rica (9.3 per cent). Argentina (8.3 per cent) and Brazil (7.8 per cent) have also expanded their export volumes considerably, thanks to buoyant manufactures and primary products.

34. As for merchandise imports, most of the increase was due to a rise in volumes, of 13.5 per cent for the region as a whole and of more than 20 per cent in five countries: Brazil and Peru (26 per cent in each), Venezuela (Bolivarian Republic of) (25 per cent) and Argentina and Colombia (22 per cent in each). If these trends continue, the trade surplus could well undergo a reversal in the next few years.

Figure IX
Latin America and the Caribbean: external trade, 1996-2007



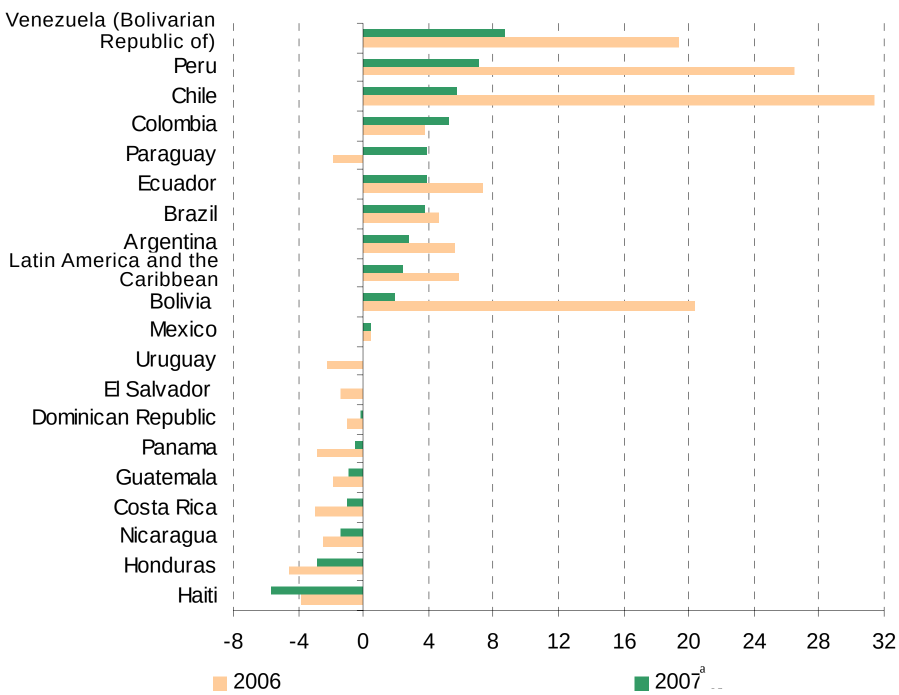
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] Preliminary figures.

35. For the region as a whole, the ongoing services deficit reached $24.8 billion (-0.7 per cent of GDP). This result is due largely to the transport deficit (only Panama and Chile are major exporters of transport services). Other business services also posted deficits, especially in Brazil. Some countries, however, such as Argentina, Brazil, Chile and Uruguay, began to post healthy figures in exports of software services and certain business services (although these were much lower than in countries like India).

36. Terms of trade for Latin America and the Caribbean were up for the sixth year in a row. From 2003 to 2007, the indicator grew by 19 per cent. However, change is under way in the factors that have been conducive to regional terms of trade (see

figure X). In 2006, there was a 5.9 per cent improvement in the region's terms of trade, but it dropped to 2.4 per cent in 2007. Nevertheless, countries such as Chile, Peru and Venezuela (Bolivarian Republic of) have made striking gains thanks to increases in the prices of their main export products. In general, the terms of trade of Central American countries continue to be far less favourable.

