CANNING HOUSE EDITION

latin american economy & business

December 2014 - EB-14-12

ISSN 0960-8702

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This edition of Latin American Economy & Business has been produced for Canning House Corporate Members by LatinNews (www.latinnews.com).

Latin American Newsletters since 1967

Peru presides over climate change deal

Officially, the 12-day United Nations climate change conference (known as Conference of the Parties 20 or COP20) held in Lima and chaired by the Peruvian government was a success: it was extended for a further two days to break a deadlock and finally concluded in the early hours of 14 December with the approval of a document that sought to balance the many, often conflicting views of the participants on how to reduce greenhouse gas emissions. While the global debate will continue, it is becoming clear that climate change issues are of growing importance in Latin America.

Peru's environment minister, Manuel Pulgar-Vidal, said of the final COP20 statement: "As a text it is not perfect, but it includes the positions of the parties". It certainly fell short of the draft agreement that some hoped would go through to Paris climate change summit, due to be held in late 2015, which will seek to replace the Kyoto Protocol. The overall aim is prevent the world temperature from rising by 2 degrees centigrade by 2050, which scientists say will have catastrophic consequences. The debate revolves around what greenhouse gas reduction commitments countries are prepared to make, and how they will be monitored and funded. In the end, COP20 could not teach agreement on mandatory measures and said that instead there should be looser national emission reduction pledges by Q115 submitted by those countries "ready to do so"; it also supported the principle that the richer countries should provide financial support to help "vulnerable' developing nations reduce their emissions (although the mechanism for this to happen remains unclear). While some specialists are hopeful that the momentum for action can be maintained, Sam Smith from the World Wide Fund for Nature (WWF) lamented that "the text went from weak to weaker to weakest, and it is very weak indeed".

What eventually happens in Paris is important for the region. The UN Economic Commission on Latin America and the Caribbean (ECLAC) updated a report on climate change for COP20. It says global warming has so far played out in a complex manner. Since the 1970s, average Central and South American temperatures have increased by between 0.7 and 1.0 degrees, with the exception of the Chilean coast, where they have fallen by 1 degree. Rainfall has increased in southeast South America, but has reduced in Central America and centre-south Chile. The Caribbean, it says, is particularly exposed to rising sea levels and extreme weather (droughts, floods, hurricanes and tropical storms).

Farming and livestock – which accounts for 5% of GDP, 16% of employment, and 23% of exports in the region – is the most affected, particularly so in the warmer areas of the continent. Rising temperatures are already

having an impact, causing a reduction in the cultivation of maize, wheat and potatoes, and an increase in the production of fruits and vegetables, along with greater depend on irrigation systems. Many farms are shifting from exclusive dedication to crop production on its own, to livestock, or to mixed crops-and-livestock operations.

Between 1950 and 2008, the level of the sea in Latin America has risen by between 3 and 7 millimetres a year. The increase has been greatest in northern Brazil and Venezuela, and least on the coast of Ecuador. According to ECLAC, Latin America currently generates around 9% of the world's greenhouse gases, but is more than proportionately exposed to the effects of global warming. Most of Latin America and the Caribbean's greenhouse emissions (42%) come from energy-intensive activities (including electricity generation, heating, manufacturing operations, and transport). Agriculture generates 28%, while forestry and changes in land use generate 21%.

While the Lima Call to Action was hailed by UNFCC executive secretary, Costa Rica's Christiana Figueres, environmentalist groups consider the document "too weak". Winifred Byanyima, the executive director of Oxfam International, commented: "Negotiators have managed to keep the boat afloat here in Lima. But there will be more turbulent waters in Paris".

ECLAC warns that if average temperatures in the region rise 2.5 degrees centigrade by sometime around 2050, the 'economic cost' to the Latin America and the Caribbean as a whole could be somewhere between 1.5% and 5.0% of GDP. There would also be additional 'adaptation costs' – including things like increased coastal protection needed because of rising sea levels – of around 0.5% of GDP.

Mariana Panuncio, director of climate change for WWF in Latin America and the Caribbean, notes that there have been some successes. Brazil, it says, has reduced the rate of deforestation by 70% in the last decade while boosting soya production by 80%, something that shows that conservation and economic growth can be compatible. Colombia and Peru have set 'zero deforestation' targets for 2020 and 2021 respectively. Another positive is Latin America's good track record on renewable energy, particularly the use of hydro-power for electricity generation. 80% of Uruguay's electricity comes from hydroelectric sources; Costa Rica is seeking a carbon neutral energy footprint by 2020. Mexico is aiming to produce 35% of its electricity from renewables by 2018, while Chile is targeting 45% by 2025.

The Lima Call to Action

Peru's environment minister formally closed the COP20 announcing that the 194 attending countries had approved a document setting the foundations for a new global treaty on reducing greenhouse gas emissions to replace the 1997 Kyoto Protocol. The approval of the 'Lima Call to Action' meant that the conference did not end in complete failure and should earn Pulgar Vidal and Peru international political credit. But environmentalist groups lamented the lack of a definitive agreement; and while recognising that the deal was better than nothing, complained that the issue has once again been kicked down the line.

