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CONTENTS

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Saving the *Petrossauro*

At last, after months of delay, Petrobras has published its accounts. The state-owned Brazilian oil company, sometimes described as a *Petrossauro*, a prehistoric and cumbersome giant from the past, has taken a series of punishing blows to its balance sheet because of the impact of a corruption scandal and the fall in international oil prices. Revealing the depth of the damage may be a first step to beginning a recovery.

Depending on the interpretation, the price tag for the Petrobras corruption and mismanagement scandal could be nearly US$17bn; and by some accounts that is an underestimate. The US$17bn number comes from the latest accounts. Announcing its fourth quarter and annual results for 2014, the company said it was writing off BRL6.2bn (US$2.1bn) due to corruption, but also an additional BRL44.6bn (US$14.8bn) to correct for the overvaluation of assets on its balance sheet. Taking these two items into account, Petrobras made a BRL26.6bn (US$8.77bn) loss in the fourth quarter, on revenues of BRL85.04bn (US$28.03bn). For 2014 as a whole, Petrobras posted losses of BRL21.6bn (US$7.1bn). Those who say the real cost of the corruption scandal is higher than US$17bn include the Fundação Getúlio Vargas (FGV) business school, which in a recent study estimated that the scandal could take US$30bn out of the Brazilian economy, with the loss of over a million jobs, mostly in the construction sector.

The implosion at Petrobras began last year, when the federal police opened an investigation into claims that company officials had received bribes from large construction and engineering companies in return for the preferential allocation of contracts. The alleged bribes represented about 3% on top of each contract. Also in operation was a scheme whereby a separate proportion of contracts was siphoned off in secret contributions to political parties. This system of corrupt payments is believed to have been in operation from 2004 to 2012. Apart from initiating the arrest and investigation of a range of top executives from 23 companies, and up to 40 key politicians, the scandal also forced the departure of the Petrobras CEO María das Graças Foster (appointed in early 2012), and her replacement by Aldemir Bendine. Another recent casualty was João Vaccari, the treasurer of the ruling Partido dos Trabalhadores (PT), who was arrested in April.

Presenting the latest results, Bendine said that the company had made a "conservative" assessment of its losses through corruption. Accountants PricewaterhouseCoopers had refused to sign off earlier versions of the accounts. "With the publication of audited 2014 results, Petrobras has cleared a significant obstacle, after a collective effort, that shows our ability to

“If you concentrate everything – all wealth – in a single company controlled by the state, then it is very easy for the political system to go there and try and grab resources. You can avoid this with more competition, more transparency, more regulation.”

overcome challenges in an adverse environment” he said. In fact, the accounts were published on 21 April, only 9 days ahead of a 30 April deadline that would have seen the company’s finances take an even more serious turn for the worse. Under a clause in some of its bond contracts, had Petrobras failed to publish audited accounts by the end of April, bondholders could have demanded early repayment of billions of dollars of debt.

Analysts say getting the audited accounts approved is the first of a number of steps needed to rebuild confidence in Latin America’s largest company by revenue (which also happens to be the world’s most indebted oil company). To address concerns that it is over-leveraged, Petrobras has already said it plans to sell an estimated US$13.7bn of assets over the next two years. It will also need to begin to reduce its net debt, estimated at over BRL282bn (US$92.9bn), at a time when its earnings are lower, because international oil prices are around 50% less than year-ago levels. As part of short-term funding arrangements Petrobras, which effectively has been shut out of international bond markets since the corruption scandal began, in early April signed a BRL9.5bn (US$3.13bn) financing agreement with Brazilian banks. It has also reached a US$3bn agreement with Standard Chartered Bank for the sale and lease-back of production platforms.

But in some ways these steps are just the beginning, since the corruption storm has raised so many questions about Petrobras governance and purpose. According to Sergio Lazzarini of the São Paulo-based Insper Business School, “If you concentrate everything – all wealth – in a single company controlled by the state, then it is very easy for the political system to go there and try and grab resources. You can avoid this with more competition, more transparency, more regulation.” Some initial but small steps have been signalled. The government said it would be removing some politicians from the Petrobras board of directors, and replacing them with respected private sector figures (one of those being tipped for the role was Murilo Ferreira, president of the mining company Vale). There has also been a suggestion that foreign oil companies may be given a larger role in developing Brazil’s gigantic pre-salt offshore oil deposits (under current regulations they have to work in a partnership where Petrobras has the controlling role).

Certainly, the ability of Petrobras to develop the pre-salt reserves has been weakened. The company has announced a reduction in its 2015 capital expenditure to US$29bn, 34% lower than the average initially planned over the next five years. There will be a further 13% cut to US$25bn in 2016. Bendine says Petrobras will reveal a new (and presumably slimmed-down) strategic plan within the next month.

REGIONAL ECONOMY OUTLOOK

REGION

Growth forecasts reined in

April could be called ‘forecast month’, with a range of multilateral institutions reviewing their forecasts for Latin American economies. On the whole, it is looking like another slow year.

One of the first off the mark in April was the UN’s Economic Commission for Latin America and the Caribbean (ECLAC), which slashed its real annual GDP growth forecast for the region to 1.0%, down from 2.2% previously.

“With the exception of the United States, growth forecasts have been reduced in the industrialized countries, while emerging economies are also slowing down” it said. The net result is that for the region as a whole this year, the picture is going to look very much like it did last year...

Much of the change was due to the region’s largest economy, Brazil, where ECLAC now expects GDP to contract by 0.9% (vs. 1.3% growth projected in its previous forecast). ECLAC said that part of the overall deterioration in the regional outlook should be attributed to the global economy, which is looking less dynamic than had been hoped at the end of 2014. “With the exception of the United States, growth forecasts have been reduced in the industrialized countries, while emerging economies are also slowing down” it said. The net result is that for the region as a whole this year, the picture is going to look very much like it did last year (when regional GDP growth was 1.1%).

ECLAC notes that this year will again see rather diverse economic performances throughout the region. Among the larger economies, Mexico will grow at a comparably fast rate (3.0%), because of its good linkages with the US economy. Argentina will flat line (with 0% growth). Economies specialised in the production of primary goods, particularly oil and minerals, will suffer, meaning means most of South America and Trinidad & Tobago. Those set to perform best have strong links to the US and/or are set to benefit from low oil prices. Peru is predicted to post real GDP growth of 4.2%, followed by Colombia with 3.6% and Chile with 3.0%. The fastest growing economies will be Panama (+6.0%), Antigua and Barbuda (5.4%), along with Bolivia, Nicaragua, and the Dominican Republic (all expected to post real annual growth of 5.0%). Prospects for Venezuela have darkened again, with ECLAC now expecting a contraction of 3.5%, deeper than the 1.0% fall predicted previously.

A week after ECLAC published its latest forecasts; the International Monetary Fund (IMF) issued its April World Economic Outlook (WEO). This was a little more pessimistic. It sees negative growth in Brazil, Argentina and Venezuela dragging South America into recession this year. Citing low consumer confidence, the prospect of water and electricity shortages, and negative investor reactions to the Petrobras scandal, the IMF now expects a 1.0% contraction in Brazilian GDP (down from the October 2014 WEO, which had Brazil growing by 1.4%). In Argentina, because declining investment and exports will be only partly offset by strong public spending and private consumption this election year, GDP will fall by 0.3%. And in Venezuela, the collapse in oil prices, policy distortions and government controls are resulting in intensifying shortages of basic goods, pushing inflation above 60% and leading to an overall GDP contraction of 7%.

Where the IMF coincides with ECLAC is in seeing a relatively strong performance by the Andean countries, with Bolivia growing 4.3%, followed by Peru (3.8%), Colombia (3.4%) and Chile (2.7%). The Fund’s take is that "The downturn in global commodity markets remains the main drag on activity in South America, even though lower oil prices and a solid US recovery provide a boost to other parts of the region". While the South American economy will contract, Latin America and the Caribbean, lifted by Mexican growth of 3.0% and Central American growth of 4.2%, will achieve an overall expansion of 0.9%, the IMF believes. This reflects a situation where there is “no apparent impulse for a near-term pickup in activity and the prospect of persistently lower commodity prices and reduced policy space in many economies.” While that sounds downbeat, the IMF also notes that output remains close to potential in many economies, meaning that unemployment levels remain low.

It is possible to divide the region up into various different types of geographic or trade sub-groups. It is interesting to note that according to both the ECLAC and IMF predictions the Pacific Alliance group of countries (Chile, Peru, Colombia and Mexico, which follow largely free-trade economic policies) are set to perform significantly better than the Mercosur group (which, led by Argentina and Brazil, with other members including Paraguay, Uruguay, and Venezuela, tends to be more protectionist).