Figure X
Latin America and the Caribbean: variation in merchandise terms of trade, f.o.b./f.o.b.
(Percentage)

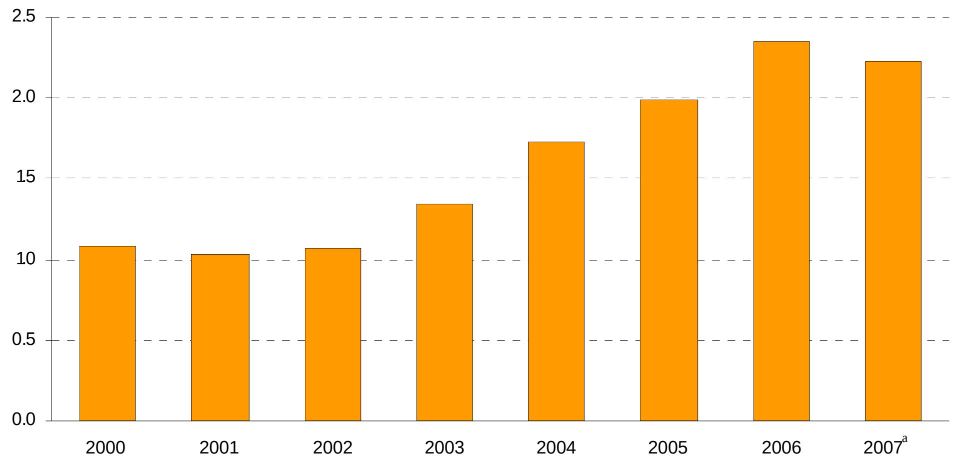


Source: ECLAC, on the basis of official figures.
[a] Preliminary figures.

37. Current transfers, mainly in the form of emigrant remittances, were moderately affected by the economic slowdown in the United States. Indeed, the positive transfers balance increased by 5 per cent in 2007 (compared with almost 20 per cent in 2006) to stand at around $62.5 billion.

38. The income balance was very similar to the previous year, with a deficit of $88 billion. As shown in figure XI below, the repatriation of profits and dividends has expanded significantly in recent years (see figure XI). This item has increased substantially in Costa Rica, Chile (resulting from the profits of foreign mining companies) and Brazil (mainly from returns on short-term financial placements on the fixed-income market, which have benefited from the higher prevailing interest rates in the country (carry trade)).

Figure XI
Latin America and the Caribbean: repatriation of profits
(Percentage of gross domestic product in current United States dollars)



Source: ECLAC, on the basis of official figures.
[a] Preliminary figures.

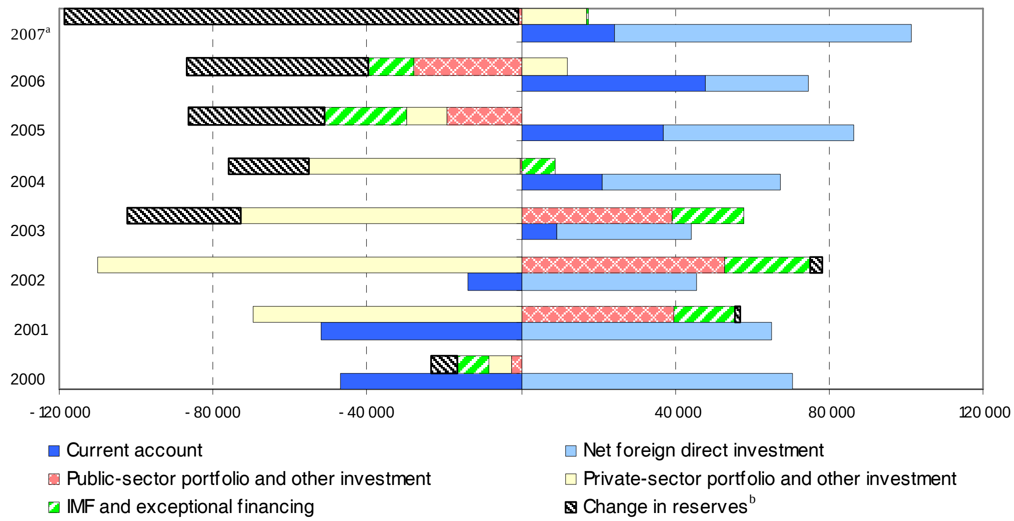
39. In 2007, the capital and financial account of Latin America and the Caribbean (including errors and omissions) recorded an extraordinary surplus of 2.8 per cent of regional GDP. This was the result of a large rise in net foreign investment, which reached the equivalent of 2.3 per cent of GDP, and a substantial net inflow of financial capital equivalent to 0.5 per cent of GDP. Combined with the current account surplus, these flows led to a build-up of reserves in the region, equivalent to 3.5 per cent of GDP. The more voluminous capital flows into the region mainly reflected the large rise of foreign direct investment in the region's countries, which generated an investment flow of $95 billion, the highest foreign direct investment figure ever for Latin America and the Caribbean. This was combined with a steep fall of outward direct investment by the region's countries, as compared with the figures for 2006 (see figure XII).