There were major differences between industrialised and emerging economies over just how much each should commit to reducing greenhouse emissions. While the US and the European Union wanted to impose well-defined global limits, developing economies led by China and India called for these to be differentiated, with less stringent limits imposed on them.

The Lima Call to Action commits all participants to draft and present their own "quantifiable" national greenhouse emissions reduction plans (Intended Nationally Determined Contributions [INDCS]) by March 2015, ahead of next year's COP to be held in Paris, France. Pulgar Vidal said that the deal reached was significant as the document calls for the national emission reduction plans to be "ambitious", "congruent with national circumstances" and supported by detailed information. He added that once submitted these would be studied, with a view to drafting a definitive deal in Paris.

REGION

Corruption is alive and well

In early December Transparency International (TI), the anti-corruption lobby group, published its annual Corruption Perceptions Index (CPI). Latin American and Caribbean countries often find themselves figuring more prominently in these global rankings than they might like. This year the issue seems particularly prominent, with a major kickbacks scandal engulfing Petrobras (Brazil's state-controlled oil company), conflict-of-interest concerns affecting a high speed rail contract in Mexico, and Argentina's vice-president potentially facing trial on charges of 'illicit enrichment', to mention only a few headline cases. Here, we look again at the dimension of corruption issues in the region.

The CPI, based on a combination of surveys and assessments, is worked out on a 0-100 score: the higher the score, the least corrupt a country is believed to be. In 2014 the least corrupt countries in the world were considered to be Denmark (ranked at no.1, with a score of 92) and New Zealand (ranked at no. 2, with a score of 91). At the other end of the spectrum, the most corrupt are North Korea and Somalia (both ranked 174th, with a score of 8). Latin American and Caribbean countries are spread out between those two extremes.

> "There has been very little change in the scores and rankings relative to 2013. Alejandro Salas, TI's regional director for Latin America, likens the results to a story of "the good, the bad, and the ugly"."

The countries in the region thought to be most corrupt are Venezuela and Haiti, tied at 161st position with a score of 19 each. They are followed, in descending order of corruption, by Paraguay, Nicaragua, Honduras and Guyana. Among the bigger economies, Argentina is ranked 107th (with a score of 34), while Mexico comes 103rd (with a score of 35), and Brazil is relatively less corrupt, being placed 69th (with a score of 43). The least corrupt countries in the region are perceived as being Barbados (ranked 17th with a score of 74), followed by Chile and Uruguay (ranked equally at 21st, with a score of 73). To put this in context, Barbados is tied with the US, while Uruguay and Chile sit just one notch below.

Another way of contextualising the data is to note that the average global score is 43 – Brazil, which scores exactly that, is therefore at something of an international mid-point. But there are more regional countries scoring lower than Brazil (i.e. perceived as being more corrupt) than scoring higher. In fact, 19 regional countries are perceived to be more corrupt than Brazil, while only seven countries are perceived to be less corrupt.

There has been very little change in the scores and rankings relative to 2013. Alejandro Salas, TI's regional director for Latin America, likens the results to a story of "the good, the bad, and the ugly". The "bad and ugly", he says, are those politicians, public officials and businessmen who continue on their 'usual' path, supporting some partial reforms such as freedom of information laws, improved public procurement, or open government initiatives. While Salas says that these are all good steps, "big corruption schemes that involve individuals at the highest level of power and lack of punishment of the corrupt continue to prevail in the Americas". Salas adds:

> "The case of Petrobras in Brazil, where corrupt officials and their private sector cronies siphoned billions of dollars from the country's largest company into political parties' coffers and private hands, and the presumed killing of more than 40 students in Iguala, Mexico, where it became evident that corruption allows criminal gangs to capture public institutions; are just recent examples that serve as a reminder of the lack of significant progress in the region. These two countries – instead of making positive use of their influ-

ence as geopolitical leaders – show signs of stagnation and even backwardness by allowing for the abuse of power and looting of the countries' resources for the benefit of the few."

Salas also has a reflection for the 'good', described as the average citizens who, while not corrupt themselves, tend to consider themselves passive victims of the corruption of others. If these citizens have been observing the corrupt practices of politicians and public officials for years, is not their passivity and resignation part of the problem too, he asks?