The World Bank also produced a set of forecasts for the region, broadly similar (it sees Latin American and the Caribbean growing by 0.8%, with the South American economies broadly speaking being the more sluggish). Interestingly however, Augusto de la Torre, the Bank's chief economist for Latin America, was much more explicit about saying that the end of the commodities super-cycle, marked by lower Chinese growth, is now the "new normal". As he put it, "the evidence suggests that external shocks, slower Chinese growth, and changes in the terms of trade are permanent." Absent structural economic reforms, this meant that the slowdown in Latin American economic growth would also be permanent. Raw material exporters with limited exchange rate flexibility would face a complicated situation, marked by fiscal austerity and requiring action to boost domestic savings rates to eventually rebuild the basis for economic stability and growth. "None of that will be easy, and it will take time", De la Torre warned.

BRAZIL

Looking for the silver lining

Recent economic data from Brazil has been dismal. Growth in consumption over the coming years will likely be in low single digits. Nevertheless, there are early signs that official policies could be moving Brazil back towards a virtuous circle of lower capital costs, lower perceptions of risk and higher investment.

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The flow of news about Brazil's economy since late March has been grim. At the end of March, the Banco Central do Brasil (BCB) lifted its inflation forecast for this year to 7.9%, up from 6.1% previously. However, the BCB noted that the impacts of past depreciation in the currency and the increase in regulated prices would be temporary. At the beginning of April, HSBC noted that its composite purchasing manager's index (PMI), which reflects activity in both the manufacturing and the services sector, had slipped from 52.3 in February to a 70 month low of 47.9 in March. A reading below 50 indicates a deterioration in conditions and a contraction in overall activity.

In early April, official data indicated that month-on-month inflation had accelerated to 1.32% in March, thanks mainly to an increase in electricity tariffs. Shortly afterwards, the ratings agency Fitch cut its outlook for the country from stable to negative – suggesting that a downgrade to the government's sovereign rating is a real possibility over the next year or so. Fitch maintained Brazil's rating at BBB, or two notches above a High Yield rating. For its part, Standard & Poor's (S&P) has assigned the government a rating of BBB-, the lowest investment grade.

All of this is in the context of a weakening currency and rising interest rates. Since mid-2014, the Real has fallen from a rate of US$1:BRL2.2 or so to around US$1:BRL3. Determined to contain inflation, the BCB has been tightening monetary policy, with the result that the benchmark Selic rate stands at 12.75% (following a 50 basis point rise in early March).

There has also been a sharp reduction in Brazil's terms of trade. The implication is that the previous cycle of lower interest rates, currency stability and reduced risk perceptions, combined with strong growth in domestic consumption (thanks in part to official anti-poverty and welfare schemes), has ended. In the meantime, the political environment has been complicated by the massive corruption scandal at the state-owned energy company Petrobras.

Nevertheless, the behaviour of financial markets since the end of March tells a different story. At 25 April levels of BRL2.95/US$, the currency has fallen by around 10% since the beginning of the year. It is, however, around 10% higher than it was in the middle of March. In US dollar terms, MSCI's Brazil index has risen by 18% since the beginning of April, meaning that it has performed significantly better than other emerging markets over that period. In US dollar terms, the MSCI Brazil index has regained all the ground that it had lost in early 2015, and is essentially at the level at which it began the year. Nevertheless, the index is still about 22% lower than it was in late April 2014.

At a press conference on 14 April to launch its latest World Economic Forecast the International Monetary Fund (IMF)'s Chief Economist, Olivier Blanchard, highlighted a 'silver lining' to an otherwise dark and cloudy outlook for Brazil's economy in the coming years. As the **chart** (*overleaf*) shows, the IMF is looking for overall GDP to contract in 2015, having stagnated in 2014. The main problem is the ongoing fall in consumption, which is expected to continue to 2016. He noted that "the problem of the past few years [has been the lack of] business confidence, primarily leading to low investment. It is still there, but the government clearly is taking measures to re-establish full credibility of fiscal policy. But we are in a situation in which confidence has not come back, yet while at the same time there is a fairly strong fiscal consolidation. So the two effects are working in the same direction for the moment of making things worse, but if confidence comes back because of the measures which have been taken, things will turn around".

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Four days previously, the IMF had released a press release in relation to the conclusion of its 2014 Article IV consultation with the Brazilian authorities. The Fund noted that a number of the factors that had boosted inflation (such as a recent drought) were temporary and that the floating exchange rate had had "an important role to play as the main shock absorber". The IMF also pointed out that, at around US$362bn, Brazil's gross international reserves were well above the levels required by the IMF's normal benchmarks.

It observed that the aim of the fiscal policy is to return the non-financial public sector primary surplus to 1.2% of GDP in 2015. The government thereafter hopes to increase the surplus to 2.0% of GDP in 2016, 2.2% in 2017 and 2.5% in 2018. Overall net public sector debt is expected to rise from 37.2% of GDP in 2014 to 39.3% this year, but then to stabilise. The IMF noted that reaching these budget targets "will require ambitious, front-loaded measures". Cuts in current spending and tax exemptions are being replaced by increased investment and allocations to social programs.

The IMF's press release pointed to other fundamental - and positive - changes. A crucial one is "the decision to end policy lending to public banks". The implication is that the private sector will play a more central role in investment and that decisions will be less influenced by political considerations. Lower investment by the oil giant Petrobras and by other companies in the energy and minerals sectors is expected to contributed to a further fall in overall investment (by 0.6%) in 2015. However, the IMF is looking for investment to grow by 5.6% next year and by around 4% in each of the following years. Inwards Foreign Direct Investment (FDI) is expected to be just under US$54bn this year, or a lot less than the US$68bn registered in 2013 and the US$66bn estimated for 2014. Nevertheless, FDI is expected to stabilise over the coming years.

Brazil's economy - as the IMF sees it						
	2013	2014	2015	2016	2017	2018
Annual % change						
GDP at current prices	2.5	0.0	-1.0	0.9	2.2	2.3
Consumption	2.4	1.9	-1.7	-0.2	1.4	1.5
Investment	7.8	-10.1	-0.6	5.6	4.3	3.9
Inflation (IPCA - end of period)	5.9	6.4	7.0	5.4	4.8	4.6
Exports in US$	-0.2	-7.0	-5.7	4.2	6.3	7.2
Imports in US$	7.4	-4.4	-11.6	3.7	4.5	4.5
In % of GDP						
Gross domestic investment	18.1	16.4	16.5	17.2	17.5	17.8
Private sector	15.6	13.7	14.2	14.9	15.2	15.4
Public Sector	2.5	2.7	2.2	2.3	2.3	2.4
Gross national savings	14.5	12.2	12.9	13.6	14.0	14.4
Current account balance	-3.6	-4.2	-3.6	-3.6	-3.5	-3.4
Central government primary balance	1.6	-0.4	1.0	1.5	1.7	2.0
NFPS* primary balance	1.9	-0.6	1.2	2.0	2.2	2.5
NFPS overall balance	-3.3	-6.8	-5.1	-4.3	-3.8	-3.2
Net public sector debt	33.6	37.2	39.3	38.9	38.2	38.1
In US$bn						
Net inwards FDI	67.5	66.0	53.9	54.0	52.6	53.8
Exports in US$	242.0	225.1	212.3	221.1	235.1	252.0
Imports in US$	239.6	229.0	202.4	210.0	219.4	229.2
Gross official reserves	358.8	363.6	358.3	358.8	359.6	360.4
*Non-Financial Public Sector						
Source: *IMF Press Release 15/167 of 10 April 2015, 'IMF Executive Board Concludes 2014 Article IV Consultation with Brazil'*						

The publication by Petrobras of its audited accounts on 21 April could well mark the first stage of a recovery: this in the wake of the company's estimated U$17bn in losses from the corruption scandal. Any other moves by Petrobras or the government to boost transparency in the non-financial public sector should lift investment confidence. Investor sentiment would also be boosted if official measures to strengthen corporate governance were accompanied by reforms aimed at boosting labour productivity (widely accepted as a significant problem) and reducing *O Custo Brasil* – the complex red tape and other factors that significantly increase the costs of doing business in the country. In this scenario, sentiment on the part of corporate and portfolio investors could improve markedly.

COLOMBIA

Steady despite challenges

In spite of the fall in energy and mineral prices, Colombia continues to manage sustainable growth and tolerably low inflation. This augurs well for further progress in poverty reduction.

In its preliminary overview of regional economies at the end of last year, the United Nation's Economic Commission for Latin America & the Caribbean (ECLAC) was positive about Colombia's performance. It noted that thanks to rising investment, domestic demand had been soaring. ECLAC noted that the re-election of President Juan Manuel Santos had been good for the continuity of policy, especially with regards to investment projects. Foreign Direct Investment (FDI) inflows the first half of 2014 rose by 10% year-on-year, from an already elevated base. In late 2014, ECLAC was looking for Colombia to achieve real GDP growth of 4.8% in 2014 and 4.3% in 2015.

ECLAC also highlighted generally favourable trends in the country's public finances - in spite of an increase in the consolidated public sector deficit from 1.1% of GDP in 2013 to an estimated 1.6% in 2014. The deterioration was mainly due to an 8.8% rise in government spending to 19.5% of GDP. However, ECLAC noted that a tax reform proposed by the Santos administration in October 2014 should eventually yield additional revenues. Proposed reforms included a wealth tax, a surcharge to boost the income tax for equality (CREE) and a possible incentive for taxpayers to comply with tax regulations by paying a fee equal to one tenth of the assets not declared on previous returns: the fee being considerably lower than the current fine.