40. Net foreign direct investment flows increased substantially in a number of countries. Colombia, Costa Rica, Ecuador and Mexico saw increases of more than 20 per cent and Chile, El Salvador, Guatemala and Peru of more than 50 per cent. The country that experienced the largest absolute rise was Brazil, with foreign direct investment inflows estimated at an unprecedented figure of almost $35 billion.

Figure XII

Latin America and the Caribbean: sources and uses of the balance of payments

(Millions of United States dollars)



Source: ECLAC, on the basis of official figures and the International Monetary Fund.

[a] Preliminary figures.

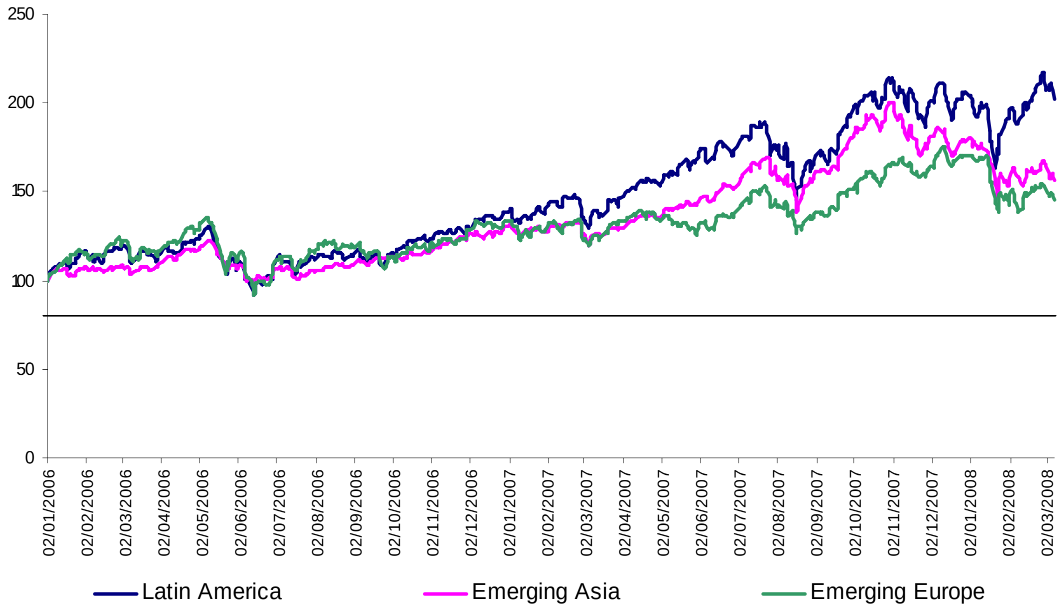
[b] Negative values indicates an increase in reserves.

41. During the course of 2007, foreign investors sought out financial investment opportunities in countries in the region whose domestic markets showed particular growth potential, especially those offering advantages in terms of interest rates and expected currency appreciation. The largest flows resulted from short-term operations (particularly the carry trade in Brazil and Colombia), which are better suited to contexts of volatility like that seen in the international markets during 2007. Brazil and Colombia also experienced the smallest rise in country risk (as measured by the Emerging Markets Bond Index Plus) over the year, even in the periods of greatest risk-aversion.

