LATIN AMERICA AND THE CARIBBEAN’S TRADE RISES FOR THE SECOND YEAR RUNNING

The region’s goods exports rose 17% during the first half of this year, according to ECLAC’s report *Latin America and the Caribbean in the World Economy 2004: 2005 Trends*. The increase was greater in South America than in Mexico, Central America and the Caribbean.

If commodity prices continue to rise, the region’s trade flows will also increase, as they did in 2004. Last year, trade in goods worldwide rose more than it had in 25 years and this trend will probably continue this year.

The ECLAC study forecasts a good year for the region’s countries’ trade in 2005, despite a less dynamic performance from world trade and economies, smaller price increases for commodities, higher oil prices and higher interest rates. In 2006, the volume of world exports should be higher than in 2005, although the pace at which commodity prices are rising will probably have slowed somewhat by then.

Two phenomena have characterized the world economy during 2004-2005. The first is a new geography of trade and financial flows, with a stronger presence from China and Asian countries. The second is the strong recovery in the US economy in 2004. Latin America has benefited from better international prices for its exports, improved terms of trade, lower interest and inflation rates, and solid fiscal results.

But medium-term risks remain formidable. They include:

CHINA SEEKING TO STRENGTHEN ECONOMIC TIES WITH LATIN AMERICAN COUNTRIES

Figures from the first half of 2005 indicate that China is the second largest export market for Chile and Peru and the third for Brazil. This region is China’s main supplier of several products: fish meal (81.4% of total imports), soy (60.7%), grapes (60.2%), sugar (49.3%), copper (39.4%), nickel (35.4%), iron (20.6%), wood and pulp (21.2%).

Provided China’s demand for natural resources continues, several South American countries will see their terms of trade strengthened for some time to come. With the signing of a number of trade and investment agreements between this region’s countries and China, the former face a relatively unexplored export market. Nonetheless, the same limitations affecting Latin American and Caribbean trade in general is also apparent in trade with China: lack of diversification and limited value added to natural resource exports, according to ECLAC’s report *Latin America and the Caribbean in the World Economy 2004: 2005 Trends*.

China’s imports from the region rose from US$1.5 billion in 1990 to US$21.668 billion in 2004. The annual growth rate reached 42% between 2000 and 2004, higher than the growth rate for Chinese imports worldwide (26%).

(continued on page 3)
As early as the 1950s, Latin America saw integration as an instrument for development. Since Prebisch, ECLAC has been closely involved in this process.

We have learned that intraregional trade is conducive to export diversification, is more “friendly” for small and medium-sized enterprises (SMEs) and is more value-added-intensive than trade with the rest of the world. Nonetheless, after several decades, the outcome in terms of integration is not very positive. The gap between rhetoric and practice is enormous and the region has shown no solid progress in competitiveness, export diversification or technological innovation. China and other Asian economies have burst onto the global scene, along with a series of bilateral trade agreements between several of the region’s economies and the United States or the European Union, posing major challenges to the region’s competitiveness and its ability to bring its integration schemes up to date.

Along with these challenges and despite good export results in 2004-2005, as we said in the report, *Latin America and the Caribbean in the World 2004: Trends 2005*, published in September, traditional flaws in regional integration persist: its institutional weakness, especially when it comes to dispute settlement; community regulations that are not put into practice; lack of macroeconomic coordination, limited, and markedly pro-cyclic intra-regional trade, and insufficiencies in dealing with internal asymmetries. This makes it difficult for key investment initiatives based on integration schemes.

The pressure on these institutions grows with bilateral North-South agreements such as the FTA between the Dominican Republic, Central America and the United States (CAFTA-RD); the agreement between the United States and three Andean community countries (Colombia, Ecuador and Peru), currently under negotiation; and the agreement for an association between Mercosur and the European Union, also in talks. These agreements involve broader and deeper commitments than those included in integration pacts, in several relevant areas.

The challenge is to promptly readjust integration schemes, avoiding the imposition of asymmetrical commitments: that is, agreements that are more demanding, with more enforceable mechanisms and more juridical certainty with partners in the North versus fewer requirements from subregional relationships. This kind of asymmetrical relationship would reinforce disininterest in integration among economic actors.