> "The potential 'peace dividend' is calculated to be significant, not least because social peace and the various economic, social and political reforms in support of an eventual peace agreement should support a virtuous circle of reform and growth in household incomes. A sustained reduction in poverty and income inequality is considered essential, not least because these factors contributed to the conflict in the past."

Meanwhile, the government continues to push ahead with structural reforms, some of which are being implemented as part of Colombia's planned accession to the Organisation for Economic Cooperation and Development (OECD), while others relate to the current peace process with the country's main left-wing guerrilla group, Fuerzas Armadas Revolucionarias de Colombia (Farc). The potential 'peace dividend' is calculated to be significant, not least because social peace and the various economic, social and political reforms in support of an eventual peace agreement should support a virtuous circle of reform and growth in household incomes. A sustained reduction in poverty and income inequality is considered essential, not least because these factors contributed to the conflict in the past.

In a September 2014 overview of policy notes, the World Bank (WB) suggested that the three objectives of peace, lower poverty and a reduction in inequality were "within reach". It added that sustainable peace was essential for human rights to flourish in Colombia.

In mid-March 2015, an International Monetary Fund (IMF) delegation visited Colombia to assess the economy as a part of a regular Article IV mission. The IMF highlighted the strong appetite in recent months for Colombian government debt, thanks in part to upgrades in the country's sovereign credit rating and a recent lift in Colombia's weighting in global bond indices. This improvement came in the context of an increase in foreign reserves held at the central bank, as well as the government's access to a Flexible Credit Line from the IMF. This improved market sentiment on Colombia allowed the Bogotá government to take advantage of historically low bond yields to issue new debt and extend the average maturities of existing borrowings. In the meantime, the capital requirements of what was already a strong and well-regulated financial system have been improved further.

The IMF is now looking for slower real GDP growth in 2015, albeit it forecasts a respectable outcome by regional standards, of 3.5% year on year. Although Colombian exporters have received a boost from the depreciation of the Peso against the US$ over the course of the last year or so, the continued slump in oil prices is a major challenge for the country. Consumption is expected to decelerate. The IMF also noted that investment (particularly in the energy sector) would slow. And indeed, FDI inflows were down by 10% in Q1 2015 to US$3.3bn, driven by a large 12% fall in inflows to the key oil sector to US$2.7bn (which nevertheless accounted for 82% of the first quarter inflow). Inflows to other sectors fell by 1.9% to US$608.7m, the central bank reported. The net FDI result was US$4.48bn in the first quarter, down by 25% year-on-year, on preliminary figures. Nevertheless, the IMF expects real economic growth to accelerate back to almost 4.5% by 2019, thanks significantly to the benefits of infrastructure investment.

The IMF emphasised that further fiscal reforms could be helpful in a scenario of low oil prices, slower investment and weaker growth. Potential options include increasing the rate of VAT, replacing traditional corporate taxation with the simplified exemption structure of the CREE (income tax for equality) and further changes to the personal income tax regime. "Enormous gains in revenue could [also] be achieved through improving tax administration, including by imposing criminal penalties for tax evasion, increasing the number of officials and strengthening the information technology of the tax administration authority", it noted.

For its part, the OECD, in a January 2015 review of the Colombian economy, also identified additional reforms that could be undertaken. The OECD suggests that the tax system could be made greener through the introduction of a carbon tax. It also argues for wholesale reform of the pensions system, in order to reduce old age poverty and inequality. Some two-thirds of older Colombians have no form of pension. The minimum old-age income support is below the national poverty line. The OECD supports an expansion of eligibility for the *Beneficios Económicos Periódicos* programme, alongside increased coverage and benefit levels under the minimum old-age income support and the Colombia Mayor programme. In an April 2015 report entitled, '*Colombia's social security system: advances and challenges*', ECLAC highlighted the need for welfare reform to address the low levels of social protection afforded to women in particular and the rural population in general.

Colombia's economy, as the IMF sees it

	2014	**2015**	**2016**
Gross domestic product, constant prices % change	4.55	3.40	3.70
Gross domestic product, current prices US$bn	384.90	332.38	360.26
Gross domestic product per capita, current prices US$	8,075.64	6,894.62	7,388.11
Total investment % GDP	24.44	22.13	21.77
Gross national savings % GDP	19.43	16.37	16.88
Inflation, average consumer prices %	2.90	3.35	3.04
Inflation, end of period consumer prices %	3.66	3.60	3.24
Volume of imports of goods and services %	10.62	-7.82	2.97
Volume of Imports of goods %	10.62	-7.82	2.97
Volume of exports of goods and services %	-0.07	5.02	6.76
Volume of exports of goods %	-0.07	5.02	6.76
Unemployment rate % of labour force	9.11	9.00	8.90
Population mn	47.66	48.21	48.76
General government revenue % GDP	28.20	26.31	26.15
General government total expenditure % GDP	29.60	29.52	28.79
General government net lending/borrowing % GDP	-1.39	-3.22	-2.64
General government primary net lending/borrowing % GDP	0.91	-0.45	-0.01
General government net debt % GDP	27.89	30.23	30.49
General government gross debt % GDP	38.02	40.60	40.10
Current account balance US$bn	-19.29	-19.13	-17.61
Current account balance % GDP	-5.01	-5.76	-4.89
Source: *IMF World Economic Outlook projections, April 2015*			

As the IMF forecasts indicate [*see **chart***], the general prospects for Colombia's economy remain favourable. Overall economic growth and per capita income levels should rise again from 2016. Investment appears set to remain substantial, at around 22% of GDP, even if it is likely to grow more slowly than the economy as a whole moving forward. For now, the IMF is not expecting tax reform to result in higher government revenues as a percentage of GDP. Nevertheless, the current government appears set to maintain fiscal discipline.

Finally, a current account deficit of US$20bn or so is manageable in the context of a US$333bn economy. The deficit was the equivalent of 5.2% of GDP last year. The IMF expects this to rise to 5.8% this year, before falling back to 4.9% in 2015, as oil prices, and therefore export earnings, begin to recover.

PERU

Modest reduction in poverty in 2014

According to Peru's national statistics institute (Instituto Nacional de Estadística, [INE]), the proportion of the population living in poverty fell by 1.2 percentage points in 2014, to 22.7%, down from 23.9% in 2013.

The INE says that 6.99m people, of a total population of nearly 31m in 2014, were living below the poverty line. Nationally, this means that roughly one in five people are poor. The reduction in poverty achieved last year was less than in earlier years, a slowdown attributed to the ending of the commodity price boom, which in turn has caused a relative cooling of Peru's previously very strong GDP growth rate. Real annual GDP growth was 2.4% in 2014, its lowest rate in five years. The government expects the pace of growth to pick up in 2015 to 4.2%, but a number of analysts think that optimistic. The UN's Economic Commission for Latin America and the Caribbean (ECLAC) is also forecasting GDP growth of 4.2% this year, but the IMF projects a lower 3.8%.

> "[O]ver a quarter of a million people – 298,000 – emerged from poverty last year."

Despite last year's slower growth, the head of the INE, Alejandro Vilches, noted that "over a quarter of a million people – 298,000 – emerged from poverty last year". According to INE's figures, the proportion of the population living in poverty is highest in the Andean region, where it stands at 33.8%. Ironically perhaps, this region, with its rich mineral resources, has been driving the country's export-led growth. In the coastal region, poverty is much lower – at 14.3% – while in the Amazon region it goes up again to 30.4%.

The general reduction in poverty in recent years is attributed to a combination of strong economic growth and a variety of social programmes introduced by the government of President Ollanta Humala. In a report last year, BBVA Research economist Hugo Perea argued that as a result of 5%-plus annual growth, Peru had gone through a sustained process of poverty reduction and an expansion of the middle class. While specific poverty reduction programmes had been successful, he argued, these were less important in the longer term than a high growth rate.

A slightly different point was made in a World Bank report published in March, which focused on "chronic poverty". According to one of its authors, Renos Vakis, Latin America has pockets of "chronic poverty" where "economic growth on its own is perhaps not sufficient" to improve peoples' income levels. In his view other factors, such as the geographic remoteness of communities from the labour market, or the absence of key skills needed for employment, need to be tackled directly.

In another recent report, the World Bank has argued that persistent poverty is not just a function of a lack of education or health services, but may also reflect psychological factors. It notes a case in Peru where a government-funded tuberculosis prevention programme in a Lima shantytown was rather unsuccessful – until the government also introduced depression-counselling services, at which point attendance rates improved. That report noted that "poverty can have complicated mental effects, which can make it more difficult to emerge from poverty – it can be a self-perpetuating vicious circle". It also suggested that conditional cash transfer programmes, where poor households receive cash subsidies on condition that they do certain things such as ensure school attendance by their children, may not be effective in all cases. One such programme, Brazil's Bolsa Familia, has been widely hailed as a highly successful approach to poverty reduction. Yet the World Bank warned such programmes do not reach everyone. The issue remains significant, says the Bank, because after a decade of sustained growth (which is now slowing down) one in five Latin Americans is still living on less than US$4 a day.