42. A breakdown of the financial account between the public and private sectors reveals some characteristics of the financial operations conducted with other countries. First, the most substantial negative financial flows were due to the build-up of assets abroad by Chile and Venezuela (Bolivarian Republic of), involving not only the public sector but also mutual and pension funds (Chile), companies (Chile, Venezuela (Bolivarian Republic of)) and individuals (Chile). The build-up of external assets by the public sector continued to be driven by fiscal, monetary and exchange-rate policy decisions. Second, the build-up of these assets was offset at the regional level by inflows of foreign portfolio investment and higher external borrowing, in particular in Brazil and Mexico. The great bulk of financial flows in the Brazilian public sector consisted of foreign investment in Brazilian securities, most of them negotiated within the country. In Mexico, public-sector financial flows were largely derived from securities issued abroad, mainly to finance initiatives under the "Projects with deferred impact in the recording of public expenditure" scheme and from an increase in foreign loans. In most of the region's other countries, financial capital inflows into the public sector came from higher foreign

borrowing, in particular in the form of short-term loans. The dynamism of capital flows to the private sector was the third major feature. The sector is estimated to have received net financial capital flows of some $17 billion across the region, which is higher than the figure for the previous year. These investments drove up share prices significantly, especially on the Brazilian, Chilean, Colombian and Peruvian stock markets. This was one factor behind the remarkable surge in the stock market indices of the Latin American countries, which outstripped share price gains in the emerging economies of Asia and Europe, according to the relevant Morgan Stanley Capital International indices (see figure XIII). Unlike what occurred in 2006, the final balance on the region's financial capital account was fairly positive in 2007, since the build-up of external assets by the pubic sector was offset by large inflows of capital, to both the public and private sectors.

Figure XIII
Morgan Stanley Capital International emerging markets index, 2006-2007
(Daily series, index value of 2 January 2006 = 100)



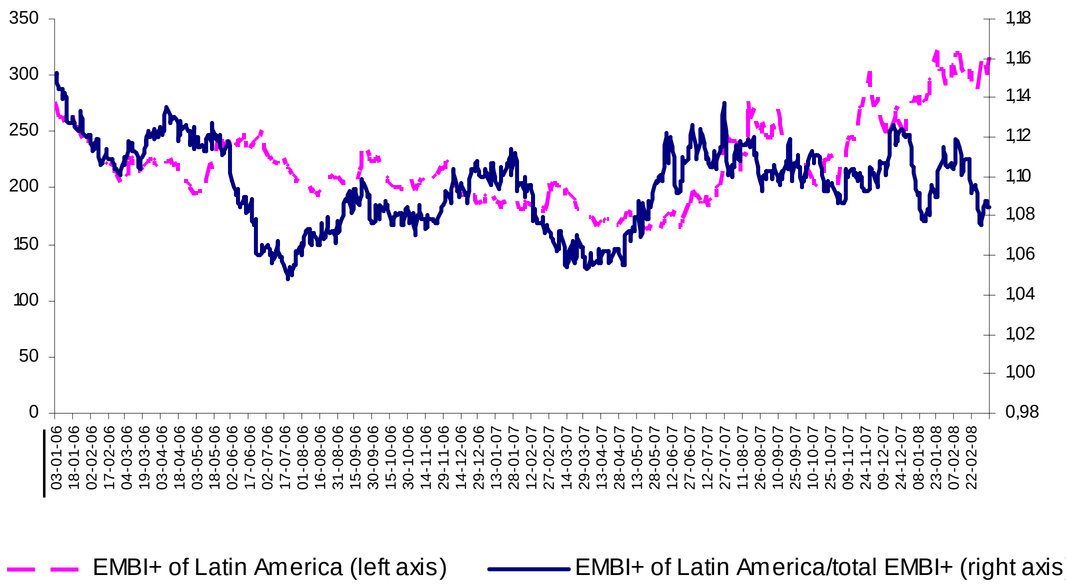
Source: ECLAC, on the basis of figures from Bloomberg.