Integration can and must renew itself. On one hand, updating its commitments in areas not covered to date, such as public acquisitions and services, for example, and, on the other, preserving the central idea of a broader market, with free mobility of goods and factors, serious progress toward macroeconomic coordination, compulsory dispute settlement mechanisms, suitable treatment of asymmetries, the management of structural funds to obtain balanced benefits, coordination on social policies and daring initiatives in the fields of energy and infrastructure. In this sense, integration schemes offer better quality than FTA, contributing elements of development and policy coordination that the latter do not consider. Implementing them, however, requires a serious technical and political effort. The Southern Cone’s “energy ring” initiative is a clear example of the right path to follow. Should it work out, it would serve as a hopeful turning point in regional integration.

An enormous effort is also required to harmonize rules governing origin, hopefully extensive plurilaterally to all the countries involved. This is also true of customs procedures, sanitary and phytosanitary regulations, technical standards, trade defence measures and dispute settlement mechanisms. These measures would send a powerful signal of practical commitment to integration, stimulating intraregional trade and investment decisions.

By deepening integration within a framework of open regionalism, integration contributes to competitiveness, operating in markets more open to external competition and complementing solid participation in the main international markets at the same time as it favours a stronger presence from SMEs (small and medium-sized firms) in export flows. This way, integration offers a more coherent link between competitiveness and social cohesion.
a large deficit in the United States’ current account, serious hurdles to higher growth in Japan and the European Union, the soaring oil price, the undiminished threat of terrorism, and signs of protectionism among the main industrialized economies.

These potential threats raise concerns about Doha Round negotiations, which encourage developing countries to consolidate or expand access to markets in industrialized countries through bilateral trade agreements.

Precise definitions

Negotiations for market access and standards, held by the World Trade Organization (WTO) in July, presented a discouraging panorama. The lack of signals from the main actors, with regard to agriculture, one of the main issues in these negotiations, has slowed progress in other areas.

At this time, regional integration requires precise definitions. In a context of negotiations on many fronts, the mechanisms available for integration continue to suffer from longstanding flaws, among them, the weak instruments available for settling disputes, community standards that are not applied, and a lack of macroeconomic coordination, according to ECLAC.

In any case, for the second year running trade within Latin America and the Caribbean, rose more than total exports. In countries belonging to the Andean Community, it increased by 58.5%, while in Mercosur it rose 36.2%. Intra-regional trade, however, increased less (17%), particularly compared to Asia (34%) and the European Union (62%). It also remained markedly procyclic.

For the countries of South America, China is today their largest market and the one posting the highest growth rates, with enormous demand for their natural resources. Chinese imports from the region rose from US$1.5 billion in 1990 to US$21.668 billion in 2004. The annual growth rate was 42% from 2000 to 2004, well above the growth rate for China’s exports from the world in general (26%).

If this high rate of demand from China for commodities and unprocessed or moderately processed natural resources continues, South American countries can look forward to a lengthy period of strong exports and their terms of trade will be strengthened.

China also offers investment in infrastructure, energy and mining that could complement financing for major works in these areas.

However, some of the region’s countries face competition from China. This is evident in the textiles market, and could become particularly important in the event of excessive production in China. National authorities should make an effort to detect and make the most of the potential for complementary activities with regard to China and the Asian countries.

Moreover, the recent growth in trade has increased maritime shipments and with them freight charges, which started to rise in 2003.

The oil price remains crucial to the region. Latin America and the Caribbean is a net oil exporter, but several small and medium-sized countries are net importers and prices of around US$60 per barrel impose significant cost burdens.
One of the outstanding features of modern financial crises is that they have occurred in emerging economies (EEs) generally considered successful right up to the crisis. In Latin America, many recent crises reveal different characteristics from those of the 1940s and 1970s.

To start, in the past they involved large fiscal deficits financed using central bank issues. Second, domestic financial systems were “repressed”, which generally meant that the private sector enjoyed access to bank credits at negative real interest rates. Third, balance of payments crises were typically associated with a sharp worsening of the terms of trade and/or the presence of overvalued exchange rates, the result of specific political decisions.