REGIONAL BUSINESS OUTLOOK

REGION

Infrastructure a key concern at corporate summit

The Summit of the Americas (SOA) held in Panama City on 10-11 April will go down in history as a major political landmark, symbolised by the handshake between Presidents Barack Obama of the US and Raúl Castro of Cuba. But it wasn't all politics: ahead of the SOA, Panama also hosted the second Chief Executive Officer Summit of the Americas (known as II CEO). Some 700 top business executives, including Facebook's Mark Zuckerberg, América Móvil's Carlos Slim, Construtora Odebrecht's Marcello Odebrecht and the CEOs of Boeing, AES Corporation, Coca-Cola and Copa Holdings, among others, were in attendance.

> "President Obama made a call for old antagonisms between Left and Right, and between the public and private sectors, to be set aside in favour of "practical solutions"."

II CEO was a chance for an impressive list of chief executives to give their corporate takes on some of the problems and potential solutions facing Latin America. It was also a chance for the heads of state to engage with them. Panama's President Juan Carlos Varela spoke of the contribution companies could make to his government's goal of achieving "prosperity with equity": he stressed the positive role of private sector investment, and the way it can help increase living standards. In his speech to the CEOs, President Obama made a call for old antagonisms between Left and Right, and between the public and private sectors, to be set aside in favour of "practical solutions". He sought to balance recognition of the wealth-creating effects of free enterprise with the acknowledgement that markets can and sometimes do fail and therefore need a degree of regulation. Inspired by a visit to the Panama Canal, Obama said he had learnt that its successful operation as a key link in world trade depends on adequate rainfall and water levels: hence global warming and action on climate change must be part of the public-private dialogue.

Various themes came up in the discussion, with a number of CEOs putting questions during one session to four heads of state: Varela, Obama, Brazil's Dilma Rousseff and Mexico's Enrique Peña Nieto. Obama and Rousseff stressed the importance of regional infrastructure integration. The Brazilian president described the infrastructure issue as one of the biggest challenges her government faced, and suggested there was potential for multilateral collaboration to address it. Brazil is already involved in collaborative gas pipeline and electricity transmission projects with its neighbours, she noted, emphasising that investment was needed not only for energy, ports and highways, but also for social infrastructure, like housing and education.

The Americas Business Dialogue (ADB), a private sector group coordinated with the help of the Inter-American Development Bank (IDB), produced a set of 30 specific recommendations for the heads of state to consider. These were grouped into four main clusters. The first aimed to "improve infrastructure and strengthen trade"; the second to "facilitate financial resources to spur growth and development"; the third to "stimulate innovation and entrepreneurship and develop our human capital" and the fourth to "maximise the potential of the region's energy and natural resources". By their nature, long lists of detailed recommendations can make rather dry reading, but there was a clear attempt to streamline and boost the impact of a number of existing public-private processes.

For example, under the second cluster – the use of financial resources to boost growth and development – the detailed recommendation was that governments should "take steps to deepen and harmonise capital markets and integrate markets that lack scale, by facilitating investments by public entities, which constitute some of the largest investors; issuing bonds with a wide variety of maturities that others can use as references to price their securities; and aligning listing requirements, credit ratings, and professional licensing requirements with internationally accepted standards to create a simple and transparent framework for issuing securities." This recommendation could be interpreted as supporting initiatives like the Mercado Integrado Latino Americano (MILA), a multi-country stock exchange incorporating the bourses of Chile, Peru, Colombia and Mexico. The MILA does get a specific mention further on in the document, when the IDB is cited as calculating growth in its first phase (before Mexico joined) at 27%, to reach a market cap of US$727bn, thus making it the second largest market in Latin America.

"IDB calculations indicate that if Latin America could double its current levels of infrastructure investment, "potential real annual GDP growth could increase by as much as 2 percentage points"."

The ADB's recommendations, coupled with a set of briefing papers prepared by the IDB, are particularly good at quantifying economic development problems and illustrating the potential gains to be had by addressing them. IDB calculations indicate that if Latin America could double its current levels of infrastructure investment, "potential real annual GDP growth could increase by as much as 2 percentage points". Also cited was data from the Economic Commission for Latin America and the Caribbean (ECLAC), which indicated that average regional investment in 2012 in the four key infrastructure categories (transport, energy, telecoms, and water and sanitation), was 3.5% of GDP. ECLAC estimated that a higher and sustained investment level equivalent to 5.2% of regional GDP, or US$170bn, would be required "to respond to business and consumer needs between 2006 and 2020". And to get up to the infrastructure investment rates of the more successful Asian economies, the rate would need to rise even further, to around 7.9% of regional GDP, or some US$260bn.

The ADB also makes the point that it is not just about finding the money. Infrastructure projects must be professionally designed, evaluated, and executed. It says that while Brazil, Mexico, Colombia, Peru and Chile have attracted substantial investment in road and rail concessions, they still face challenges, which include "lack of independence, technical expertise, and coordination among regulatory agencies; poorly designed contracts that lead to constant renegotiations; and national policies that may prevent foreign companies from competing in badly needed services such as cabotage or air cargo".

The recommendations also mention the need to integrate Latin American economies more closely into global value chains (GVCs). Modern and robust logistics, and easier of cross border movements, are considered key conditions to allow companies to compete efficiently in GVCs. But the main global GVCs are located in the EU, South Asia, and North America – not in Latin America or the Caribbean. The IDB says that the typical regional economy has "fewer backward and forward production linkages than the typical country in Asia or Europe. The share of exports linked to a "multi-country production process" is 13 percentage points lower in Latin America and the Caribbean than it is in Europe.

Innovation and entrepreneurship featured high on the list of CEO concerns. Both are seen as critically important to lift productivity levels, but the region is said to lag far behind in the kind of STEM (science, technology, engineering and mathematics) skills that are deemed "most likely to contribute to innovative entrepreneurship". Other worrying indicators are that start-ups face higher barriers to market entry in Latin America. Banks provide 15-30% of start-up financing in the US, 7% in Brazil, and close to 0% in Chile and Mexico. Average research and development spending in the OECD countries is over 2% of GDP, but under 1% in Latin America and the Caribbean. More encouragingly perhaps, the documents presented by the IDB show that something is stirring in this area. According to InfoDev, a World Bank donor fund designed to support entrepreneurship and business incubators, there are about 3,600 companies with 16,000 employees taking part in incubated businesses as part of a continent-wide network of business incubation organisations. The comparable number in the US is 27,000 start-up companies. According to US research, US$1 of public investment in incubators can generate US$30 in future tax revenues. If a similar relationship holds for Latin America, start-ups could begin to play a significant role in supporting growth and diversification.

"[S]tart-ups face higher barriers to market entry in Latin America. Banks provide 15-30% of start-up financing in the US, 7% in Brazil, and close to 0% in Chile and Mexico."

REGION

Latin lessons to be learnt from South Korea?

The Inter-American Development Bank (IDB) has suggested that Latin America could learn some useful economic lessons from South Korea. Or is it too late?

According to Federico Basañes, head of the IDB's department of knowledge and learning, "South Korea has one of the most impactful development stories of recent times". He points out that between 1961 and 1993 the proportion of its population living below the poverty line in the country dropped from 48.3% to 7.6%. Many Latin American governments would love to have a comparably impressive record on poverty reduction. Whichever way you look at it, South Korea does seem like a fast car overtaking everyone else on the highway to development. As recently as 1980, 15 countries in Latin America and the Caribbean had GDP per capita levels that were higher than in South Korea. Today, none of them do (the closest is Trinidad & Tobago, where per capita GDP is 88% of South Korea's). Presenting its annual report in Busan in South Korea in April, the IDB organised a workshop to look at the lessons that can be learnt.

According to Basañes, among the things that South Korea got right were the "relentless" promotion of exports and the efficient allocation of human capital and resources to the sectors of the economy where it had the highest productivity. It also had solid institutions and a public sector that recruited "the best and brightest" into the civil service. But it did get some things wrong, he says: it over-invested in heavy engineering and chemicals, and developed a belief that the government would not let the big conglomerates fail, all of which contributed to the economic crisis of the late 1990s. Nevertheless, the country has bounced back strongly. Basañes describes modern South Korea as "an industrial and knowledge powerhouse", adding that "its experiences in education, vocational training, trade promotion, smart cities, use of smart grids and other technologies to increase productivity have provided valuable lessons for Latin America and the Caribbean."

But Mauricio Moreira, an IDB consultant, says the "South Korean model" cannot be mechanically transported to Latin America. Speaking to Spanish news agency Efe, he pointed out that "various parts of the model can work for us, but others not… the world is different, domestic conditions are different, economists have been arguing about this for 30 years and it still isn't settled". According to Moreira, after an initial experiment in protectionism, by the 1970s South Korea had realized a foreign trade opening could become an engine for development. Latin America didn't come to that realisation until the 1990s, and by that time it was a late convert, because it had to compete with exporting giants like China and India.

