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CONTENTS

REGIONAL BUSINESS REVIEW

Brazil-Peru 3
Big infrastructure: the trans-oceanic railway

Region 5
Corporate Radar

SPECIAL FOCUS

Venezuela 7
Pdvsa's cash crisis

REGIONAL ECONOMIC REVIEW

Peru 12
On track for gathering recovery in H215

Brazil 14
Levy on the ropes?

Argentina 16
The next government's economic policies

Bahamas 18
Two wildcards – one negative, one positive

Region 20
UK services exports and Latin America

POSTSCRIPT 24
China's crisis and Latin America

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Towards a single digital market

The headline numbers suggest that Latin America and the Caribbean has done very well, as a region, to develop internet connectivity and capture what might be called 'the digital dividend' – the extra business opportunities and competitive edge that comes from using online systems. After all, according to the latest data, half the region's population is now connected, the regional digital economy is worth US$27bn per annum, and the spread of the Internet has helped create around 900,000 new jobs a year. But there's a catch.

Two reports published in August acknowledge the major growth of digital systems in Latin America and the Caribbean, but also point out how much more needs to be done. The UN's Economic Commission for Latin America and the Caribbean (ECLAC) says that countries in the region are lagging behind developed economies in terms of Internet readiness. They are also advancing unevenly at very different speeds.[1] While half (50.1%) of the regional population is now connected to the web, this is still way behind the average of 81.8% among the 34 members of the Organisation of Economic Cooperation and Development (OECD). Overall the region is also said to be lagging behind in terms of infrastructure, public policies and content. Panama, Chile and Argentina were identified as being in the regional vanguard, ranked 34th, 41st and 49th respectively for "Internet readiness" in a list of 65 countries (the US was 6th and Germany was 11th). Lower down came Mexico (51st), Brazil (52nd), Colombia (56th) and Venezuela (55th).

ECLAC notes that three things helped boost the spread of regional Internet connectivity over the last decade or so: a sustained economic boom (which expanded the size of the middle class by 82m people between 2002 and 2012); a significant reduction in poverty levels and, in third place, the gradual reduction in telecoms and Internet access tariffs. But the report says that two of those three factors are fading. The boom is over and economic growth, while still positive, has fallen back to low single percentage digits. The reduction in poverty levels has also come to a stop – in the short to medium term it is hard to see the proportion of the regional population living in poverty falling below the current average of 28%. The third factor, falling access charges, can be expected to continue, but the net result is that the growth of Internet penetration now risks becoming an exogenous factor – something determined outside the region by global technology trends – in effect making the region a follower, rather than a leader.

This matters, says the ECLAC report, because it can lock the region into a pattern of Internet use based almost exclusively around private consumption, which would see it exporting only low-tech digital goods and services and importing high-tech ones – in other words a digital version of the traditional physical-world division of labour whereby Latin America has exported raw materials and imported manufactured goods. The region is already lagging behind in terms of hardware and software production, and could miss out on a whole range of new developments, including the move from a consumption-based Internet to a consumption- and production-based one.

ECLAC notes that for more sophisticated digital applications and activities bandwidth becomes critically important. Greater bandwidth – typically between 38 and 74 megabits per second – is necessary for example for intelligent traffic systems, clean energy and transport, and a whole range of health services and education systems. 3D video for interactive industrial design can require up to 148 megabits per second. The trend in developed economies is towards using digital systems in advanced manufacturing and robotics. Connections at the speeds required for these advanced systems are extremely scarce in the region. In September 2014, only 1% of mobile connections in the region were at 4G speeds; fibre optic connections are also critically important but the latest available data (2013) indicated that only 2.6% of fixed broadband connections in the region used fibre-optics. The bottom line is that if Latin America and the Caribbean as a region "fails to participate in the digital revolution, it will lag behind both in economic growth and in social development" the report says. One of ECLAC's suggestions is that the region needs to introduce a single digital market, standardising technical and commercial parameters and, by guaranteeing the free circulation of digital goods and services, thereby help to accelerate growth and develop capacity.

One of the main conclusions of this report is that governments need to be more pro-active in developing public policies and infrastructure for Internet access and development, explicitly focused on closing the 'digital gap with the more advanced countries.

Another study (jointly prepared by ECLAC, the CAF-Development Bank of Latin America, Fundación Telefónica and the Centro de Estudios de Telecomunicaciones de América Latina[2]) also draws attention to what it calls "asymmetries" in Internet development in the region. One is that the business is still dominated by those providing the web connection itself: the ISPs and operators generate two out of every three web-based jobs and make the biggest tax payments within the digital ecosystem. Another way of saying the same thing is that connectivity has grown faster than local services and applications. Of the 100 most popular websites in Latin America only 26 (roughly a quarter) are based in the region. Sixty-three percent of Internet traffic is international, and is mostly linked to visits to US-based sites.

Latin America: most popular websites (m unique users/month)

Rank	Sites	Unique users (m)
1	Google sites (Google, YouTube etc)	168.1
2	Facebook	145
3	Microsoft sites (Bing, MSN etc)	127.9
4	Yahoo sites (Portal, Tumblr etc)	110.6
5	Wikipedia	60.5
6	Terra	58.9
7	UOL (Universo Online)	54.1
8	Ask	48.1
9	R7	45.5
10	Mercado Libre	45.2

Source: *Comscore.*

Of the ten most popular websites in Latin America, six are international offerings that were first developed outside the region. While these are regionalised in different ways, the content on offer is often less comprehensive than the globalised version. *Wikipedia*, for example, has about 27.3m entries in English, but only 3.7% of them are available on the Spanish-language *Wikipedia* site. In most Latin American countries, the four big international providers (*Google*, *Facebook*, *Microsoft* and *Yahoo*) are the most popular. The exceptions are Brazil, where the local Portuguese language portal *UOL* makes it into the top four, and Venezuela, where *Mercado Libre*, the Argentina-based e-commerce site, is ranked at number four. *Mercado Libre* and *Taringa*, a social networking site also originating in Argentina, are among the local sites with greatest cross-regional appeal. In most countries, local news sites linked to media groups also figure prominently in the top ten – sites like *Clarín* and *Nación* in Argentina, *Globo* in Brazil, *El Tiempo* in Colombia, *El Universal* in Mexico, *El País* in Uruguay and *Grupo Copesa* in Venezuela.

[1]'The new digital revolution – from the consumer Internet to the industrial Internet" ECLAC avaolable at: http://repositorio.cepal.org/bitstream/handle/11362/38767/S1500587_en.pdf;jsessionid=C63AFDE06C26CB5B09A58DA26E8F5DE5?sequence=1

[2]"El ecosistema y la economía digital en América Latina" – see http://www.fundaciontelefonica.com/arte_cultura/publicaciones-listado/pagina-item-publicaciones/?itempubli=430

BRAZIL-PERU

Big infrastructure: the trans-oceanic railway

The trans-oceanic railway, known in Spanish as the Corredor Ferroviario Bioceánico Central, designed to provide an east-west freight transport link stretching across South America from Santos or Açu on Brazil's Atlantic coast to Ilo on Peru's Pacific coast, is nothing if not ambitious. Big infrastructure projects can deliver major benefits, but also struggle with major problems. It remains to be seen how the costs and benefits of this one will play out.

In May, Peru's President Ollanta Humala, Brazil's President Dilma Rousseff and China's Prime Minister Li Keqiang signed a series of agreements designed to get the project in motion. Much detailed work remains to be done, but in round numbers this is a US$15bn-plus project to build an approximately 5,000km freight rail link through challenging territory, including the Amazon and the Andes mountain range; it could take around six years to complete.

The core benefit of building such a link may seem obvious and compelling, but nevertheless it has been subject to challenge almost from the get-go. For more than a decade, Brazil been a key commodity exporter to China, shipping large volumes of soya, iron ore, and other products. In addition, the port of Açu, north of Rio de Janeiro, will start shipping hydrocarbons in November. Peru is also a key exporter of minerals including copper and gold to China. A faster, more efficient rail-based export corridor to move bulk shipments to Pacific coast ports would seem to make sense. Various officials have suggested that it would cut transport costs by as much as US$30 a tonne. It would also open a more efficient route for South America to bring in Chinese imports. It is understood that Beijing has indicated its willingness to help fund the project, in exchange for Chinese engineering companies and suppliers getting an important share of the civil engineering contracts. There are other benefits for Peru and Brazil: both governments get the opportunity to develop previously isolated regions and further expand transport infrastructure. Some Brazilian analysts say the country already relies too much on north-south transport links, so adding an east west one would help reduce congestion.

"The core benefit of building such a link may seem obvious and compelling, but nevertheless it has been subject to challenge almost from the get-go..."

Yet a study by the International Union of Railways Union (known by its French acronym UIC [Union Internationale des Chemins de Fer]) questions this. As reported by Brazil's *Estadão* website, it currently costs US$120.4 a tonne to ship Brazilian soya from Lucas do Rio Verde (in the Brazilian state of Matto Grosso) the long way round via the Atlantic port of Santos to Shanghai, while shipping it on the shorter route via a new rail link to the Peruvian Pacific port of Ilo would actually cost more – US$166.9 a tonne. Details of the assumptions made by the study, particularly as to the freight rates the new railway would charge, and its estimated exchange rates, were not immediately available. But it did suggest that the savings from following a shorter route might be less than anticipated at first sight. Despite this, Brazil's planning minister Nelson Barbosa has insisted that the project is realistic and has strategic value: he added that it could be justified by demand for domestic transport between the states of Mato Grosso and Rondonia alone.