In the past 25 years, a new sort of crisis has developed in the countries of Latin America and East Asia, with four characteristics that set them apart from their predecessors.

First, international financial capital markets have been the main generators of shocks (both positive and negative). Second, flows generally have moved between private agents. In contrast, fiscal deficits have played a secondary role and, in fact, in most cases public finance has been relatively balanced. Third, the victims of these financial crises have been EEs considered “successful”. Fourth, these trends have typically involved a lack of regulation on both the supply and the demand sides. Normally, national financial systems have been liberalized with no parallel development of a prudent regulatory and supervisory system.

To avoid repeating past failures

Latin America finds itself in a new period of some optimism and recovery. The understanding of recent crises is essential to avoid repeating the failures experienced in the past.

A potent message is that there is enough room for diverse policies. In fact, Chile, China, India and Taiwan have all become examples of diverse and successful economic policies that ensure prudent macroeconomic regulation of the capital account. Korea and Malaysia, meanwhile, are two successful economies that were capable of bouncing quickly back from crises provoked by volatile capital.

It is typically argued that the complete opening of the capital account prevents irresponsible domestic macroeconomic management and promotes the achievement of macroeconomic “fundamentals”. This is true, in part, for domestic sources of instability: large fiscal deficits, permissive monetary policy and an arbitrarily overrated foreign exchange rate. However, the volatility that is typical of the financial market makes this type of control highly inefficient at times of international liquidity. In truth, emerging economies’ recent experiences show that permissive policies toward demand or over-evaluation of the foreign exchange rate tend to be promoted by financial markets during boom times (or “irrational exuberance” to use Alan Greenspan’s words). The market itself generates incentives for emerging economies to enter zones of vulnerability when times are good, pulling macroeconomic variables away from sustainable levels. These same markets impose an unjustifiably harsh punishment when crisis hits, forcing domestic authorities to adopt policies involving an excessive contraction in demand.

Financial operators evidently play an irreplaceable microeconomic role as intermediaries between savers and users of funds, in hedging and as suppliers of liquidity. However, in practice, their role also involves strong macroeconomic implications. With their herd instinct they contribute to intensifying cash flows toward “successful” countries during booms, producing unsustainable growth in financial asset prices and sharp revaluations of foreign exchange.
Reform definition of macroeconomic “fundamentals”

During boom times, international financial bodies have typically encouraged this behaviour. The regrets and criticisms over excessive borrowing come later, during periods of enormous outflows, encouraged by the same agents who praised these emerging economies’ performance when times were good. There is an obvious contradiction between these two attitudes: together they constitute the complete opposite of the transparency and accountability that we seek.

There is consensus about how essential it is to achieve sound macroeconomic fundamentals. However, there is enormous misunderstanding about how they are defined. The conventional, inappropriate definition is what brought high praise of Chile just before the 1982 crisis, of Korea and Thailand in 1996, Mexico in 1994, and Argentina in 1994 and 1997. Something “fundamental” is lacking in market evaluations of the “fundamentals”. Clearly, the sharp crises in these five cases were not simply bad luck or purely contagion, but rather the result of a decline in key components of an integral set of fundamental indicators, a deterioration preceded by enormous cash inflows.

A reformed definition of macroeconomic fundamentals should include (along with low inflation, responsible fiscal accounts and strong exports) sustainable external deficits, reduced net liquid liabilities, avoidance real exchange rate appreciation, and strong regulation and supervision of the financial system. When capital is abundant, the regulation of cash inflows becomes a requirement for maintaining real macroeconomic equilibria. Similarly, in times of recession or scarce financing, having available policy tools for regulating residents’ and non-residents’ cash outflows contributes to smoothing contractive forces and speeding recovery.

ECLAC Senior Regional Advisor, holder of Chile’s National Award for Humanities and Social Sciences, 2005. This article is based on his book, Reforming Latin America’s Economies: After Market Fundamentalism, Palgrave Macmillan, London, 2005.
As part of its development strategy, China needs to strengthen its ties with Latin America, ECLAC notes. Its high growth rate and industrial reconversion of rural areas have boosted infrastructure and energy needs. Combined with rising demand for food, these have become powerful reasons to consolidate relations with countries exporting natural resources. China also needs to secure the free entry of its exports and acceptance of its market-based economy, a goal that the President of China worked toward in visits to the region during 2004.