Education could be another transferable part of the "model", Moreira says. "It is impressive. The priority that the South Koreans gave to education at the start of their industrialization process is fantastic. It is now part of the culture. The importance they give to teachers, and to universities, it is difficult to find anything comparable in Latin America". In his view, during their protectionist phase, Latin American countries had things the wrong way round. There was no emphasis on education and training, because industries were protected. The result was that the region ended up with lots of uncompetitive industries, which lacked staff with the right skills.

"But Mauricio Moreira, an IDB consultant, says the "South Korean model" cannot be mechanically transported to Latin America."

Moreira feels that Latin America did miss the bus. With the possible exception of Mexico, he believes the continent can't go for a manufacturing and export-led growth model, simply because South Korea showed the way and was eagerly followed by the likes of China and India. There are too many doing the same thing; that market is now just too competitive. Mexico is an exception, because its close proximity to the US allows it to be very competitive and to become closely integrated into the US value production chain. For the rest of the continent, Moreira says, "We have to take advantage of the resources that we have, and diversify from that starting point. We have to add value to mining and agricultural production. Many regional governments are still a little bit obsessed with manufacturing as the only option, and it isn't. We have to think of other alternatives".

Trade opportunities

The IDB used the Busan meeting as a vehicle to promote new South Korea–Latin American trade opportunities. Business representatives from both sides were invited to investigate trade in technology, transport, energy and environmental services. The IDB says that since 1990 trade between South Korea and Latin America and the Caribbean (LAC) has grown at an average annual rate of 17% to reach US$54bn in 2014. LAC countries have exported mineral and agricultural commodities to South Korea, while importing manufactured and hi-tech products.

The IDB notes, however, that LAC exports to South Korea are more diversified than to other Asian markets. South Korea has also become an important source of foreign direct investment (FDI) in LAC countries, particularly in the manufacturing sector. There are free trade agreements (FTAs) between South Korean and Chile, Peru and Colombia. During the summit, the South Korean government announce that it would provide US$1bn of policy financing to

Latin America, including setting up a US$500m Economic Development Cooperation Fund (EDCF). The Fund will provide loans to infrastructure development projects in Latin America. "Connecting Seoul's prowess in information technology and manufacturing with Latin America's abundant mineral and energy resources will benefit all sides", said the South Korean finance minister, Choi Kyung-hwan.

REGION

Corporate radar

Ecopetrol to divest ISA stake

Colombia's state-owned oil company, Ecopetrol, has been authorised by the government to sell its 5.32% stake in the also majority state-owned electricity transmission company, ISA. The decision came in early April; shortly after former finance minister Juan Carlos Echeverry as Ecopetrol's new chief executive, replacing Juan Gutiérrez Pemberthy. The oil company said that the proceeds of the share sale would be used to help finance Ecopetrol's investment programme. Separately, Ecopetrol also said it had received finance ministry approval to issue bonds on international capital markets worth up to US$3.2bn. In 2014, Ecopetrol posted net profits of COP7.8bn (US$3.0bn), down by 41% on the year earlier, a fall that the company attributed to the slump in international oil prices. Earlier, there were reports that Ecopetrol was considering taking over direct operation of the Rubiales oil field, currently operated by the Canada-listed oil company Pacific Rubiales. Under the existing licence, which expires in mid-2016, Ecopetrol has the rights to 60% of the field's output, with Pacific Rubiales holding 40%. While the two companies were reported to be in talks over post-2016 arrangements, Colombian press reports said Ecopetrol was considering taking 100% control of the field, which produces around 160,000 bpd, or one sixth of the country's total production.

"In 2014, Ecopetrol posted net profits of COP7.8bn (US$3.0bn), down by 41% on the year earlier, a fall that the company attributed to the slump in international oil prices."

Carlos Slim spins off Telesites

Shareholders in América Movil (AMX), the Mexico-based telecoms giant controlled by Carlos Slim, voted in April to spin off a new company called Telesites, which will manage a total of 10,800 mobile telephony transmission towers around the country. Telesites will be listed on the Mexican stock exchange. According to the newspaper *El Financiero*, the new company will have 43.2% of the radio transmitter tower market in the country, followed by American Tower with 34.2% and Mexico Tower Partners with 4.8%, with the remainder divided up among smaller players. AMX highlighted forecasts according to which Mexico needs to multiply the number of transmission towers in operation four-fold, suggesting the new company will be well positioned for strong growth. Mexican analysts say that although AMX has been ruled to be "predominant" in the local telecoms market by the regulator, Instituto Federal de Telecomunicaciones (IFT), and therefore must divest part of its operation; the spin-off of Telesites is a separate matter. Jesús Romo, of analysts Telconomía, said that Telesites was being spun off to allow AMX to focus on other parts of its business, more than for regulatory reasons. Nonetheless he expected the IFT to consider Telesites to be "predominant" in the transmission towers market, just as its parent AMX had been deemed to be before. The new company would be subject to the same 'asymmetric measures' – basically the obligation to grant access to its transmission network to other players at rates fixed by the regulator. AMX still needs to carry out other divestments to reduce its market dominance; in July 2014, the company said that it would present a plan to do this by 30 June 2015 at the latest.

> “The headlines about Petrobras are not pretty, but we are talking about something long term here...”

Shell’s BG takeover has implications for Brazil

The 7 April announcement that Royal Dutch Shell was in advanced talks to takeover BG Group is believed to have implications for oil and gas operations in Brazil. Globally, Shell (which has a market valuation of US$202bn), by acquiring BG (with a market cap of US$46bn) is seeking to extend its lead in gas production and get closer in revenue terms to the world’s biggest private sector oil company, the US-based Exxon-Mobil. The takeover, if approved, will be the first since the collapse in oil prices last year, and, in the eyes of some analysts, a sign of a new wave of market consolidation. Shell chief executive Ben van Beurden made it clear that one of the attractions of the deal was BG’s Brazilian assets. He described Brazil as “probably the most exciting area in the world for the oil industry”, adding, “We are already in Brazil and we are happy there, but we want more. A significant part of this deal was gaining a stronger presence in Brazil’s deep water”. BG has drilling rights to the Iara, Saphinoá, Lapa and Lula (formerly Tupi) oil blocks. The Shell CEO recognised that to develop Brazil’s pre-salt offshore deposits the company needs to work in partnership with the state-owned Petrobras, currently mired in corruption allegations and enquiries. “The headlines about Petrobras are not pretty, but we are talking about something long term here” he commented.

Brazil’s OAS seeks bankruptcy protection

One of Brazil’s major construction companies caught up in the Petrobras corruption scandal, Grupo OAS, filed for bankruptcy protection for nine of its subsidiaries on 31 March. The company has debts of BRL8bn (US$2.48bn) and has not been able to borrow or raise capital because of the impact of its involvement in the Petrobras scandal. It has also been hit by the flatlining Brazilian economy, public sector austerity and a weak domestic currency. The OAS move to seek bankruptcy protection followed similar action by two of its competitors, Alumini Engenharia and Galvão Enghenheria. The three companies are alleged to have been part of a cartel of over 20 large groups that paid bribes to Petrobras executives in exchange for contracts. Several top OAS managers were arrested last year as part of the investigation into the cartel. The decision to file for bankruptcy was taken after negotiations with the company’s main creditors. Sources said the outlines of a rescue plan had been agreed, involving a debtor-in-possession (DIP) loan to tide the company over, followed by the sale of shareholding stakes in subsidiaries including infrastructure operator Invepar, a shipbuilder, two football stadiums, a waste management company, an oil and gas sector supplier, and a defence contractor.

General Electric upbeat over the region

Despite “turbulence” and a poor performance this year in two of its key markets, Brazil and Venezuela, US company General Electric said it expected to achieve a 1% growth rate for its Latin American division in 2015. Speaking at the summit of CEOs held in Panama in April just before the Summit of the Americas organised by Organisation of American States (OAS), Reinaldo García, head of GE’s Latin American division, told the *Reuters* news agency that the company had boosted its profits in Latin America by 7% in 2014, and over the last four years had almost doubled the size of its regional business. This year it was expecting 1% growth in Brazil, which would be a good result in a “difficult year” for the economy. In Venezuela, where GE is involved in power generation and the oil and gas sector, it was expecting revenue to remain flat or fall a little. But García remained upbeat about prospects for the business. “The continent has 600m people with a growing middle class, and with big infrastructure challenges” he said, adding, “We love this continent”.

Ford announces US$2.5bn Mexico investment

Ford Motor said in April that it would invest a total of US$2.5bn to build a new engine factory in Chihuahua and a transmission plant in Guanajuato, creating an estimated 3,800 new jobs. This was the latest in string of new investments announced for the country's booming automotive sector. It followed an earlier announcement of a US$1bn plant investment by Toyota, designed to build 200,000 Corolla compact cars for North American markets.

In March, Volkswagen said it would invest US$1bn to expand its production plant in Puebla state. Welcoming Ford's new investment at a ceremony in Mexico City, President Enrique Peña Nieto noted that Mexico has moved up from eighth to seventh largest car producer in the world, and is the fourth-largest car exporter.