It is also worth noting that major transport investments sometimes have unanticipated results. The 'inter-oceanic highway' linking Brazil and Peru, which was completed in 2011 at a cost of around US$3bn, was also supposed to provide an export route to the Pacific for Brazilian soya and other grains,

but is widely believed to have fallen short. One of the problems is that because of very tight bends in the Andean section of the highway, it is now considered unsuitable for the heavy lorries and articulated trucks required to carry soya by road. At the Universidad Nacional Agraria de Lima in Peru, Professor Marc Dourojeanni notes that, "highways are the worst transport mode in the Amazon, in terms of environmental impacts". He acknowledges that a railway is more environmentally friendly, but still considers the trans-continental project "unnecessary", adding, "the best way to connect Brazil and Peru is through river transport".

> "[O]n 5 July, while the Brazilian authorities were flying five Chinese engineers over the Serra do Divisor national park in Acre, site of a possible route for the railway line, below them a group of Nawa indigenous people had just kidnapped four federal employees in a long-running dispute over the demarcation of indigenous reserves (the employees were later released). Thiago Pinheiro Correa, a lawyer working for the Ministerio Público Federal (MPF), admits that invasions of indigenous and national parklands by illegal loggers, game hunters, and drug smugglers are frequent."

On the Brazilian side, the railway is to be built in four main sections. An initial round of planning and feasibility studies were conducted before 2008, when development was put on hold. China's involvement this year has pushed the *bioceánica* back centre stage. The project has rapidly become the flagship of a new BRL200bn (US$60bn) infrastructure investment programme announced by President Rousseff in June. It is the most important single project in the programme, with an allocation of BRL40bn (US$12.6bn). It seems to have eclipsed Brazil's previous big rail vision, the Rio-São Paulo-Campinas bullet passenger train, which was intensely discussed in 2011-2014 (at one stage it was included among the infrastructure improvements for the 2014 World Cup and the 2016 Olympics), and would have had a similar overall cost. While still officially under consideration, the 511km bullet train proposal was not included in the latest infrastructure programme. According to transport expert Paulo Resende, "there are numerous other more important, and less costly, projects to concentrate on, and the bullet train should be considered in the long run, more like 2020".

As per the plans, the first of the four sections of the Brazilian segment of the *bioceánica* runs for 901km from Campinorte (Goiás) to Lucas do Rio Verde (Mato Grosso); the second continues for a further 646km to Vilhena (Rondonia); the third runs 770km to Porto Velho (also in the state of Rondonia) and the fourth runs 1,183km to Boqueirão da Esperança (Acre), close to the Peruvian frontier. In the first three sections, initial work has been done on viability studies and environmental impacts, but little has yet happened in the fourth section, which could be the most problematic. The Spanish newspaper *El País* noted that on 5 July, while the Brazilian authorities were flying five Chinese engineers over the Serra do Divisor national park in Acre, site of a possible route for the railway line, below them a group of Nawa indigenous people had just kidnapped four federal employees in a long-running dispute over the demarcation of indigenous reserves (the employees were later released). Thiago Pinheiro Correa, a lawyer working for the Ministerio Público Federal (MPF), admits that invasions of indigenous and national parklands by illegal loggers, game hunters, and drug smugglers are frequent.

At present, it is proposed that the rail line will run through the Serra do Divisor Park, although not through the most disputed area. Nonawá Huni Kui of Opiara, an organisation representing the indigenous peoples of Acre, Rondonia and southern Amazonas state, says of the railway project, "we are worried about the impact on the environment and local communities. We don't see any benefits because we are not soya exporters". By contrast, Acre governor Tião Viana (of the ruling Partido dos Trabalhadores [PT]), a supporter of the project, says it will have minimal negative impacts. He notes that construction of the BR364 highway ran through areas inhabited by other isolated communities, and in his view was positive in cost-benefit terms: "before the road was built the Katukina had a very complicated situation. Now 49 members of that community are university graduates".

The controversy over social and environmental impacts looks set to continue. A lobby group, the Society for the Anthropology of Lowland South

America (SALSA), has argued that the railway will require a network of support roads which of itself will "increase colonisation pressure and the flow of loggers and traffickers. This will have a serious negative impact on indigenous communities". The authorities, meanwhile, say that no final decisions are being taken on the rail route until viability and environmental impact studies being carried out by Chinese and Brazilian contractors are concluded. Planning Minister Barbosa says that the first tenders for construction and related works are likely to be issued before the end of 2016. Kevin Gallagher, an associate professor of global development policy at Boston University, has said, "If it's done right, a high-speed railway with high-level engineering, a minimal amount of environmental damage, and engagement with local communities is going to be a win-win all round. But it could also be the complete opposite".

SALSA statement

"The proposed railroad would cut through the western Amazon in the border region between Peru and Brazil, one of the largest continuous rainforest areas in the world with relatively intact primary forest and among the highest biodiversety indexes in the world. This area concentrates the world's largest number of indigenous peoples with little or no contact with outsiders from national societies. The majority of these indigenous populations have chosen isolation as a lifestyle in response to their fatal historical experiences with modern society. The impact of a railroad cutting through this unique environment will involve severe consequences for the isolated indigenous groups as well as many indigenous peoples whose territories are located along its path."

The exact route that the railway will take in Peru is not fully confirmed. Pedro Tipula of a local NGO, Instituto del Bien Común (IBC), notes, "All the projects that the Peruvian government has undertaken in the name of development have had very incomplete information… only the benefits of this project are discussed". Fabiola Muñoz Dodero, the head of the Peruvian National Forestry and Wildlife Service (Serfor in the Spanish acronym), told the website *Diálogo Chino* earlier this year that "everything is still under discussion".

Disputes and lobbying over the railway's route are not limited to domestic politics. Bolivia's President Evo Morales has argued that it would be better to build the line further south, so that it runs through parts of his country, as well as Brazil and Peru. On his calculation, a southern route would be shorter at around 3,500kms, compared to 4,700km. Such a route, he maintained at the end of July, would benefit not only Bolivia but also other regional exporters without Pacific ports, including Paraguay, Uruguay and Argentina. In June, Morales and Peru's President Ollanta Humala signed an agreement to conduct joint studies on a Brazil-Bolivia-Peru railway. Morales has said he will also discuss the project with potential contractors and funders during a visit to Germany this November.

An inevitable comparison is being made between the transcontinental railway project in South America and the proposal to build a new transoceanic canal through Nicaragua (costed at up to US$50bn). Both are high profile and costly mega-projects that may deliver very significant economic benefits, but they are also controversial with as yet unanswered questions raised about their viability and environmental impact. Both have major Chinese involvement, but interestingly, in the South American case the Chinese government is formally backing the project, while the Nicaraguan project is being backed by a Hong Kong-based private company set up for the scheme, Hong Kong Nicaragua Canal Development Company (HKND), linked to a 42-year old Chinese telecoms magnate, Wang Jing.

REGION

Corporate Radar

Big Cola makes African move: Big Cola, the soft-drink brand controlled by Peru's Aje Group, is initiating operations in Africa, where it has opened two bottling plants, one in Nigeria and the other in Egypt. Although less than 30 years old (the company was set-up in Ayacucho in 1988), Big Cola is now a significant player in the global market. According to the UK-based Euromonitor, it is ranked number 10 by revenue among global soft drinks producers, with a 1% market share (Coca-Cola is number 1, with a 20% global market share, while Pepsi takes 9.7%). Annual sales are reported at

US$1.2bn, and Big Cola is present in 20 countries around the world, particularly in Asia: this year it became the top soft drink by sales volume in Indonesia. The company originally started as a family business run by Eduardo Añaños and Mirtha Jerí, a couple with five children, who at the height of the violence and scarcities sparked by the Sendero Luminoso guerrilla movement realised that there was a gap in the market – the big bottling companies had stopped supplying the region. As a result of some experimentation they created a new carbonated soft drink with citric overtones that was initially marketed as Kola Real. Sales grew strongly in Peru, prompting international expansion starting in Venezuela in 1999 (when the name was changed to Big Cola), Ecuador in 2000 and the fiercely competitive Mexican market in 2002.

Juan Lizariturry, a Madrid-based executive of Aje Group, told Spain's *El País* that its strategy is not to seek a head-on confrontation with dominant players like Coca Cola that have spent massively on marketing but instead to focus on the price-sensitive lower middle classes in emerging markets. "People have got used to Coca Cola. No one has enough money to break the link between a customer and a brand that has been in the market for years. Our target market is the consumer who hasn't been drinking Coca-Cola for long and doesn't have their head full of advertising" he said. Another executive, chief marketing officer Jorge López-Dóriga, told *Beverages Daily*, "This is a new world. You can be global without having to be in Europe or the USA – actually, around 90% of the world population is outside USA and Europe".

"Cemex has been seeking a general repositioning of its business strategy to reduce debt and restore profitability. In the first half of this year the company reported a net US$32m loss, a reduction of 86% on the US$220m loss registered in the year-earlier period."