43. During the first two quarters of 2007, the countries of the Latin America and the Caribbean region issued a total of $33.6 billion in new bonds abroad, an increase of 9.8 per cent over the same period in 2006, even though new issues were suspended in August because of the unfavourable conditions in the international financial markets. Much of the rise in issues abroad was due to increased issues by agents in Argentina, Jamaica and Peru and Venezuela. Sovereign issues continued to lose ground to those of other sectors, which accounted for about 75 per cent of total issues up to the third quarter. The preponderance of non-sovereign issues reveals the growth potential of firms and banks in the Latin American and Caribbean countries, which have ever larger and more diverse sources of financing at their disposal.

44. The international market turmoil in August and early September, whose underlying causes had already led to some briefer episodes of volatility in February and May, had a fairly limited impact on the region. Although Latin America's country risk, as measured by the emerging markets bond index plus published by J.P. Morgan, rose from an average of about 175 basis points in June to a peak of 281 in mid-August, contributing to a temporary lull in international issues, the financial positions of foreign investors in the region did not sustain any significant or prolonged reverses (see figure XIV). This was a characteristic of emerging markets generally.

Figure XIV
Emerging markets bond index plus for Latin America and emerging markets, 2006 and 2007

(Daily series in basis points)



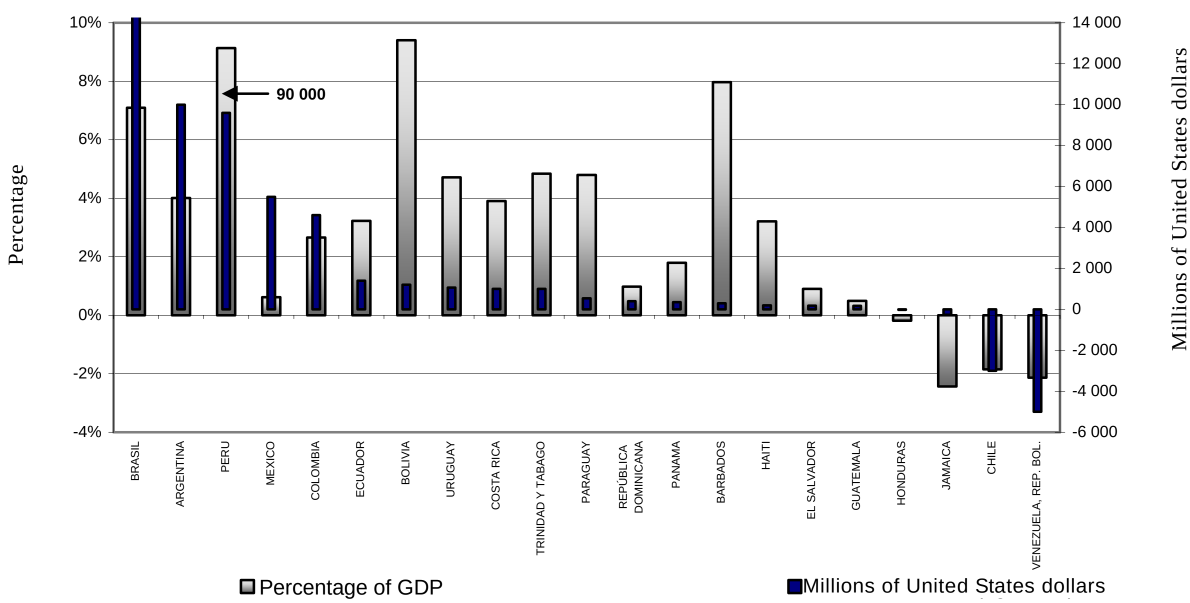
Source: ECLAC, on the basis of figures from J.P. Morgan.