The Mexican authorities say cumulative foreign investment in the sector has now reached over US$22.6bn. Ford's new investment will be to build 1.5 litre and 1.6 litre four-cylinder engines, mainly assembled up to now in the UK and China, and used to power Ford Fusion and Escape models. It confirms the strong growth of the automotive sector in the country, with a range of companies attracted by Mexico's multiple free trade agreements, competitive wage levels and proximity to US consumers.

The announcement was not well received by the main US industry labour union, the United Auto Workers (UAW). In a statement it said "The announcement by Ford to invest US$2.5bn in Mexico is disappointing, but not any more disappointing than GM's decision to invest US$5bn in Mexico or similar investments like FCA Chrysler, Nissan, Mazda, Honda, and now both Toyota and Kia, which have announced investments in Mexico." Industry analysts, however, note that not all the traffic has been one-way. GM recently said it was spending US$185m to move Cadillac SRX production out of Arizpe in Mexico and back into the US.

"Mexican authorities say cumulative foreign investment in the sector has now reached over US$22.6bn."

Grupo Radio Centro gets cold feet

The Mexican media conglomerate Grupo Radio Centro will not, after all, operate a national digital free-to-air TV service. Mexico's telecoms and broadcasting regulator, Instituto Federal de Telecomunicaciones (IFT), had selected Grupo Radio Centro as one of two successful bidders for national licences, offered in a bid to help break up the existing duopoly of *Televisa*, the dominant network and *TV Azteca*, the number two. Having paid an initial MXN415mn (US$26.9m) deposit, Grupo Radio Centro has been due to pay the remaining balance of its bid, which including the deposit came to MXN3.06bn (US$200m) on 10 April. But as the deadline approached it became evident that the conglomerate was scrambling to seek out partners to help it raise the money. On the day itself, no payment was made, meaning Grupo Radio Centro was deemed to have forfeited the licence – and lost its deposit. The other successful bidder, *Cadena 3*, which offered a lower MXN1.8bn, is still on track to launch next year. IFT said it would consider what to do next in a forthcoming meeting. Referring to the now unallocated licence, the IFT president Gabriel Contreras said, "There is interest from regional operators and we will analyse every possibility".

Southern Copper expects big growth

Peru-based mining group Southern Copper said in a report filed with the Lima stock exchange that it expects to almost double its annual copper production to 1.15m tonnes by 2017, as projects in Peru and Mexico come to fruition. The company said that its expected growth would make it the world's third largest copper producer by 2017. Grupo México controls

Southern Copper. In 2014 it produced 676,600 tonnes of copper. In early April this year, it successfully issued US$2bn worth of 30-year bonds, designed to help fund its expansion plans and possible "strategic acquisitions".

Its current projects include expanding the Buenavista mine in Mexico, where US$3.4bn in investment is earmarked to boost production from 180,000 tonnes per year (tpy) now to 512,000 tpy. It also highlighted its US$1.4bn Tía María project in Peru, which is scheduled to produce 120,000 tpy by 2017. The Tía María mine is facing opposition from local communities, who fear that farms will suffer contamination. On 22 April, one person died as a result of clashes between police and protestors demanding that the project be cancelled. Southern Copper is still awaiting a mining permit from the government, which delayed the project after a first wave of protests in 2011. President Ollanta Humala has defended the project, saying that Southern Copper should be "given a chance". The mining company is also focusing on expanding its existing mine at Toquepala, where it plans to invest US$1.2bn to double the capacity of its concentrator.

CUBA

SSOT delisting boosts sentiment

"The government of Cuba welcomed the news that the country is to be removed from the SSOT list (also comprising Syria, Sudan and Iran), as an important step towards the restoration of normal diplomatic relations between the US and Cuba."

On 14 April, President Barack Obama notified the US Congress of his intention to remove Cuba from the State Department's list of state sponsors of terrorism (SSOT).

The government of Cuba welcomed the news that the country is to be removed from the SSOT list (also comprising Syria, Sudan and Iran), as an important step towards the restoration of normal diplomatic relations between the US and Cuba. In theory, the US congress has 45 days to respond. In practice, President Obama could veto any objections. While the de-listing will facilitate banking and financial relations between the two countries (including allowing the Cuban interests section in Washington and the Cuban Mission to the United Nations in New York renewed access to banking services), and certainly spur the nascent US interest in doing business with Cuba, the considerable legal and technical hurdles to doing so under the congressionally-codified embargo remain firmly intact, without much hope of removal any time soon.

Implications

In a report outlining the main implications of Cuba's SSOT de-listing, a multinational law firm, Hogan Lovells, identified the following: (Cuba's) eligibility for a wider range of (US) exports of dual-use items (for example software, communications technology and other items with potential military use); eligibility for US foreign assistance and humanitarian aid; elimination of Private Right Action (meaning that the statutory authorisation for individual US citizens to pursue private claims against Cuba in US courts would be eliminated, thereby facilitating trade without the potential fear of asset seizures); the elimination of a rule requiring publically-traded companies to disclose to the US Securities and Exchange Commission (SEC) their dealings with Cuba; and finally, the elimination of State divestment laws (some US states have laws or policies prohibiting investments in companies doing business with blacklisted countries).

Meanwhile, the mainstream media continues to highlight how a number of leading US companies in the broadly defined technology, media and telecommunications (TMT) sector are looking to expand into Cuba. In February, for instance, the online movie provider Netflix said that it would

"Less attention has been paid to the logistics of online payments to Technology, Media and Telecoms (TMT) companies by Cubans buying goods and/or services. Credit cards and debit cards, typically used by customers in other countries, are not yet available."

extend its service to Cuba, as a part of a longer term plan to expand its geographical footprint from around 50 countries to 200 over the next two years. At the VII Summit of the Americas, Mark Zuckerberg, the founder and Chief Executive Officer of *Facebook*, said that it was looking to expand its internet.org initiative, which brings Wi-Fi services to countries and areas that are lacking in Internet access, to Cuba. Internet.org is already active in the region in Colombia, Guatemala and Panama. Apple has indicated that it may provide some of its products to Cuba. Other reports indicate that Amazon may be looking to provide its clients with the opportunity to ship to Cuba.

Online commerce in Cuba is and will remain hampered by the lack of Internet access. According to the International Telecommunications Union (ITU), Internet penetration in 2013 was 25.7%. Although the state-owned telecommunications company Etecsa reduced the cost of an hour of Internet use from the equivalent of US$5 to US$2.50 for a two month period to mid-April, that lower price is still way too expensive for most Cubans. Alternatively, Cubans may pay Etecsa the equivalent of US$10 per month for 20 hours of Internet access, US$15 for 50 hours or 220 hours for US$60. The charges must be paid in convertible pesos (CUC), which are fixed at (near) parity to the US dollar. In a country with over 11m people, there are only 155 public access points where connection to broadband Internet is possible.

Less attention has been paid to the logistics of online payments to Technology, Media and Telecoms (TMT) companies by Cubans buying goods and/or services. Credit cards and debit cards, typically used by customers in other countries, are not yet available. In theory, TMT companies could sell vouchers for national pesos (CUP) or (more likely) CUC – the two currencies in Cuba's dual currency system, which then could be redeemed by customers online. In practice, though, no details have been made public.

Details of how TMT companies might be paid likely will remain scant until the Cuban authorities resolve a much more fundamental problem. As we have regularly noted in our reviews of the Cuban economy, neither the CUC nor the CUP adequately perform the basic functions of money. Neither really serves as a unit of account, a means of payment or a store of value. Unless and until the current dual currency system is replaced with a new system that is clearly sustainable (such as a properly constructed new currency peg to the US dollar, for instance), e-commerce is very unlikely to flourish in Cuba.

This is not to say that recent weeks have not seen significant and positive announcements involving foreign companies. In late March, for example, Canadian company Sherritt International said that it should benefit from a reduction in tax rates applied by the Cuban authorities to its local operations. The new foreign investment rule cuts the tax rate on oil & gas operations from 30% to 22.5%. The equivalent reductions for power generation and mining, two other areas in which Sherritt International has significant interests in Cuba, are from 30% to 15% and from 45% to 22.5% respectively. The halving in the tax on mining comes at a time that there is the potential for a substantial increase in volumes of nickel production. Nickel prices have been boosted in the recent past by a global shortage. In part because of the mothballing of plants, output of nickel from Cuba's mines in the last year or so has been about half of the normal level of the last decade.

Press reports in early March indicated that Brazilian construction group Odebrecht is starting work on a US$200m project to modernise and expand Havana's José Marti International Airport. This is Odebrecht's third major infrastructure project in Cuba. Three quarters of the funding will come from

Brazil's state-owned development bank, Banco Nacional de Desenvolvimento Econômico e Social (BNDES), which will disburse the money directly to the Cuban government through a bilateral export credit facility set up in 2014.