Cemex sells European assets: Mexico-based Cemex – one of the world's largest cement and construction materials producers – announced the sale of a number of European assets, principally in Austria, Hungary and Croatia, for EUR391m (US$445.3m), with the funds to be used to reduce debt and for general corporate purposes. Operations in Austria and Hungary – a number of aggregate quarries and ready-mix plants – were sold to the Rohrdorfer Group for EUR160.1m (US$179m), while in Croatia operations were sold to Duna-Dráva Cement, and included holdings in Bosnia, Montenegro and Serbia. Cemex has been seeking a general repositioning of its business strategy to reduce debt and restore profitability. In the first half of this year the company reported a net US$32m loss, a reduction of 86% on the US$220m loss registered in the year-earlier period.

SolarReserve gets Atacama go-ahead: Chilean authorities in August approved the environmental impact study for the US$2bn Copiapó Solar project, considered one of the largest solar energy and storage projects in the world. The project, to be executed by US-based SolarReserve, is designed to add 260MW of new capacity to the country's electricity grid. It will use concentrating solar power (CSP) tower technology and solar photovoltaic (PV) panels combined with molten salt thermal energy storage. It is envisaged that the project will supply mining companies and other industrial consumers with some 1,800-gigwatt hours (GWh) every year. In a statement SolarReserve noted: "No other proven renewable energy technology can provide this cost competitive energy solution to meet the needs of Chile's largest and most important industries." According to Tom Georgis, the senior vice president of development, "This technology realistically has the potential to power the entire country of Chile using two phenomenal Chilean resources, salt and sun".

Trouble in the air: Share prices in the main Latin American airlines fell in mid-August, as investors became nervous over lower levels of demand and the effects of currency depreciation in a number of countries around the region. Latam Airlines Group SA (the carrier formed in 2012 from the merger of Chile's LAN and Brazil's TAM) saw its share price fall 10% to a nine-year

low in the week to 14 August; Colombia-based Avianca saw a 15% fall, Copa Holdings of Panama lost 19%, and Brazil's budget airline Gol Linhas Aéreas Inteligentes lost 3.9% on that date. Analysts said the effects of lower fuel prices – a positive for the airlines – were being more than offset by slower economic growth across Latin America.

Earlier, Latam Airlines had reported an unexpected US$49.7m Q215 loss, on a 22.2% year-on-year drop in revenue to US$2.3bn. It also modified its guidance for operating margins, down to 3.5%-5.0% from 6.0-8.0% previously, a change it attributed to "a weaker macroeconomic context in Brazil, caused by higher inflation and a steep depreciation of the Brazilian Real". The company also said it was looking into delaying the delivery dates for new long-haul passenger aircraft. Separately, Copa said that its sales fell 20% year-on-year to US$538.4m in Q215, while its profits dropped by 44% on the same basis to US$64.1m. The airline attributed this to a "weak economic environment in South America".

According to Daniel Guardiola of Larrain Vial, "massive depreciation of currencies and economic slowdown in the region is affecting demand" across the region.

> "The bank benefited from rising interest payments on loans and extra earnings from commissions, which more than compensated for the negative effects of a rise in non-performing loans (NPLs) and lower demand for credit. Tighter cost control and risk management procedures introduced by Chief Executive Roberto Setubal were also credited for the good performance."

Profits up at Itaú: Itaú Unibanco Holding – Brazil's largest private sector bank by loan portfolio – reported record profits of BRL6.13bn (US$1.78bn) before extraordinary items in the second quarter. The results were significantly ahead of market expectations (in a survey of analysts by *Reuters*, the consensus was for profits of BRL5.74bn). The bank benefited from rising interest payments on loans and extra earnings from commissions, which more than compensated for the negative effects of a rise in non-performing loans (NPLs) and lower demand for credit. Tighter cost control and risk management procedures introduced by Chief Executive Roberto Setubal were also credited for the good performance.

Analysts wondering whether the Brazilian recession is eventually going to dent the sector's strong profits have watched bank performance closely. Overall bank profits reached a four-year high in 2014. Some argue that the recession is now making its first real appearance in bank balances through the rise in NPLs. In fact, Itaú's 90-day NPL ratio rose for the first time in 11 quarters to 3.3%. Philip Finch of UBS securities said the markets should receive Itau's results positively, but that perceptions might be clouded by worries over asset quality and the need for bigger gross provisions.

SPECIAL FOCUS

VENEZUELA

Pdvsa's cash crisis

Venezuela's state-owned energy company, Petróleos de Venezuela SA (Pdvsa), barely generated any cash from its unprofitable oil and gas operations in 2014, when the average oil price received from its export customers was US$88/barrel (/b). So, what happens now that the global oil price has plunged to around US$41/b?

A statement of Pdvsa cash flows over the three years to the end of 2014 [***see table 1***] makes for grim reading. Cash flow from normal operations – essentially net profit after tax (NPAT) plus non-cash expenses such as depreciation less non-cash revenues – slumped from US$16.34bn in 2012 to US$5.01bn in 2013 and to just under US$2.42bn in 2014.

Table 1. PDVSA's Cash Flow, 2012-2014 (US$m)			
	2012	**2013**	**2014**
Cash at beginning of year	8,610	8,233	9,133
Cash at end of year	8,233	9,133	7,911
Movement in cash (A+B+C+D+E)	-377	900	-1,222
Issuance of debt	7,130	6,923	18,197
Repayment of maturing debt	-1,537	-2,892	-7,068
Payment of cash dividends to government	-1,395	-952	-289
Other financing items (1)	-897	-1,546	-28
A. Impact of financing activities	**3,301**	**1,533**	**10,812**
B. Capital expenditure	**-25,221**	**-22,381**	**-24,448**
Net Profit After Tax (NPAT)	4,335	15,835	9,074
Depreciation	7,105	8,335	8,441
Write downs of assets etc.	1,568	1,540	8,276
Non-cash currency gains included in NPAT	-19	-7,817	-19,127
Non-cash expense or (benefit) from deferred tax in NPAT	2,297	-5,094	-4,610
Non-cash profit on sale of stake in ENA		-9,524	
Other items (2)	1,052	1,736	362
C. Cash from operations	**16,338**	**5,011**	**2,416**
Increase in accounts receivable	-12,113	-21,588	-17,975
Change in inventories	-2,902	-2,319	760
Prepayments etc.	-6,674	-435	-7,502
Tax credits	-2,875	-2,155	-964
Increase in accounts payable	4,371	7,924	6,598
Increases in employee/retirement benefits payable	4,602	3,210	8,732
Increases in provisions	549	138	569
Increase in tax payable and other liabilities	34,048	56,930	46,727
Reduction in interest payable	-1,645	-2,060	-429
Cash payment of tax and royalties	-12,156	-22,753	-24,640
D. Movement in working capital	**5,205**	**16,892**	**11,876**
E. Adjustments for currency movements		**-155**	**-1,878**
Contributions to FONDEN etc.	*-17,336*	*-13,023*	*-5,321*
Dividends to government	*-1,395*	*-952*	*-289*
Taxes and royalties	*-12,156*	*-22,753*	*-24,640*
Apparent extraction of cash by government	***-30,887***	***-36,728***	***-30,250***
Net issuance of debt	*5,593*	*4,031*	*11,129*
Revenue from sales of crude and products	*124,459*	*113,979*	*105,271*
Net profit before tax less financial income	*8,462*	*3,333*	*-8,203*
1. Mainly dividends to external shareholders in subsidiaries			
2. Non-cash adjustments to inventory and accounts receivable			
Source: *PDVSA*			

The non-cash revenues provided very substantial boosts to reported NPAT in each of 2013 and 2014 (*see box below*). Through 2013 and 2014, reported NPAT was also boosted by deferred tax benefits, of US$5.09bn and US$4.6bn respectively. In 2012, NPAT had been reduced by a deferred tax expense of

US$2.3bn. The other main non-cash item is depreciation (of US$7.1bn in 2012, US$8.34bn in 2013 and US$8.44bn in 2014), which is about one third of annual capital expenditure.

Making losses from energy in 2014

Although Pdvsa's main business of producing oil, gas and refined products generated cash of US$2.42bn – on sales of US$105.27bn – in 2014 it was basically unprofitable. Excluding the financial income, net profit before tax fell from US$8.46bn in 2012 to US$3.33bn in 2013. But for the financial income arising from the adoption of the SICAD II exchange rate, the company would have suffered a pre-tax loss of US$8.2bn last year. The export basket price received by Pdvsa fell from an average of US$103/b in 2012 to US$98/b in 2013 to US$88/b in 2014. However, as we discuss below, this is not the only factor constraining Pdvsa's profits.

Aside from operations, Pdvsa can generate – or run down – cash in two ways. One of these is movement in working capital. The company can improve its cash position by increasing current liabilities relative to current assets. In this way, Pdvsa boosted its cash flow by US$5.21bn in 2012, by US$16.89bn in 2013 and by US$11.88bn in 2014. The other way is through financing operations – which include the issuance or repayment of long-term borrowings, issuance of stock and payment of dividends. Financing activities (mainly net issuance of debt) provided cash of US$3.3bn in 2012, of US$1.53bn in 2013 and of US$10.8bn in 2014.

In effect, Pdvsa had to compensate for the ongoing deterioration in cash flow from normal operations, and a fall in cash flow from working capital, by borrowing from global markets (in its own name and through subsidiaries such as US-based CITCO). Gross issuance of debt rose from around US$7.0bn in each of 2012 and 2013 to US$18.2n in 2014. After allowing for repayment of maturing debt, net issuance fell from US$5.59bn in 2012 to US$4.03bn in 2013 before surging to US$11.13bn in 2014.