45. The increase in liabilities abroad pushed up the total external debt of the Latin America and Caribbean region, in particular its short-term component. The stock of debt was some $710 billion in 2007, representing a rise of 8.7 per cent over the figure for the end of 2006, although as a percentage of GDP it is estimated to have fallen from 22 per cent to about 20.8 per cent in 2007. The rise in the stock of external debt reflected the appreciation of several of the region's currencies and other currencies, particularly the euro, against the dollar. There was also a tendency for foreign borrowing to rise in quite a number of the region's countries. The most striking exception to this rising trend was the reduction in the outstanding external debt of the region's heavily indebted poor countries (Bolivia, Guyana, Honduras and Nicaragua) as a result of debt forgiveness under the Multilateral Debt Relief Initiative, in particular by the Inter-American Development Bank.

46. As a result of operations abroad, the international reserves of Latin America and the Caribbean rose substantially in 2007 (see figure XV). This build-up

occurred in a context of currency appreciation and a rising number of monetary sterilization operations in the region. The region's international reserves totalled close to $460 billion at the end of the year, a rise of 42 per cent from the end of the previous year. The high proportion of dollar assets in the region's total international reserves creates a potential risk at a time when the value of the dollar is falling against currencies everywhere. A sharp depreciation of the dollar in the short or medium term could produce a large negative wealth effect that would be reflected in the monetary balances of central banks. This is a concern in many parts of the world, in particular in emerging countries, which hold a large proportion of the assets deriving from the external imbalance of the United States in the form of large international reserves.

Figure XV
Latin America and the Caribbean: change in international reserves, 2007[a]
(Millions of United States dollars and percentages of gross domestic product)



Source: ECLAC, on the basis of official figures and the International Monetary Fund.
[a] Preliminary figures.

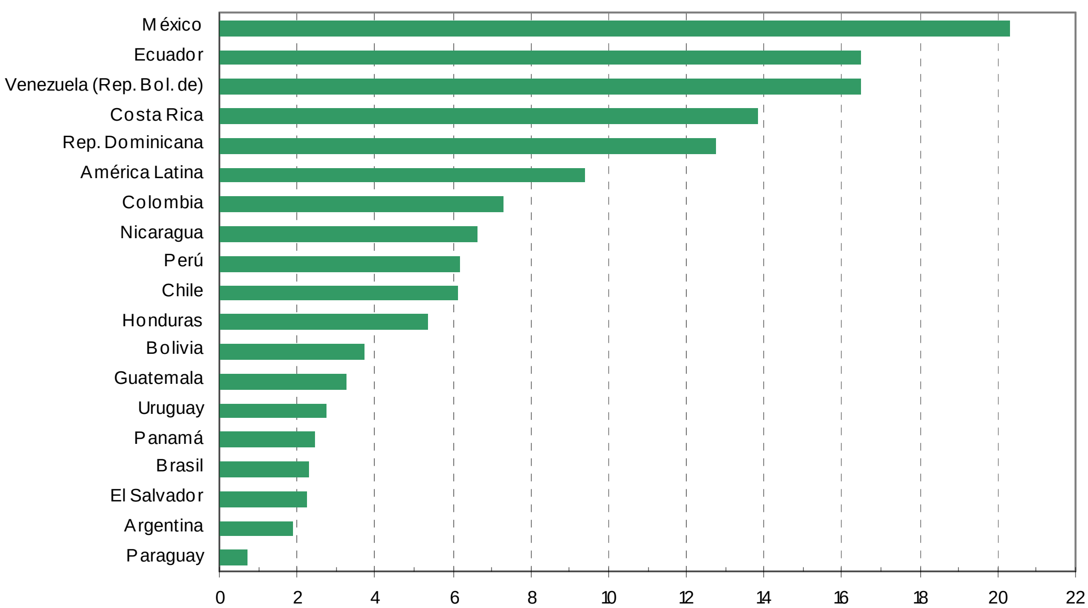
V. Situation and outlook for 2008

47. Despite the turmoil in financial markets and the evolution of the United States economy, the relative stability of the region's economies provides grounds for cautious optimism. The growth trend that began five years ago is expected to continue in 2008, although at a slower pace than in 2007. The region's economic activity will expand by around 4.7 per cent, which would mean a fourth consecutive year of growth at a rate of over 3 per cent in per capita output. Domestic demand should remain strong in the region in 2008, sustained by rising investment (whose