Several trade agreements have also been necessary to ensure that China’s products continue to enjoy preferred access to markets and ongoing competitiveness with American products, which have been favoured by the FTAA or bilateral trade agreements, and European goods. This situation pushed it to make progress in this direction anticipating the European Union’s free trade agreement with Mercosur and the Andean Community.

**Formulae for approaching the region**

The formulae for approaching Latin American countries have varied and are not mutually exclusive: different sorts of trade agreements, joint ventures with state-owned firms, and special agreements in the fields of science and technology. China, moreover, offers investment in infrastructure and energy. Despite the fact that most foreign direct investment (FDI) goes to its Asian neighbours, in 2004 Latin America received almost US$889 million, going into energy (Venezuela, Colombia and Brazil), mining (Chile, Peru, Ecuador and Venezuela) and infrastructure (Argentina and Brazil).

**Largest and fastest growing market**

For this region’s countries, China is the largest and fastest growing market in the world, with high demand for natural resources. But not all are equally involved: while China’s relationship with Central America and the Caribbean has been less fluid, the positions it takes internationally have tended to coincide with those of Brazil, and the negotiation of a free trade agreement with Chile has created conditions favourable to a more privileged relationship with South America.

The interest in an alliance with China also varies by country. For Chile, the free trade agreement is an important step forward in its strategy to become an investment platform and bridge for trade between Asia and Latin America. Chile also has free trade agreements with South Korea, Singapore, New Zealand and one is forthcoming with Brunei.

For Brazil, China is an important ally, along with India and Russia, in its effort to build a world with multiple power centres. Brazil and China have been innovative in their efforts within the Doha negotiations in the G-20, a group that articulates the agricultural positions of developing countries. The G-20 has become key to shaping these negotiations. Both countries have similar positions on other issues within the multilateral trade negotiation agenda, among them investment, intellectual property and services. Moreover, they promote the creation of strategic alliances to add value to primary or manufactured products, and investment that encourages technological transfers.

Venezuela has an active interest in trade agreements with China. The world’s fifth largest oil exporter seeks to diversify its sales and foreign investment and reduce its economic dependency on the United States. Moving closer to China has given it more room to act. China, meanwhile, is interested in joint ventures in mining and oil operations.

The challenge for Colombia is greater than for its neighbour. On one hand, it produces many of the same intermediate goods as China is offering to the world and, on the other, it does not have the mining or oil reserves of Venezuela or Ecuador. Nonetheless, the President of Colombia’s visit to Beijing this year led to the signing of several cooperation agreements, and China committed to investing in textiles, infrastructure and hydrocarbons.

According to the tenor of joint statements from the governments of Peru and China, along with cooperation agreements signed in 2005, these efforts will see natural resource, mining, fruit and vegetable exports rise, and the development of more tourism. In 2004, Argentina hosted a visit from the Chinese president and President Kirchner headed a visit to China where agreements were signed to facilitate the entry of soy with more value added, meat and other processed foods into China.
The decline in public investment has grown alarming in some countries of Latin America and the Caribbean, partly reflecting the harshness of recent episodes of fiscal restraint.

Data available for 1980-2003 reveals that as a percentage of GDP, public investment peaked in 1982 (7.5%), and bottomed out in 2002 (4%), after falling steadily throughout this period.

Since 1998, the region’s countries have been living a period of fiscal adjustment, which has brought a strong recovery in the primary balance. Half of these adjustments in Argentina, Bolivia, Brazil, Chile and Peru during the 1990s reflected cuts to infrastructure investment, which hurt medium-term growth. The study estimates that primary surplus targets will remain high in the medium term, since reducing public debt is considered a priority.

The paper Opciones para enfrentar el sesgo anti-inversión pública (Options for Dealing with Anti-Public Sector Investment Bias), by Ricardo Martner and Varinia Tromben (Gestión pública series Nº 50, ILPES/CEPAL, Spanish) suggests options for reducing anti-public sector investment bias during periods of fiscal consolidation, such as the current one.