The government's take: at least US$30bn in cash annually

In spite of the deterioration in Pdvsa's fortunes, it appears that the government led by President Nicolás Maduro has continued to extract a little over US$30bn annually in actual cash from the company. The money flows through three channels. By far the most important are the dividends paid by Pdvsa to the government, its sole shareholder. Taxes and royalties have increased from US$12.26bn in 2012 to US$22.75bn in 2013 to US$24.64bn in 2014. Thanks in part to currency movements, the US dollar value of contributions to the national development fund (FONDEN) and other social programs has plunged, from US$17.34bn in 2012 to US$13.02bn in 2013 to just US$5.3bn last year. The fall in apparent cash payments to the government from US$36.73bn in 2013 to US$30.25bn in 2014 is about the same as the fall in the generation of cash from working capital. By increasing its net current liabilities in 2013, Pdvsa was able to pay around US$6bn more in actual cash to the government than it would otherwise have done.

"In spite of the deterioration in Pdvsa's fortunes, it appears that the government led by President Nicolás Maduro has continued to extract a little over US$30bn annually in actual cash from the company."

Other figures published by Pdvsa in its annual accounts point to additional problems [***see table 2***]. Production volumes and export volumes have been falling – even though Pdvsa's annual capital expenditure has amounted to around 20%-23% of revenues from energy. In spite of the fall in production and export volumes, both operating costs and sales & administration costs have been rising: the latter have more than doubled since 2012. In other words, Pdvsa's operational efficiency has been deteriorating. As Pdvsa and its subsidiaries have been net issuers of debt over recent years, financing costs have grown steadily, increasing from US$3.4bn in 2012 to US$4.08bn in 2014.

Pdvsa's long-term debt amounted to US$39.87bn at the end of 2014. This is not particularly large in the context of total assets of US$226.76bn and shareholders funds (including capital and retained earnings) of US$89.76bn. However, as is discussed in the box below, profits – and, therefore, retained earnings – have been boosted by items that are one-off and/or artificial in nature. Further, the valuation of Pdvsa's property plant and equipment (including proven reserves of conventional and extra heavy crude oil of around 300 billion barrels) at US$141.25bn is open to question. NPAT was reduced by a little over US$1.5bn in each of 2012 and 2013 by asset write-downs. In 2014, such write-downs amounted to US$8.27bn.

Table 2. PDVSA - Key performance indicators	2012	2013	2014
Production of oil and gas liquids ('000 BOPD)	3,034	3,015	2,899
Production of gas ('000 BOPD equivalent)	768	796	831
Exports of crude oil and products ('000 BOPD)	2,568	2,425	2,357
Of which: China and Petrocaribe ('000 BOPD)		565	493
Export basket price ($/barrel)	103	98	88
Selected income statement items (US$m)			
Sales of crude and products	124,459	113,979	105,271
Financial income	3,152	20,347	23,168
Crude oil purchases	40,012	37,017	37,754
Operating costs	22,974	22,544	24,494
Sales and administration costs	3,998	4,217	9,211
Depreciation and amortisation	7,105	8,335	8,441
Royalties and other taxes	17,730	19,262	13,466
Financing costs	3,401	2,934	4,082
Other costs	3,441	3,314	10,705
Contributions to FONDEN etc.	17,336	13,023	5,321
Net profit before tax	**11,614**	**23,680**	**14,965**
Income tax	7,279	7,845	5,891
Net profit after tax	**4,335**	**15,835**	**9,074**
Selected balance sheet items ($USm)			
Property, plant and equipment	115,905	129,831	141,248
Deferred tax and other long-term assets	27,637	33,557	30,304
Total non-current assets	143,542	163,388	171,552
Cash	8,233	9,133	7,911
Other current assets	66,649	58,599	47,297
Total assets	**218,424**	**231,120**	**226,760**
Shareholders' funds	**72,486**	**84,486**	**89,757**
Long term debt	35,647	36,353	39,871
Other non-current liabilities	39,231	45,055	46,094
Short term debt	4,379	7,031	5,865
Income tax payable	2,267	10,116	9,554
Other currrent liabilities	64,414	48,079	35,619
Total shareholders' funds and liabilities	**218,424**	**231,120**	**226,760**
Source: *PDVSA*			

Desperate times and desperate measures

On 23 July, the government of Jamaica announced a bond issue of US$2bn, of which US$1.5bn was used to settle around US$3bn in official obligations to Pdvsa through the Petrocaribe regional discount oil scheme. This deal follows a similar one earlier in 2015, when the government of the Dominican Republic paid US$1.9bn in cash to settle nearly all of the US$4.1bn that it owed to Pdvsa.

> "In the past few years, Pdvsa typically has had US$8-9bn in cash on its balance sheet at year-end. In our last detailed assessment of the company (*Latin American Economy & Business, July 2014*), we suggested that the company no longer had the financial strength and cash flow to shelter the government from the generally downward movement in energy prices. The company's accounts for 2014 confirmed that bleak assessment."

In essence, it appears that Pdvsa, or the government of Venezuela, or both of them, are so short of ready cash that they are allowing Petrocaribe creditors to buy back the debts that they owe for around 50 cents on the dollar. The US$3.5bn received from the governments of Jamaica and the Dominican Republic is significant in the context of the US$5.87bn in Pdvsa debt obligations maturing in 2015. A further US$5.37bn is maturing in 2016, while US$7.33bn is maturing in 2017. As of the end of 2014, it appeared that maturities would fall to US$1.11bn in 2018 and US$1.29bn in 2019 before rising again to US$3.08bn in 2020.

Up to late July 2015, the average price for oil from Venezuela has been just under US$50/barrel, or about 43% lower than through 2014 as a whole. Since then, the price has slipped further to around US$39/barrel (as of 27 August 2015). Pdvsa should benefit from a fall in the cost of purchases from external sources of crude oil for its refineries – which amounted to US$37.75bn in 2014. However, the impact on gross revenues from sales of crude oil and refined products will likely be much greater.

As noted above, Pdvsa's operations were hardly generating cash (US$2.42bn on revenues of US$105.27bn) last year. The slippage in the price of oil through the first 7.5 months of 2014 almost certainly will mean that Pdvsa's operations are now cash flow-negative, and possibly strongly so. The size of the deficit will depend on the company's slashing of operating costs and sales & administration expenses in US dollar terms. However, Pdvsa's performance over the last three years suggests that it will not be able to do this easily.

In the past few years, Pdvsa typically has had US$8-9bn in cash on its balance sheet at year-end. In our last detailed assessment of the company (*Latin American Economy & Business, July 2014*), we suggested that the company no longer had the financial strength and cash flow to shelter the government from the generally downward movement in energy prices. The company's accounts for 2014 confirmed that bleak assessment. But for its net new borrowing of US$11.13bn through 2014, Pdvsa would have run out of cash last year. Given the further fall in oil prices since then, it is not necessary to make radical assumptions to derive a scenario in which Pdvsa is currently desperately short of cash.

The company has three alternatives, none of which are attractive. One is a dramatic curtailment of capital expenditure, which, as noted, has been running at around US$24bn annually. The operational performance of the company over recent years suggests that this move would run the risk of a substantial fall in production volumes. The second is a further rise in net current liabilities – through the squeezing of trade creditors (such as international oil services companies) and other measures. However, movements in working capital provided US$33.97bn in cash – equivalent to roughly one third of energy-related sales last year – over the three years to the end of 2014: Pdvsa may be approaching the point at which it can no longer tap this source of cash. The third is a massive increase in gross (and net) issuance of bonds, by both Pdvsa and subsidiaries such as CITGO. However, this would result in further scrutiny by investors of Pdvsa's financial position. Analysts would likely conclude that there has been a substantial deterioration in cash flows, asset values, profits, retained earnings, debt ratios and financial risk. The company might not be able to access the funds that it needs, except at prohibitively high costs.

If Pdvsa is unable to do any of these three things, the implications for the government would be catastrophic. The company would not have the cash

flow to continue payments of cash to the government – through taxes and royalties, contributions to the FONDEN and other programs, or dividends – to support the extraction of anything like US$30bn. The government would have to accelerate the printing of local currency (the inaptly-named Bolivares Fuertes) to cover its spending within Venezuela – thereby further increasing the risks of hyper-inflation.

At the time that Pdvsa began using the SICAD II exchange rate, we identified three developments, which, together, would indicate that a default by the Maduro government was imminent (*Latin American Economy & Business, September 2014*). One, which has happened, is further slippage in the price of oil. Another, which will be a sign that Venezuela truly has reached hyper-inflation, is a clear pick-up in the velocity at which currency circulates within the country (that too is becoming more evident). The third is widespread labour or social unrest.

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In the third quarter of 2014, Pdvsa was still approaching a cash crisis. We believe that the point of crisis has now been reached.

Pdvsa as asset trader and currency trader

One of the most important changes to have taken place at Pdvsa since the end of 2012 has been a surge in the relative importance of what the company describes as financial income – from just 2.5% of total revenues in that year to 15.1% in 2013 and 18.0% in 2014. As we explained in our last detailed analysis of Pdvsa (July 2014), financial income in 2013 came from two sources. Some US$7.82bn was derived from an exchange gain when the Bolívar Fuerte (BF) was devalued against the US dollar by around one third in February 2013. Generally, Pdvsa is a net debtor in relation to parties with which it deals in Venezuela. As the company's 2013 annual accounts noted, the liabilities include amounts payable to the government, contractors and domestic suppliers, holders of debt securities issued by Pdvsa that are denominated in BF and employees. At the time of the devaluation, the company's net liabilities in Venezuela amounted to just over US$25bn – and the reduction of the US dollar value was booked as financial income.