The projects being operated by Sherritt International and Odebrecht have a number of features in common. First, the government of Cuba (and/or its various agencies) is the main client. Sherritt International and Odebrecht are providing physical infrastructure that the country badly needs. Both companies have ample access to the funding that they need from global capital markets (and, in Odebrecht's case, indirectly from the government of Brazil). In short, the absence of payments systems and the shortcomings of the dual currency system do not affect the activities of either on a daily basis in the way that they would hamper the normal operations of TMT companies seeking to engage with large numbers of Cuban consumers.

Taking a one-year view, a number of trends are foreseeable. The US and Cuban governments will move further towards a normalisation of relations, focused initially on re-establishing embassies. These improving diplomatic relations will provide a favourable backdrop for multinational construction and mining companies. High profile consumer businesses from the US (and large TMT companies in particular) will continue to make clear their desire to extend their geographical footprints to Cuba. In practice, however, little will happen until the Cuban authorities have undertaken wholesale currency reform.

REGIONAL MARKETS REVIEW

REGION

Fairly shockproof

"[T]he credit risk profile for the vast majority of countries is stable and the likelihood of a regional debt crisis is extremely low."

For Latin America and the Caribbean, most economic trends in recent months have been negative. Minerals and energy prices have fallen, in part because of the slowing of the Chinese economy. The end of Quantitative Easing (QE) by the Federal Reserve has, at the margin, reduced the funds that are available for investment in emerging markets. As we noted earlier, multilateral institutions are looking for fairly slow economic growth across the region this year. Nevertheless, the credit risk profile for the vast majority of countries is stable and the likelihood of a regional debt crisis is extremely low.

The causes of debt crises in emerging markets are varied. In countries with high savings rates, crises typically happen as a result of over-investment. In essence, too much money is invested in low returning assets at interest rates that are too low to properly compensate lenders for the risks that they were taking. Although the details varied from country to country, Indonesia, South Korea, Thailand and Malaysia – the four countries most seriously affected by the Asian debt crisis of 1997-98 – are classic examples.

In countries with fairly low savings rates, crises typically happen as a result of external shocks. Such shocks can include: a rapid deterioration in the terms of trade, a rise in interest rates globally, or a sharp fall in investors' appetite for emerging markets risk. The risks of crises in such countries can be heightened by policy errors – such as insufficient commitment to boosting productivity or lax fiscal policy. Most financial crises in Latin America and the Caribbean have, in the past, been the result of at least some of these factors.

The region - as Moody's sees it					
	Rating*	Outlook	Growth % 2015-16	Growth Prospects	Comment
Group 1: Rapid Growth					
Bolivia	Ba3	STABLE	5.0	Above trend	Growth from public investment
Colombia	**Baa2**	STABLE	4.3	Above trend	Growth from prior years' reforms
Dom. Republic	B1	STABLE	4.7	Trend	Growth from strong tourism sector
Nicaragua	B3	STABLE	4.4	Above trend	Growth from remittances and investment
Panama	**Baa2**	STABLE	6.2	Below trend	Reduction in public sector capex will retard growth
Paraguay	Ba1	STABLE	4.3	Above trend	Broadly based growth
Peru	**A3**	STABLE	4.8	Below trend	Growth from prior years' reforms
Group 2: Moderate Growth					
Bahamas	**Baa2**	STABLE	2.4	Above trend	Growth from tourism thanks to US recovery
Belize	Caa2	STABLE	2.5	Below trend	Recovering agriculture and resilient tourism
Chile	**Aa3**	STABLE	3.6	Below trend	Growth will be underpinned by sound policy framework
Costa Rica	Ba3	STABLE	4.0	Below trend	Tourism and other exports should underpin growth
Ecuador	B3	STABLE	3.3	Below trend	Economic gains from energy matrix transformation
Guatemala	Ba1	STABLE	3.6	Trend	Growth from remittances and exports to US
Honduras	B3	STABLE	3.2	Below trend	Growth from remittances and exports to US
Mexico	**A3**	STABLE	3.5	Above trend	Structural reforms should boost growth
Uruguay	**Baa2**	STABLE	3.8	Above trend	Growth moderating slightly, from commodity-driven high
Group 3: Slow Growth					
Argentina	Caa1	NEGATIVE	0.5	Below trend	Unorthodox policy-making to retard growth
Barbados	B3	NEGATIVE	1.3	Above trend	Possible recovery in tourism
Brazil	**Baa2**	NEGATIVE	0.0	Below trend	Restrictive fiscal, monetary policies low confidence
El Salvador	Ba3	STABLE	2.0	Trend	Low investment and tight fiscal policies
Jamaica	Caa3	POSITIVE	2.0	Above trend	Growth from recovery in tourism
St Vincent & G.	B3	NEGATIVE	2.0	Below trend	Stagnant tourism sector
Trinidad & T.	**Baa1**	STABLE	2.0	Below trend	Growth may be boosted by upturn in gas production
Venezuela	Caa3	STABLE	-2.8	Below trend	Unorthodox policy-making to retard growth
Group 4: Other					
Cayman Is.	**Aa3**	STABLE			
Bermuda	**A1**	STABLE			
Sint Maarten	**Baa1**	STABLE			
Suriname	Ba3	STABLE			
*Investment grade ratings are shown in bold					
Source: *Moody's Investor Services, 'Credit profiles stabilizing amid lower growth, moderate external vulnerabilities', 26 March 2015*					

Many forecasters have been cutting their growth forecasts for the region in recent weeks. This is in the context of a sharp fall in energy and minerals prices in the second half of 2014, in part because of slowing growth in China. As a result of the deterioration in their terms of trade, many countries in the region have had to endure drops in their currencies, which have boosted inflationary pressures. At various stages in the past year, global investors have fretted about the possible impact of an increase in the federal funds rate by the US Federal Reserve: the Fed already has ended its QE program.

In spite of these generally negative developments, the overall level of credit risk across the region has not deteriorated much. In a recent research note[1], the ratings agency Moody's Investor Services noted that its ratings downgrades in 2014 (8) exceeded the number of upgrades (6) for the second consecutive year.

[1]Moody's Investor Services, 'Credit profiles stabilizing amid lower growth, moderate external vulnerabilities', 26 March 2015

“The ratings agency notes that, with the arguable exception of Venezuela and Argentina, most countries in the region experienced less volatility in growth in 2010-14 than they had in the period 2000-14. Also contributing to lower risk has been a general reduction in the proportion of government debt that is denominated in foreign currencies.”

The last time that happened was back in 2002-03. Moody’s pointed out that because of the generally weak institutional strength of most countries in the region, the average sovereign rating for the region (a sub-investment grade Ba2) is similar to those of Sub-Saharan Africa and Eastern Europe & Central Asia. Outside Latin America and the Caribbean, Moody’s lifted ratings for 14 countries (including eight developed countries in Western Europe and North America) and downgraded ratings for 11 over the course of 2014.

Of its various ratings changes in 2014, Moody’s considers three to have been particularly important. One was the elevation of Mexico and Peru to an A3 rating. The two countries are the first Latin American sovereign issuers to have attained an ‘A’ rating since Chile in 2006. According to Moody’s, the upgrades for Mexico and Peru resulted from the implementation of “reforms that [should] bolster potential growth in Mexico and reinforce sound macro-economic management and fiscal strength in Peru”. Structural reforms also contributed to upgrades for Colombia and Paraguay last year.

The second key change was the downgrading of Costa Rica to a sub-investment grade rating of Ba1. Over the last decade, Moody’s has cut only two other sovereign issuers in the region to below investment grade: Barbados and El Salvador. Moody’s explained that, “Costa Rica’s downgrade was a consequence of a persistent fiscal weakening. Increased current expenditures and political unwillingness to adopt corrective measures, including a comprehensive tax reform, drove the weakening and consequent downgrade”.

Thirdly, governments at the bottom of the ratings scale moved in different directions. On one hand, Moody’s responded to unorthodox policies in Venezuela and Argentina by lowering its ratings for both countries. Conversely, Moody’s upgraded Ecuador by one notch “to reflect fiscal and economic metrics that are stronger than Caa-rated countries and [Moody’s] view that the government’s willingness to pay its debt obligations has increased since its default in 2008”.

As the **chart** indicates, Moody’s is not expecting ratings to change much in the region over the next year or so. The vast majority of countries have stable outlooks. Jamaica is the only country to have a positive outlook. Only four – Brazil, Argentina, Barbados and St Vincent & the Grenadines – have negative outlooks. The ratings agency notes that, with the arguable exception of Venezuela and Argentina, most countries in the region experienced less volatility in growth in 2010-14 than they had in the period 2000-14. Also contributing to lower risk has been a general reduction in the proportion of government debt that is denominated in foreign currencies.

The chart highlights how the countries are quite varied in terms of their actual and potential ratings, and their assessed economic growth potential. Most of the countries are expected by Moody’s to grow in line with, or slightly below, their long-term trend in 2015-16. Nevertheless, there are seven countries – Bolivia, Colombia, the Dominican Republic, Nicaragua, Panama, Paraguay and Peru – for which the agency is looking for real growth of more than 4%. Costa Rica falls just outside this group. Relatively high investment is (or, in the case of Panama, has been) common to many of these countries.