Successful “Golden Rule”

The first option that ECLAC proposes to reduce anti-public sector investment bias includes the “golden rule” of public finance, which calls for financing current expenditures with current revenues and net public investment with borrowing. Despite its macroeconomic rationality, this rule is hard to apply because it requires significant institutional changes and enormously sophisticated accounting.

Other proposals for reducing anti-public investment bias include applying the general accounting principles in the IMF’s new Government Finance Statistics Manual (2001), changing the way fiscal goals are reflected in accounting, developing public-private partnerships, and implementing structural targets for the public balance.

The study examines the experience of Chile, where authorities established a fiscal policy rule based on achieving a central government structural budget surplus equivalent to 1% of GDP, in effect since 2001. This percentage is calculated over trend GDP, regardless of actual GDP fluctuations.

This rule was first applied when the output gap was negative (the cyclical component of the budget was negative until 2003, peaking at 1.7 points of GDP in 2002). During 2004 and 2005, the rule has proven strong during the high part of the cycle, when pressures to spend are greater. Thus a fundamental requirement for this type of rule has been met: neutrality throughout the fiscal policy cycle. The surplus during the 2004-2005 period is forecast to be greater than the deficit accumulated from 2000 to 2003, thus confirming the even application of the rule.

Specific taxes, public-private joint ventures

ECLAC’s proposals include the use of specific taxes to finance infrastructure projects, in particular fuel taxes to finance roads, as per the experience of the United States and Argentina.

Other proposals include initiatives to favour public-private partnerships in areas traditionally taken care of by government, as Mexico has done with both energy and oil, and Chile with transportation, airports, jails and irrigation systems.

A third group of ideas focuses on managing fiscal accounts more flexibly and emphasizes that an excessively simplistic accounting approach, which does not distinguish between current expenditures and the economic impacts of investment, hurts future economic growth.

Actions to make fiscal goals more flexible are particularly important in countries with some type of programme or agreement with the International Monetary Fund. Although recent proposals from the Fund itself are headed in the right direction, “they seem insufficient given the magnitude of the problem,” the authors note.

Multilateral development banks should also play a role. Today, their capacity to disburse approved loans has been limited by ceilings on public budgetary spending reflecting countries’ fiscal targets, which has delayed projects and works. For example, in 2000 the IDB disbursed just 60% of its budget approved for investment projects, and this fell to 30% in 2003. The suggestion is that spending on these kinds of projects should be entered on the books gradually, as governments amortize their loans, and not all at once, when the debt is incurred.
**RECENT TITLES**

1. **Políticas de competencia y acuerdos de libre comercio en América Latina y el Caribe: aprendiendo de la experiencia internacional** (Competition Policy and Free Trade Agreements in Latin America and the Caribbean: Learning from International Experience), by Iván Valdés, *Comercio Internacional* series No. 51 (LC/L.2365-P, August 2005, Spanish). This report identifies criteria for evaluating commitments included in agreements to protect competition. It includes a comparative analysis and a list of sectors, subsectors and products vulnerable to anti-competition practices, and explains how they are different from or similar to those of more developed markets. [WWW](www)


4. **La tributación a la renta en el Istmo Centroamericano: análisis comparativo y agenda de reformas** (Income Tax in Central America: Comparative Analysis and Reform Agenda), by Juan Carlos Gómez Sabaini, *Macroeconomía del Desarrollo* series No. 37 (LC/L.2359-P, July 2005, Spanish). Through a comparison of the common elements in Central America’s income tax systems, the author concludes that none of this subregion’s countries has managed to create an overall, personal and progressive tax base. Nor do these systems meet their basic objectives, in terms of collecting sufficient revenues, neutrally assigning resources and improving income distribution. [WWW](www)

5. **Privatización, reestructuración industrial y prácticas regulatorias en el sector telecomunicaciones** (Privatization, Industrial Restructuring and Regulatory Practices in the Telecommunications Sector), by Patricio Rozas, *Recursos Naturales e Infraestructura* series No. 93 (LC/L.2331-P, Spanish). The author reviews the government’s role in developing policies that contribute to the success of privatizations. [WWW](www)

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**CALENDAR**

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