The other, and larger, element of financial income in 2013 was a profit of US$9.52bn. This was generated by the sale of a 40% stake in a company called Empresa Nacional Aurífera (ENA). As its name indicates, ENA is a gold mining company. However, it did not operate throughout 2013 and was ascribed no value in Pdvsa's accounts for that year.

In 2014, financial income included a non-cash currency gain of US$19.13bn. This arose from new rules introduced last year (*Latin American Economy & Business, September 2014*), which allowed Pdvsa to purchase BF for payments of creditors within Venezuela at the SICAD II rate, which at that time was around BF50/US$1. Given that the official exchange rate that Pdvsa previously had been obliged to use was BF6.3/US$1, this represented another devaluation – of about 87%

REGIONAL ECONOMIC REVIEW

PERU

On track for gathering recovery in H215

There are signs that the recovery is gathering pace in the Peruvian economy. According to the Banco Central de Reserva del Peru (BCRP), real GDP growth reached 3.9% year on year in June, coming in above expectations (the consensus had been for growth of around 3.1%). The June result meant that GDP, which had expanded by 1.7% in the first quarter of this year, has now accelerated quite sharply to 3.1% in Q215.

The BCRP breaks GDP down into two sectors: primary, essentially linked to commodity exports, and non-primary, which is seen as a better indicator of the pattern of internal demand and includes retail trade, services and manufacturing for the domestic market. The numbers indicate that the big boost to the growth rate in the first half of this year came from the primary sector, where output jumped from 0.7% in Q115 to 6.8% in Q215. Non-primary GDP, by contrast, rose only moderately from 2.0% in Q115 to 2.1% in Q215. As such, it appears that although international commodity prices remain low, Peru has been able to substantially boost the value of its agricultural, fishing and mining exports.

What will happen next? In a recent BBVA Research paper, economist Yalina Crispin Velásquez said she expected GDP to have slowed a little in July but to pick up again in August and to average about 3.0% year on year in the second half of the year. She attributed the expected dip in July to a fall in the anchovy catch and lower oil production, with weakness also in public sector investment and construction. But the outlook for the second half is lifted by various factors. Big public sector investment projects, some of which have been running behind schedule, will begin to catch up. These include work on Línea 2 of the Lima Metro, the Southern Peru gas pipeline, and work on the modernisation of the Talara refinery. Big copper mining projects such as those at Toromocho and Constancia will help lift copper production by as much as 20%. Local government spending is also expected to gather momentum. Finally, the El Niño weather pattern is expected to have some positive effects, such as enabling a second anchovy fishing season.

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The outlook for Peru is not risk-free. Headwinds from the global economy could intensify, with a range of current or expected events creating turbulence and perhaps pushing commodity prices further down. They include the latest turns in the Greek debt crisis and its potential impact on the Eurozone; the recent stock market volatility in China and lower growth prospects there; and the expected tightening of US interest rates in the third quarter, which has already prompted a weakening of Latin American currencies and a higher risk of a pass-through effect pushing up domestic inflation rates. Further ahead, there may be heightened domestic risks around Peru’s 2016 general election, due in April.

The BCRP has faced something of a policy dilemma, with inflation consistently coming in above the 1%-3% target range, but any rise in interest rates likely would put the brakes on the recovery process. The 12-month rate of inflation in July was 3.56%, slightly up on June due to increased electricity and water rates; food prices also contributed. Analysts say there is evidence that currency depreciation is contributing to a pass-through effect, fuelling inflation. However, on 14 August the BCRP kept its benchmark interest rate unchanged at 3.25%, arguing that growth remains “below potential”. Most analysts expect the benchmark rate to stay unchanged for the rest of this year even through inflation may rise further (the London-based consultancy Capital Economics expects retail inflation to reach 4.0% by year-end). That would set the scene for a tightening cycle to begin in 2016, when, all being well, the recovery will have gathered pace. BBVA Research predicts real annual GDP growth of 2.5% this year, rising to 3.8% in 2016 and 5.0% in 2017. It also sees a gradual widening of the fiscal deficit, from 2.1% of GDP this year to 2.4% in the election year of 2016.

BRAZIL

Levy on the ropes?

The fiscal austerity programme introduced in early 2015 by Brazil's newly appointed finance minister, Joaquim Levy, was seen at the time as the key to restoring business and consumer confidence in the Brazilian economy. Most analysts would agree that it has taken some particularly hard knocks in recent weeks. Here, we assess its chances of surviving the ongoing political crisis affecting the government led by President Dilma Rousseff.

Broadly speaking, there are two intertwined problems undermining the Levy plan: technical on the one hand and political on the other. On the technical side, it is now clear that the initial deficit-reduction targets will not be met. Progress in boosting government revenues and cutting expenditure has just been too slow. At the end of July, the government officially revised its targets for this year. Instead of achieving a primary (net of debt interest payments) fiscal surplus equivalent to 1.2% of GDP this year, it is now aiming instead for a much more modest 0.15% of GDP. The targets for 2016 and 2017 have also been reduced, to 0.7% and 1.3% respectively (down from "around 2.0%" for both years). What this means is that the overall Non-Financial Public Sector (NFPS) deficit, which includes debt interest payments, currently estimated to be running at around 6% of GDP, is going to increase in the short term (and will reach 6.8% of GDP this year, according to some estimates). Crucially, Brazil's still-high public debt, which was 58.9% of GDP at end-2014, will continue on a rising path, perhaps only stabilising by 2018 at somewhere above 70% of GDP. This situation underlay the decision by international ratings agencies Moody's and Standard & Poor's (S&P) to reduce their outlook for Brazil in early August. The probability that the ratings agencies will downgrade the country to below investment-grade remains strong.

> "Employment levels had appeared resilient, but are now falling. The national statistics institute (IBGE) reported an unemployment rate of 7.5% in July, up by 0.6 percentage points on the preceding month and 2.6 points higher than the July 2014 level of 4.9%. The overall economy is taking a hit too..."

Some analysts have commented that Levy's original plan was just too optimistic. This relates to the wider debate over whether fiscal austerity programmes imposed during cyclical downturns help bring about a recovery or end up creating a downward spiral and making matters worse. In a recent research note on the Brazilian case, Capital Economics commented, "As we've noted several times before, the weak economic backdrop means that efforts at fiscal consolidation were always doomed to disappoint". Certainly, latest data suggests that the economy is now falling more swiftly into the grip of recession. That automatically makes fiscal restructuring tougher, as it reduces tax revenues and increases outgoings on social welfare payments.

Employment levels had appeared resilient, but are now falling. The national statistics institute (IBGE) reported an unemployment rate of 7.5% in July, up by 0.6 percentage points on the preceding month and 2.6 points higher than the July 2014 level of 4.9%. The overall economy is taking a hit too. In Q215 (April-June), the central bank's IBC indicator of economic activity (considered an early-warning proxy for GDP) fell by 1.89% quarter-on-quarter, posting a steeper contraction of 3.09% year-on-year. The government predicts a GDP fall of 1.5% in calendar 2015, but private sector analysts surveyed by the central bank (BCB) for the 21 August edition of its weekly *Focus* consensus report forecast a contraction of 2.0% in 2015; they also calculated that the recession would drag on into 2016, with GDP falling by another 0.24% year-on-year.

One small silver lining may be that the 'double whammy' suffered by the Brazilian domestic economy, the combination of simultaneously restrictive

fiscal and monetary policies, is beginning to come to an end. Fiscal policy will have to remain restrictive for the foreseeable future. But a more supportive monetary policy now seems within grasp. Annualised inflation to mid-August was 9.6%, widely seen as putting Brazil at, or near, a peak caused by earlier increases in regulated prices and tariffs and other factors. BBVA Research now expects the inflation rate to trend down to 5.3% by the end of 2016. This means that the BCB, which has been ratcheting up the benchmark Selic interest rate for 28 months (since April 2013), will now probably keep it on hold at the current 14.25% before beginning an easing cycle, perhaps in Q216. The BCB has formally signalled that the tightening cycle is now over.

The reality, however, is that for the immediate future the change in the monetary policy stance will have little effect: Brazil is in recession and the credibility of Levy's austerity programme has taken a beating. The political situation has certainly changed for the worse since the beginning of this year, becoming much more complex and fragmented. At the start of the year it looked as if the main source of tension would be generated by the fact that the re-elected centre-left Rousseff and her coalition of six equally-minded parties was having, out of necessity, to impose a centre-right fiscal adjustment programme under Levy, a representative of the business sector with an orthodox approach to economic policies. Fast forward eight months and that challenge is still present, but it has been overshadowed by much bigger problems. President Rousseff is battling to avoid impeachment and there is a sense of a breakdown of her authority across the country. The ruling coalition has begun to fall apart. Under the pressure of the Petrobras corruption scandal, the largest party in the coalition, the Partido do Movimento Democrático Brasileiro (PMDB), has split into rival wings. Many PMDB deputies are in open rebellion against the President and the austerity programme, and have voted for so-called *pautas bomba* (loosely, 'bomb resolutions') that break austerity guidelines by increasing certain categories of public sector expenditure (such as spending on some public sector salaries). PMDB senators, meanwhile, have rallied round the government and sought to support pro-austerity legislation (such as a reduction in payroll tax exemptions).