Chile should continue to benefit from a sound policy-making framework and past structural reforms. Otherwise, the factor that is common to most countries expected to achieve moderate growth in the coming year (i.e. of more than 2% but no more than 4%) is that they are natural beneficiaries of the growth in domestic demand in the US. This should undoubtedly be true of Mexico, although Moody’s has also highlighted the positive impact of recent structural reforms.

“We would not expect a crisis in those countries to change investors’ appetite for Latin American debt generally, with the result that ‘contagion’ produces a regional sell-off in bonds. In spite of the various challenges that have caused many commentators to cut economic growth forecasts, we see minimal risk of a regional crisis.”

The ongoing growth in the US should provide a boost to the tourism sector in Jamaica (and, therefore, to government revenues). Otherwise, the countries in Moody’s third group, which are expected to achieve real growth of less than 2%, are generally characterised by softness in investment or consumption. Several are also suffering as a result of a lack of competitiveness in their tourism sectors.

We would broadly agree with Moody’s assessment of most of the countries. We would judge the prospects for some of the countries in the third group in a different way to the rating agency. In particular, we think that Brazil gradually will move towards a situation whereby business sentiment and investment will recover. We remain of the view that the government of Argentina will probably continue to ‘muddle through’ its various financial problems. By contrast, we would assess the outlook for Venezuela’s government as being negative.

In the event that the governments of Venezuela or (much less probably) Argentina suffer a financial crisis in 2015, this would be seen as the result of factors and problems that are specific to those countries. Put another way, we would not expect a crisis in those countries to change investors’ appetite for Latin American debt generally, with the result that ‘contagion’ produces a regional sell-off in bonds. In spite of the various challenges that have caused many commentators to cut economic growth forecasts, we see minimal risk of a regional crisis.

ARGENTINA

Back to market

On 21 April Argentina sold around US$1.4bn in US dollar-denominated bonds to local banks and institutional investors. The economy minister, Axel Kicillof, immediately claimed that the sale “buried the idea that no one wants to invest in Argentina”.

While the government will pay a high rate of interest, of 8.75% on the 10-year bonds, the fact that it was able to attract buyers at all is welcome news for the government. In December 2014, Argentina failed to raise much interest in a US$3bn debt offer. However, NML Capital, one of the lead ‘holdout’ bondholders currently locked in a legal battle with the Argentine government, said it would closely examining the new issue to see “what enforcement actions are appropriate”.

Speaking on a trip to Moscow, where he was accompanying President Cristina Fernández, Kicillof said, “This is an important milestone because it has been quite a while since Argentina has tested the market”. The government plans to use the money to fund infrastructure projects, including social housing, Kicillof said.

NML Capital, however, issued a warning that the latest bond issue may be subject to the legal restrictions put in place by US District Judge Thomas Griesa. “Those contemplating participation in Argentina’s latest attempt at a global offer should understand that it appears to have all the hallmarks of external indebtedness that is covered by our *pari passu* rights”, Robert Cohen, an attorney for NML, said. “We are closely scrutinising this highly unusual transaction to determine what enforcement actions are appropriate”, Cohen added.

Following the successful sale, Kicillof was dismissive of NML's intervention. "I believe that with regards to the NML incident, we saw today another attempt of extortion; NML's direct attack through a statement in the middle of the auction", the minister fired. "The vulture funds are trying to frighten those who want to work with Argentina in the international markets", Kicillof concluded.

Some analysts in the local media believe the strong demand may be linked to the opposition's strong showing in the 19 April primaries ahead of the October general elections, with investors keen for greater exposure ahead of the possible election of a more market-friendly government in October.

Government appeals latest Griesa ruling

On 6 April the Argentine government appealed in a New York court against a decision by the US District Judge Thomas Griesa that blocked Citibank from processing Argentine bond payments.

Argentina argues that the dollar-denominated payments on bond issued under Buenos Aires law "are not external debt, but internal debt, for which reason they cannot be touched by the judgement of Griesa". Judge Griesa had agreed to make an exception to the 31 March bond payment on an ad hoc basis, but Argentina objected to this deal. The March payments have now been made, but another payment under the same terms is due on 30 June.

"Argentina argues that the dollar-denominated payments on bond issued under Buenos Aires law "are not external debt, but internal debt, for which reason they cannot be touched by the judgement of Griesa"."

The previous week, Argentina's central bank (BCRA), said that Gabriel Ribisich, the head of Citibank Argentina, could no longer represent the bank as he had "ignored Argentina's legal framework regarding sovereign debt restructuring". As the bank has a bond custodianship business in the country, it has a legal obligation to process interest payments on Argentine bonds. Citibank Argentina has itself appealed that decision to a Buenos Aires based court, but in the meantime it has appointed Rosa Aranguen, an executive with 37 years' experience at the bank, to front its operations in the country (*see box*).

The judge due to preside over the Citibank appeal, Claudia Rodríguez Vidal, has confounded the government with her rulings in the past. In 2010, she declared the government's plans to use BCRA reserves to pay down its debts as "unconstitutional" and in 2008 she ordered the national statistics agency (Indec) to explain how it calculates inflation. Also on 6 April, regulators from BCRA raided the headquarters of Citibank in Buenos Aires, in order to "monitor operations".

Citibank Argentina has been banned from operating in the local securities market and its bond custodianship business has been transferred to Caja de Valores SA. It is unclear how far the Argentine government wishes to punish Citibank, the 12th largest bank in the country, given that its real quarrel is with Judge Griesa and its 'holdout' creditors who refuse to accept a write-down on the value of the Argentina's debts. However Economy Minister Kicillof has also threatened action by the Inspección General de Justicia (IGJ), a body that has the power to take legal action and withdraw its operating licence.

Citibank – caught in the middle?

It might be thought that only Citibank's parent company, Citigroup of the US, would have the right to appoint or dismiss its chief executive in Argentina, but under local legislation the BCRA has the power to withdraw its recognition of Ribisch as the legal representative of Citibank. Behind the move lies the country's long-standing dispute with holdout creditors and the US courts.

Citibank Argentina has been caught in an impossible legal situation, and the Buenos Aires government has not been making things any easier. Under its bond custodianship business in Argentina, it has a legal obligation to the government to process interest payments on Argentine bonds. Yet as part of the foreign debt dispute, US

Judge Thomas Griesa ordered Citigroup not to make any such payments. So Citibank Argentina was caught in a "pay or don't pay" dilemma. Various attempts to wriggle free have been thwarted. The bank said it would divest its custodianship business: Argentina said it would not allow it to do so. Citigroup then negotiated a deal with Judge Griesa, allowing it, on an ad-hoc basis, to process quarterly bond coupon payments on 31 March and 30 June this year. While the 31 March payments have been made, this doesn't get Citibank off the hook, either: the Argentine authorities object to the fact that the ad-hoc payments are part of an understanding reached by Citigroup with its main adversaries, the US-based hedge funds with whom they are in dispute.

Cash-strapped Ecuador ditches mandatory pension fund contribution

On 14 April Ecuador's unicameral national assembly (AN) approved by 91 votes to 29 the organic law for labour justice and recognition of work in the home, which reforms the labour code, the social security law and the public service law.

The reform, designed to cut public sector costs at a time of a severe fiscal squeeze on the back of the oil price shock, may prove politically costly for President Rafael Correa. The five representatives of the leftist Avanza party broke with Correa's ruling Alianza País (AP) in protest at changes to the social security law, which scrap the government's 40% obligatory annual pension fund contribution to the State-run social security institute (IESS). The industries minister and Avanza leader, Ramiro González, shortly afterwards tendered his resignation. The President asked Natalie Cely, the coordinating minister of production, to assume the portfolio on an interim basis. Meanwhile President Correa went on TV to reassure anxious pensioners that the State will continue to guarantee their pensions. "Trust me", he declared, "we will never let you down". Pensioners, who often use their monthly payments to support their extended families, are unconvinced.

Within the AP itself, there was some discomfort with the reform. Some key AP legislators sent their alternatives to vote, thereby tacitly signalling some dissent. The issue overshadowed other progressive elements in the reform, including new pensions benefits for housewives.

"Ever since 1948, the State has contributed 40% of the IESS pension fund annually, and employers and employees the rest (60%). The State's contribution is currently around US$1.1bn."

The IESS, nominally independent, in practice is run by government appointees. Ever since 1948, the State has contributed 40% of the IESS pension fund annually, and employers and employees the rest (60%). The State's contribution is currently around US$1.1bn. Under the reform, the State will continue to guarantee pensions, but with the specific 40% obligation scrapped. Given that the IESS is currently in surplus, the State will make immediate savings this year. With a relatively young population and growing labour market, the government argues that pensions will be amply funded for years to come.

However critics accuse the government, which is struggling to fund a budget deficit of over US$10bn this year, of cutting corners for all the wrong reasons. They warn that the reform could ultimately undermine the State's ability to ensure pensions and health services for future generations of retirees. In his 4 April weekly TV broadcast, President Correa admitted that an increase in the retirement age and/or an increase in employer and employee contributions were all options to be considered in future.

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