current levels, despite the increases of the past few years, are still not high enough to sustain a growth rate of approximately 5 per cent to 6 per cent). Private consumption, boosted by the reduction in the region's unemployment rate and the rise in formal sector employment, will also sustain domestic demand. Improved labour-market indicators and lower poverty, combined with an incipient lessening of inequity (as revealed by lower Gini coefficients in some economies), could boost consumption and thus support domestic demand in the region's countries.

48. These forecasts depend to some extent on whether the strategies implemented to control the situation in the international financial markets actually succeed in preventing a deeper retrenchment that could affect the sustainability of world growth and, in a context of greater financial market volatility, lead to mounting risk premiums and a further deterioration in financial conditions for emerging economies. The slowdown in United States growth can be expected to affect Mexico and Central America the most, as their exports are more oriented towards the United States market and consist mainly of manufactures, many of which are subject to very specific rules of origin and are thus harder to reposition in the short run (see figure XVI).

Figure XVI
Latin America (18 countries): merchandise exports to the United States, 2006
(Percentage of gross domestic product)



Source: ECLAC, on the basis of official figures.

49. Other warning signs have come from the region itself and relate to the macroeconomic policy applied in the countries, including the persistent strengthening of real exchange rates in certain South American economies, despite the measures taken by their monetary authorities. At the same time, inflation is accelerating in a number of countries, reflecting the emergence of pressures from both the supply side (rising food and energy prices) and the demand side. In addition, public spending has tended to increase everywhere, not only by more than

nominal output but by more than revenues. This procyclical behaviour of public spending does not raise fiscal problems in the short term because resources have been increasing but it does give grounds for some concern because of the possibility that it might signal a change of course in economic policy. At the same time, consumer credit is growing in several of the region's countries and this may put further upward pressure on prices at a time of steadily rising demand.

50. Central banks may face rising inflation and may need to raise interest rates at a time when international interest rates are unlikely to increase. In this context, a tighter fiscal policy seems the best strategy since it would reduce inflationary pressures as well as relieve the strain on the credit market and make it possible for interest rates to be cut.

51. Despite the performance of the region's economies in the last few years and the growth prospects for 2008, taking a longer view, there are also doubts as to whether the region is taking advantage of the favourable external situation to allocate some of the extraordinary resources available to the countries for activities that might contribute to sustained growth.

52. It is highly likely that the structural changes in global demand caused by the industrialization processes in China and India, which favour the commodities produced by Latin America, will continue to benefit the region for a number of years to come. In order to build upon this opportunity, commodity production activities need to be given a strategic boost. However, the development of other activities, many of them related to these commodities, also needs to be stimulated. First, the countries in the region should be preparing themselves for the time, which will undoubtedly come, when the relative value of the commodities will diminish. Second, it is possible that development based exclusively on natural resources, with no further value added and without any incorporation of additional know-how, may not contribute to better income distribution. It may also be insufficient to generate externalities that will boost the development process.

53. Accordingly, the region's countries should formulate strategies for incorporating know-how into activities based on natural-resources exploitation and for developing new sectors. In this context, three activities are indispensable: (a) strengthening of the infrastructure; (b) creation of an innovation network; and (c) promotion of higher-quality education. Resources and capabilities should be allocated to these activities, following a strategic decision to take advantage of the revenues from the exploitation of natural resources. While some countries have made progress in this area, it is plainly insufficient, casting doubt on the region's ability to lay the groundwork for sustainable growth.