> "The political crisis threatens to overshadow the fiscal programme and accelerate the erosion of its credibility. Yet amid the chaos Levy seems to be focused on keeping his head down and trying to ride out the storm."

Agenda Brasil

The political crisis threatens to overshadow the fiscal programme and accelerate the erosion of its credibility. Yet amid the chaos Levy seems to be focused on keeping his head down and trying to ride out the storm. One example of the extreme volatility of the political situation is that Renán Calheiros, the PMDB senate president, has sought to rebuild support for the beleaguered government by launching a new market-friendly action plan called 'Agenda Brasil'. Whether it can get meaningful support in the currently unpredictable and rebellious congress remains to be seen, but both President Rousseff and the business community have welcomed it.

The 27-point plan, somewhat short on detail, is a wide-ranging declaration of the importance of investing in infrastructure, achieving fiscal discipline, and protecting social benefits. It is clearly designed to appeal to the centre ground, although it includes controversial elements such as relaxing environmental controls and giving consideration to a reduction in retirement benefits. At least one version included the suggestion that Brazil should withdraw from the Southern Common Market (Mercosur, the regional customs union and trade integration bloc between Brazil, Argentina, Paraguay, Uruguay and Venezuela) to give it a freer hand to negotiate, unilaterally, foreign trade deals.

Finance Minister Levy reacted positively to the plan, picking out four of the 27 points as initiatives that might get approval before the end of this year. These were increased payroll taxes, amendments to the ICMS sales tax,

reform of social contributions taxes known as PIS/Cofins; and new legislation encouraging Brazilians to repatriate capital assets. But whether he can make any progress on these fronts depends on whether there can be a resolution to the wider political crisis. For the moment, politics is leading economics in Brazil.

ARGENTINA

The next government's economic policies

There are two ways to think about Argentina's economic problems in the current election period. One is to form a diagnosis, define priorities and decide a plan of action, popular or unpopular. A second approach is to think of economic policy primarily as a way of winning votes and gaining power, knowing that once in office something rather different may be required. Most election campaigns see some kind of mix between these two approaches. So far in Argentina, the main candidates are favouring the second, electorally-led approach. But as the polls get closer they will face increasing pressure to get down to brass tacks.

There are two main front-runners in the election: the government's candidate, Daniel Scioli of the ruling Frente Para la Victoria (FPV), a faction of the traditional Partido Justicialista (PJ, Peronists), and Mauricio Macri of Cambiemos, a opposition alliance cobbled together for this year's polls. After more than a decade in power, the FPV's economic credentials are well known: it favours economic nationalism and state intervention, and it maintains a long-running dispute with some of the country's external creditors (known as the 'hold-outs'), who refused to accept the terms of the post-2001 default settlement.

"While the economy grew strongly during the commodities boom, it is now in recession and critics point to deep imbalances: a large and growing fiscal deficit, high inflation and endemic foreign currency shortages."

While the economy grew strongly during the commodities boom, it is now in recession and critics point to deep imbalances: a large and growing fiscal deficit, high inflation and endemic foreign currency shortages. On the other hand, Mauricio Macri, mayor of the city of Buenos Aires and leader of the centre-right Propuesta Republicana (PRO), is known for his market-friendly economic policy preferences. So it might be assumed that the 2015 election will see a classic Left-vs.-Right economic debate.

But over the last month this is precisely what has *not* been happening. With opinion polls in their hands, the two candidates appear to have been doing two things; first, avoiding making any clear commitments, and second, racing to try to occupy the middle ground in economic policy. Analysts say the electoral numbers are the key driver: Scioli, with a strong base of working class electoral support, needs to appeal to the middle classes to win. Macri, with a strong base of middle class electoral support, needs to appeal to the working classes to win.

This would explain some of their recent statements. Before the county's obligatory national primaries (held on 9 August), Macri surprised some of his supporters by saying that as president he would keep the oil company Yacimientos Petrolíferos Fiscales (YPF) and the airline Aerolíneas Argentinas in state hands. In the last two decades, the two have been privatised and then renationalised. Aerolíneas in particular is seen by many as a heavily-subsidised and loss-making political enclave controlled by La Cámpora, the youth wing of the FPV, led by Máximo Kirchner, the son of President Cristina Fernández and her late husband and predecessor in office, Nestór Kirchner (2003-2007). Macri was also keen to reassure voters that he would maintain welfare programmes such as a child benefits scheme known as Asignación

Universal por Hijo. He would also maintain ANSES, the state-run pension system (also privatised and renationalised in the last two decades). Macri said that rather than re-privatising, he would concentrate on reducing losses and de-politicising state enterprises.

For his part, Scioli has begun to address what could be seen as key middle class concerns, inflation and the exchange rate. Also before the primaries, he spoke of a gradual reduction in Argentina's inflation rate: "with investment, it will come down gradually, I think we can reduce it to single digits within four years. I'm not proposing miracles, just common sense", he said. A friend and adviser, Gustavo Marangoni (president of Banco Provincia) told news agency *Reuters* that Scioli would gradually reduce the fiscal deficit (currently estimated to be running at around 5.5% of GDP) and phase out energy subsidies (put at 2% of GDP).

Another advisor, Miguel Bein, has acknowledged that the next government will have to find ways to boost dollar earnings. Scioli has said that "the idea is to give freedom for the purchase of foreign currency, although this can't be done from one moment to the next, it has to be done gradually...The middle classes want a country that operates normally". After the primaries, however, he clarified that the multiple exchange rate system (which he called an "administered exchange rate") would continue. As he put it, "We have to keep on administering the exchange rate to maintain stability and provide continuity for our development programme."

"The exchange rate could turn into a big issue: the current central bank president, Alejandro Vanoli, claims that an abrupt Peso float as promised by Macri would imply "maxi devaluation, lower real wages, basically hyperinflation and recession"."

This is one area where there is a clear difference with Macri, who argues that the existing government has created an artificial overvaluation of the Peso, and proposes a free Peso float from the first day of the new government (10 December). The exchange rate could turn into a big issue: the current central bank president, Alejandro Vanoli, claims that an abrupt Peso float as promised by Macri would imply "maxi devaluation, lower real wages, basically hyperinflation and recession".

As the elections draw nearer both candidates will face increasing pressure to get more specific about what their plans for the economy. Both, for example, have remained vague on how they hope to disentangle the legal dispute with the hold-out creditors, which continue to limit Argentina's access to international capital markets. (On Scioli's behalf, Marangoni would only say that negotiations would be "in good faith"). It is also possible that a new run on the Peso or other outbreak of financial turbulence may develop before election day – if that happens, the candidates will find it difficult to sit on the fence.

Fernández does some ring fencing

In a 20 August televised speech President Fernández said that new legislation was being prepared to limit the next government's ability to privatise state assets. While Fernández will step down in December, she seems determined to try and influence what the next government does. As such, she is proposing new legislation to make the future privatisation of state-owned utilities or energy companies subject to a two-thirds congressional majority. In addition she wants to create a new agency, Agencia Nacional de Participaciones Estatales (Anpe), to administer State holdings; there will also be a bicameral congressional committee providing oversight.

Congressional representation on Anpe and the bicameral committee could limit the new government's ability to sell assets; making it hard for Macri, for example to muster the required two-thirds majority.

But even in the case of a Scioli victory, Fernández may think it will be useful to have additional checks and balances in place. Scioli is widely seen as more moderate and less of an ideologue on economic matters than she is. As part of a settlement in Argentina's long dispute with some of its foreign creditors, Scioli might conceivably

consider asset sales. That is a possibility that Fernández would like to rule out.

The initiative also needs to be seen in terms of the likely political complexion of Argentina's next national congress. While this obviously depends on the results of the 25 October general elections, many Argentine politicians are expecting there to be no clear majority. They calculate that a Scioli presidency or a Macri presidency will lack a majority in the lower chamber of congress in particular. Based on the August national primaries, they believe no party will have an outright majority. Allegiances to the FPV will also weaken. Equally, there will be fragmentation within the ideologically diverse opposition coalition backing Macri. That suggests Argentina's next president will face some difficult challenges.

The speech by Fernández was the first time she appeared in public with Scioli in the 11 days after the primaries, a period in which there were rumours that the two had become estranged. She nevertheless took care to support her party's candidate, name-checking him and endorsing his claims that the opposition is fighting a "dirty tricks" campaign.

BAHAMAS

Two wildcards – one negative, one positive

The latest (June 2015) monthly economic and financial report from the Central Bank of the Bahamas (CBB) indicates that overall economic growth is likely to remain sluggish. In subsequent weeks, two wildcards have emerged. One – negative (if temporary) – is the filing for Chapter 11 bankruptcy in Delaware by the developer of the US$3.5bn Baha Mar resort, and associated litigation. The other – positive – is the slump in the price of oil to a little over US$40/barrel.

The latest CBB review took a cautiously optimistic tone, anticipating continued "relatively modest economic growth over the remaining months of 2015, supported by steady improvements in the high value-added stopover segment, and ongoing foreign investment projects." In the projections that accompanied its latest (July 2015) Article IV consultation with the government of the Bahamas, the International Monetary Fund (IMF) said that it was looking for real GDP, which stagnated in 2013 and expanded by 1.0% in 2014, to rise by 1.8% this year and by 2.8% in 2016.

"In the five months to the end of May, the total number of visitor arrivals was 2.8m, or 0.2% fewer than in the previous corresponding period. This was mainly due to the fall in the number of cruise visitors by 1.9% to 2.2m: the number of air passenger arrivals increased by 5.8%. Other metrics point to growth in the tourism sector, as the gradual US economic recovery has continued."

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Persistent challenges

This scenario is in the context of an economy facing a number of challenges. One is a dependence on imported energy. However, as the CBB notes, the impact on inflation of the introduction at the start of the year of a 7.5% Value Added Tax (VAT) has been mitigated by the fall in the global price of oil. The Bahamas Electricity Corporation's fuel charge at the end of June was 16.95 cents per kilowatt hour (kWh), or 29.9% lower than at the end of June 2014. In the same period, the average price of diesel fell by 19.0% to US$4.10 per gallon, while gasoline was down by 5.8% to US$4.73 per gallon.

According to the IMF, persistently high unemployment rates in the Bahamas (with 12.0% out of work at the time of the Department of Statistics' latest labour force survey in May this year) points to wage rigidities and to a lack of skilled labour. Although the country has some clear strengths in international financial services, growth in that area is unlikely to have much of an impact on the labour market. Official data shows that, as of May 2015, 12,355 people, out of a total workforce of 183,915, worked in financial/business services (including real estate and insurance).

The IMF also highlights impediments to the growth of small- and medium-sized enterprises (SMEs) and a mediocre overall business environment. For instance, the World Bank's latest *Doing Business Report* ranks the Bahamas 97th for the overall ease of doing business, out of 189 countries surveyed. The country is lowly rated for registering property, protecting investors and getting credit. According to the CBB, private sector credit fell from US$6,468m at the end of June 2014 to US$6,290m at the end of June 2015. This outcome reflects deleveraging by households: however, the CBB and the IMF both note that the financial sector is well capitalised and liquid, while ongoing improvements are being made to the supervisory framework.

> "Like a number of other governments of Caribbean countries, public finances have been issue. The overall budget deficit peaked at 5.4% of GDP in 2013, before falling to 3.3% of GDP in 2014."

Like a number of other governments of Caribbean countries, public finances have been issue. The overall budget deficit peaked at 5.4% of GDP in 2013, before falling to 3.3% of GDP in 2014. Thanks to the introduction of VAT, the IMF is looking for the overall budget deficit to shrink to 3.0% of GDP this year and to 2.1% of GDP in 2016. The Fund expects overall government debt to amount to 63.0% of GDP at the end of 2015. This will include external public debt of 22.7% of GDP.

In addition, the Bahamas has to attract sufficiently large numbers of tourists to fill the new Baha Mar mega-resort and two other projects, which will increase the country's total inventory of hotel rooms by 20%. Baha Mar is the largest overseas commercial real estate project to be backed by Chinese interests (China Construction America Inc., a wholly owned subsidiary of China State Construction Engineering Corp. Limited) and includes five upscale hotels, a casino, an 18-hole golf course, luxury condominiums and a nightclub designed by singer Lenny Kravitz. Costing US$3.5bn, Baha Mar is massive in relation to the entire economy: the IMF estimates that the country's GDP in 2015 will be just over US$8.9bn. Imports of construction materials for Baha Mar have been a major contributor to the current account deficit, which is expected by the IMF to peak at 21.9% of GDP in 2014, before falling to 12.5% of GDP in 2015 and 8.3% in 2016.

Wildcards

As of late August 2015, it is not clear when Baha Mar will open its doors to paying guests, or when it might start to contribute to employment and – provided that it does not cannibalise the business of other, older resorts – export revenues and economic growth. The resort originally had been due to open at the end of March. However, following a number of disputes between China Construction and the Baha Mar developer, the latter filed for Chapter 11 bankruptcy protection in the US Bankruptcy Court in Delaware at the end of June. Protection under Chapter 11 would enable Baha Mar's CEO, Sarkis Izmirlian, and his management team to remain in control of the resort as debtors in possession, while they look for new sources of funding and a possible restructuring of the project's finances.

EB-15-08_Canning House_Latin American Economy & Business 27/08/2015 14:4 Page 20

The situation is a complex and fluid one. As of August 22, the government of the Bahamas had attempted to intervene by appointing a provisional liquidator: the Supreme Court of the Bahamas is expected to decide on the matter on September 4. Meanwhile, Rosewood Hotels and Resorts, the backer of one of the mega-resort's hotels, has initiated an action in the US Bankruptcy Court in Delaware to terminate its licensing agreement with Baha Mar. Sarkis Izmirlian notes that Rosewood's decision is based mainly on what it sees as its vulnerabilities as a result of actions of the Supreme Court of the Bahamas: Baha Mar will "vigorously oppose" Rosewood's move to end its licensing agreement.

If the financial problems of Baha Mar represent a negative – if temporary – wildcard, the latest slump in the price of oil represents a positive factor. In recent years, oil imports have amounted to around US$500m annually, equivalent to 5%-6% of GDP. The IMF noted in its Article IV consultation that the fall in the price of oil since late 2014 should cut the import bill by 2.5% of GDP. Oil prices have fallen further since then.

> "Provided that the oil price remains below US$50/barrel for some time, and the legal and financial problems of Baha Mar can be resolved so that the mega-resort can actually commence operations in the coming months, the prospects for the Bahamas will be favourable."

Provided that the oil price remains below US$50/barrel for some time, and the legal and financial problems of Baha Mar can be resolved so that the mega-resort can actually commence operations in the coming months, the prospects for the Bahamas will be favourable. Actual and expected growth should accelerate. This will further help with the reduction in the current account and budget deficits, which are already moving in the right direction. If the government makes progress with the National Development Plan, which looks to promote diversification of the economy, takes steps to reduce rigidities in the labour market and reforms state-owned enterprises such as Bahamasair and the Water & Sewerage Corporation (WSC) of the Bahamas, the country could sustain a significantly higher growth trajectory than that of the last decade or so.

REGION

UK services exports and Latin America

Latin America is a smaller market for UK services exports than Southeast Asia, which is roughly the same distance from London and a significantly smaller regional economy.

According to the Office for National Statistics (ONS), the UK's total merchandise goods exports in 2014 amounted to UK£291.8bn. The largest destination for good exports was the US, which accounted for 12.8% of the total. The largest destinations in Latin America were Brazil (the 28th largest overall, taking 0.7% of the total), followed by Chile (39th and 0.4%) and Mexico (43rd and 0.3%). Aside from China/Hong Kong (together in 4th place with 7.0% of the total), the most important UK export destination outside Europe was the United Arab Emirates (12th largest and 2.1%).

The countries of the Association of South East Asian Nations (ASEAN) collectively represent a more important market for UK exporters than does Latin America. Three ASEAN countries appear in ranking of the top 50 export markets for 2014. They are Singapore (23rd largest overall and 1.2% of the total), Malaysia and Thailand (respectively 32nd and 33rd largest overall, each accounting for around 0.5% of exports).

The ONS data for UK's services exports (excluding travel, transport and banking) tells a similar story [***see table 1***]. Services exports increased from UK£97.3bn in 2011 to UK102.8bn in 2012 to UK£117.2bn in 2013. Services exports to Latin America have remained broadly unchanged, at around UK1.4bn – which means that the region's relative importance has been declining. In 2013, UK services exports to Singapore alone amounted to the same – UK£1.41bn. Within the region, Brazil is the most important single market, accounting for well over half of this total. Services exports to Mexico identified by the ONS amounted to £224m.

Table 1. UK Services Exports (GBPm)

	2011	2012	2013
Total services exports, of which:	97,311	103,828	117,193
to Brazil	556	743	819
to Mexico	175	171	224
to other Latin America/Unallocated	666	580	371

Source: *Office for National Statistics, International Trade in Services*

The comparison between ASEAN and Latin America is relevant because both regions are about the same geographic distance from London and have similarly sized populations (of 625m and 522m respectively, according to the World Bank). They also include both large and small developing countries. However, the five large economies of the ASEAN (Indonesia, Thailand, the Philippines, Malaysia and Vietnam) are, together, a lot smaller than the combined economies of Latin America. According to the International Monetary Fund (IMF), these ASEAN countries' combined GDP in 2015 will be US$2.12trn at current exchange rates and US$5.9trn in terms of purchasing power parity. For Latin America, the equivalent figures are US$5.24trn and US$9.5trn.

In recent years, HSBC – the UK-based bank with largest global footprint – has seen the need to consolidate its operations. In doing so, it has tended to reduce its presence in Latin America. HSBC announced the sale of its operations in Paraguay, Peru, Uruguay and Colombia in May 2012. In early 2013, HSBC announced that it would sell its operations in Panama, but noted that Brazil, Mexico and Argentina would remain its focus markets in the region. Nevertheless, in a move to boost return on equity, the bank in June announced that it would divest its operations in Brazil (and Turkey, another large emerging market).

Another indicator that the UK's exporters (of both goods and services) and direct investors in foreign markets see the ASEAN countries as a greater priority than Latin America is the breakdown of business handled by Lloyd's, the London-based specialist insurance market, whose gross written premiums in 2014 amounted to UK£15.28bn [***see table 2***]. Some 11% of Lloyd's premiums last year came from the Asia-Pacific, which includes greater China and Central Asia as well as the ASEAN countries. A little under half (45%) of the premiums written in that part of the world came from reinsurance business (i.e. insurance companies using Lloyd's to lay off local risks in the global market), with remainder coming from direct insurance. The direct business was dominated by property and casualty covers, but also included marine, energy, motor and aviation business. By contrast, Latin America was the source of 8% of Lloyd's gross written premiums in 2014, and nearly three quarters of that business was reinsurance. The direct insurance business was also quite broadly diversified.

EB-15-08_Canning House_Latin American Economy & Business 27/08/2015 14:4 Page 22

However marine insurance was the only area in which premiums from Latin America exceeded those sourced from the Asia-Pacific.

Table 2. Lloyd's business in Asia-Pacific** and Latin America, 2014		
	Asia-Pacific**	**Latin America**
Share of total GWP*	11%	8%
Reinsurance	45%	74%
Property	16%	6%
Casualty	25%	8%
Marine	8%	5%
Energy	3%	5%
Motor	1%	1%
Aviation	2%	1%
*Gross Written Premiums, which amounted to GBP25,283mn in 2014		
**Including Central Asia		
Source: *Lloyd's Annual Report 2014*		

Even more significant is the geographic location of the staff that work for the so-called 'Magic Circle' of five large corporate law firms based in London [***see table 3***]. Linklaters, Allen & Overy and Clifford Chance each have lawyers working from offices in the ASEAN countries and in São Paulo. Freshfields' lawyers can be found in the ASEAN countries, but not in Brazil. Freshfields' clients with matters that relate to Latin America are served by staff based in Washington DC, New York City, Madrid, Paris and London. Some 30 partners and 20 associates form Freshfields' Brazil group are qualified in that country and/or have experience of working there. Unlike the other Magic Circle firms, Slaughter & May does not have a presence on the ground in the ASEAN countries or in Brazil. Outside the UK, Slaughter & May has offices in Hong Kong, Beijing and Brussels. Elsewhere in Europe, it partners with prominent local firms in the various countries in order to deal with cross-border matters.

Table 3. Magic Circle law firms:															
Numbers of partners/counsel/associates															
	São Paulo			**Bangkok**			**Jakarta**			**Singapore**			**Hanoi/HCMC***		
Clifford Chance	3	0	7	3	2	14	4	0	11	21	9	60	0	0	0
Freshfields	0	0	0	0	0	0	0	0	0	4	1	16	1	1	15
Allen & Overy	1	1	1	3	4	21	3	3	24	12	7	45	1	0	9
Linklaters	1	1	2	4	1	10	0	0	0	9	4	36	0	0	0
Slaughter & May	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
TOTAL	**5**	**2**	**10**	**10**	**7**	**45**	**7**	**3**	**35**	**46**	**21**	**157**	**2**	**1**	**24**
*Ho Chi Minh City															
Source: *websites of the Magic Circle firms*															

None of the Magic Circle firms has a physical presence in Latin America outside São Paulo. Together, they employ a smaller number of partners, counsel and associates than they do in Jakarta. Perhaps because of Singapore's importance as a regional trading centre and/or because of its common law system, the Magic Circle firms have more people in Singapore than in Bangkok, Jakarta, Hanoi/Ho Chi Minh City and São Paulo combined.

It may be that clients with matters in Malaysia – which is another common law jurisdiction – are handled by personnel in Singapore. Manila is the only other national capital within the five main economies of ASEAN in which the Magic Circle firms do not have a physical presence.

The organisational structure of the major accounting/consulting firms such as the Big Four – Ernst & Young (EY), PriceWaterhouseCoopers, Deloitte and KPMG – mean that it is impossible to quantify how they work with UK firms that are looking to expand into Latin America or the ASEAN countries. The large consulting firms are typically constituted as Swiss Vereins, which are confederations of member firms in each of the countries in which they operate. A major UK exporter that, for example, seeks the advice of one of the Big Four in relation to an expansion into Brazil or Mexico, might well be served by the local affiliate – even if its initial approach is to a relationship manager based in London. The fee for the advice provided in this case may not appear as an export of services to Latin America.

Similarly, it is very difficult to quantify the extent to which UK banks are exporting services to Latin America (in part because ONS statistics exclude banking services). However, league tables of banks that are active in corporate finance transactions such as Initial Public Offerings (IPOs), primary bond issues and mergers & acquisitions in Latin America rarely include UK institutions. Instead, they tend to be dominated by major US or European banks with global footprints and/or leading local groups. As noted, HSBC has been reducing its commitment to Latin America.

“Perhaps for historical reasons, the UK’s internationally-oriented services firms have found the ASEAN countries an easier part of the world in which to do business than Latin America. In the ASEAN countries, Singapore is a services and logistics hub, famous for the excellence of its business environment. Panama has good claim to being the regional logistics hub of Latin America, but is not a services hub in the same way that Singapore is, and nor does it have a world-class business environment.”

Perhaps for historical reasons, the UK’s internationally-oriented services firms have found the ASEAN countries an easier part of the world in which to do business than Latin America. In the ASEAN countries, Singapore is a services and logistics hub, famous for the excellence of its business environment. Panama has good claim to being the regional logistics hub of Latin America, but is not a services hub in the same way that Singapore is, and nor does it have a world-class business environment.

The high savings rates of the ASEAN countries (or, at least, their substantial communities of high income earners) have attracted the UK’s Prudential plc, which is one of the largest regional life insurance companies. Prudential plc also has a significant presence in Hong Kong and, through joint ventures, in China and India. Other large multinational life insurance companies whose footprints span Greater China and the ASEAN countries include Canadian majors Manulife Financial and Sun Life Financial, as well as Hong Kong-based AIA. None of these companies have a presence in Latin America – unlike a number of leading US and Spanish insurers.

Taking a five-year view, it is difficult to see what could cause the UK’s leading services exporters to place greater importance on opportunities in Latin America. Mexico’s economy should continue to benefit from the steady expansion in the US: however, the UK’s services exporters are only minor players in Mexico. The latest softening in energy and minerals prices will have an adverse impact on growth in a number of Latin American countries, the most important of which is Brazil. The ASEAN countries have been affected by the slowing of growth in China. However, they are still benefiting from favourable trends such as rising household incomes and improving business environments. In this scenario, if anything the relative importance of the ASEAN countries as a market for the UK’s exporters of services will likely increase.

POSTSCRIPT

China's crisis and Latin America

On 25 August Brazil's Real fell to R$3.6/US$1, a twelve-year low. The Real was not the only victim of market worries over the economic slowdown in China: the Mexican and Colombian currencies also fell following the crash in Chinese stocks the previous day. The slowdown in the world's second-largest economy now seems more profound than originally feared. With China having overtaken the US as Brazil's top trading partner in 2009, the Real has been badly hit by China's slowdown, losing 30% of its value against the US dollar this year. By comparison, the Mexican peso has lost 20% of its value, the Argentine peso around 10% and the Colombian peso over 30%

The devaluation of the Chinese Renminbi, initiated on 11 August, has caused concern over the potential impact on key Latin American economies. China's currency fell 3.5% against the US dollar over two days (11-12 August) after the Peoples' Bank of China announced changes to the way it calculates its reference exchange rate, around which the currency is allowed to trade within a 2 percentage-point band of tolerance. Analysts are concerned that this devaluation may reflect an underlying policy change in favour of a more competitively priced Chinese currency, and that this will have negative effects on Latin America's currencies and its economies.

While the devaluation of the Renminbi may not be as serious a threat as many fear, these are still nervous times, with Latin American central banks awaiting a tightening of US interest rates. Although it may now be delayed, a tightening move by the US Federal Reserve, coupled with uncertainty over the Renminbi, could lead to a degree of unwanted currency volatility.

Almost all economists agree that a faster-than-expected depreciation of the Renminbi is bad news for Latin America; but opinions differ on how serious a problem it could be. If, as some fear, the Beijing authorities are now deliberately seeking a more competitive currency to pursue export-led (rather than domestic consumption-led) growth, that means Chinese demand for Latin American commodities will ease back further, and competition from Chinese manufactured exports will increase. That could be particularly bad news for the likes of Brazil, where the embattled government of President Dilma Rousseff is hoping to bring the region's largest economy out of recession by boosting commodity exports to China and manufactured exports to markets which are also served by China; and Mexico, Latin America's largest exporter of manufactured goods, which directly competes with China for a share of the global demand for cheap manufacturing costs.

One analyst, former IMF economist Stephen Jen, has warned that Brazil's Real, Indonesia's Rupiah, and South Africa's Rand could all be hit by the Chinese move. Others have warned that China's devaluation could set off a flurry of "competitive devaluations" around the world. Paulo Figueiredo of a Brazilian consultancy, FN Capital, says that a reduction of Chinese purchases of Latin American minerals, soya, and foodstuffs will represent "an additional difficulty for the economies of this region". There are also concerns that for Mexico the move produces "the risk that China's exports to the US will become cheaper, and that this could displace Mexican exports to the US", according to Manuel Herrera Vega, president of the confederation of Mexican industrialists (Concamin), one of the country's main business groups.

But Mauricio Mesquita Moreira of the Inter-American Development Bank (IDB) points out that many Latin American currencies have depreciated by much more than the Renminbi so far this year, limiting the negative effect. In Mesquita's view, China's growth rate is more important for Latin America than its exchange rate. Mesquita notes that if China's economy grows by less than 7% this year, Latin America will more negatively affected. "For each percentage point of Chinese growth, Latin America grows 0.7 percentage points. That is a very high correlation" Mesquita explained. "Mexico will be affected by oil prices but other countries will suffer more. I am more worried by Brazil, Venezuela, and Argentina, which are not growing right now, than by Colombia, Chile and Peru, which have more solid economies", Mesquita added.

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