While there have been few sharp year-on-year changes, an analysis of TI reports over the last 16 years (1998-2014) is perhaps a little more optimistic. It shows that seven countries have increased their scores (i.e. reduced the perception of corruption) while five remained unchanged and four saw their scores fall (i.e. increased the perception of corruption). Uruguay and Colombia have shown the greatest improvements. Mexico and Argentina are

2014 Perceptions of Corruption – In Descending Order

Country	Global Ranking (countries in descending order of corruption)	Score (the higher the score, the less corrupt a country is perceived to be)	Score change since 2013 (= means no change + is improvement, - is deterioration)
Venezuela	161	19	-1
Haiti	161	19	=
Paraguay	150	24	=
Nicaragua	133	28	=
Honduras	126	29	3
Guyana	124	30	3
Guatemala	115	32	3
Dominican Republic	115	32	3
Ecuador	110	33	-2
Argentina	107	34	=
Mexico	103	35	1
Bolivia	103	35	1
Suriname	100	36	=
Panama	94	37	2
Colombia	94	37	1
Trinidad & Tobago	85	38	=
Peru	85	38	=
Jamaica	85	38	=
El Salvador	80	39	1
Brazil	69	43	1
Cuba	63	46	=
Costa Rica	47	54	1
Dominica	39	58	=
Puerto Rico	31	63	1
St Vincent & the Grenadines	29	67	1
Bahamas	24	71	=
Uruguay	21	73	=
Chile	21	73	2
Barbados	17	74	1

Source: *Transparency International*

among the countries that are broadly unchanged in their scores, while Nicaragua, Venezuela, and Peru are among those that have worsened.

The publication of this year's CPI report coincided with the release of the Organisation for Economic Co-operation and Development (OECD)'s

Foreign Bribery Report. This suggests that many of the developed world countries perceived as having low levels of corruption in the ranking are nevertheless a key part of the problem. The report is based on analysis of 400 bribery cases across 41 countries. Among its findings is the conclusion that one-fifth of bribes were paid by or offered to officials in countries with "very high human development". These included 24 of the 41 members of the OECD Working Group on Bribery and 15 of the 19 members of the G20. In 41% of the cases, senior managers had authorised the payment of bribes, and in 12% of cases the go-ahead came from the chief executive. Three per cent of the cases involved illicit payments to ministers, and 2% to heads of state. In 25% of cases, payments were made through "subsidiary companies, local consulting firms, companies located in offshore financial centres or tax havens or companies established under the beneficial ownership of either the public official who received the bribes or the individual or entity that paid the bribes".

The US-based Pew Research Centre has also published the results of a global survey of attitudes towards a number of issues including corruption. Respondents in 34 selected "emerging and developing nations" were asked to list what they saw as top problems in their societies. At a global and Latin American level, crime and corruption (which of course are closely connected) led the list, ahead of other issues such as health care, poor schools, pollution, food quality and power cuts. For the Latin American nations surveyed, 86% identified crime as a major problem, followed in second place by corruption, highlighted by 77%.

% Saying the issue is a "very big problem for their country"

Country	Crime	Corruption	Health Care	Poor Schools	Water pollution	Air pollution	Food safety	Power Cuts	Traffic
Colombia	90	87	91	85	91	90	81	58	69
El Salvador	90	80	65	54	78	72	65	24	45
Argentina	89	85	50	59	66	64	50	36	44
Nicaragua	87	77	79	73	88	86	74	52	51
Chile	86	68	80	78	66	77	59	44	64
Venezuela	86	69	59	57	69	65	68	57	38
Peru	84	77	63	64	73	72	53	23	56
Brazil	83	78	83	64	50	50	43	35	47
Mexico	79	72	54	52	70	69	58	31	33
Regional Average	86	77	65	64	70	72	59	36	47
Global Average	83	76	59	56	54	54	50	46	44

Orange highlight = issue of greatest concern, green = issue of least concern

Source: *Pew Research Centre, Spring 2014 Global Attitudes Survey*

The US-based Pew Research Center compared the results with a similar survey done seven years ago, in 2007, to find that concerns have increased over that period. The biggest change has been in Argentina, where the number of people identifying "corrupt leaders' as a problem has increased by 10 percentage points to 85%, followed closely by Mexico, where there has been 9 percentage point increase to 72%. There has also been a 9 percentage point increase in Chile, but that takes the proportion of people expressing concern to a slightly lower 68%. In Peru, there has been a four percentage point increase to 77%.

Petrobras swamped by corruption scandal

For Dilma Rousseff, this is definitely not a good time for a corruption scandal. She has just been re-elected to a second presidential term with an uncomfortably narrow majority. The economy is at a standstill and despite her left-wing convictions Rousseff has found herself having to appoint financially orthodox ministers: fiscal austerity lies ahead. The middle class is restless and unhappy. And into this mix has been added explosive revelations about Petrobras, the state-controlled oil company, previously considered a proud example of national entrepreneurship.

There has long been a suspicion about corruption at the giant Petrobras, the sixth largest energy company in the world in terms of assets, with 86,000 employees. Claims of wrongdoing trickled out rather slowly during the course of 2014. A key point came in March, when Paulo Roberto Costa, a former director of the company, was arrested in Switzerland on charges of accepting bribes and holding illicit accounts. He was released and then re-arrested in June. Suspicions of wrongdoing at Petrobras were an uncomfortable presence during the presidential elections, won by Dilma Rousseff of the left-wing Partido dos Trabalhadores (PT) in a second round run-off with a narrow margin over Aécio Neves of the centrist Partido da Social Democracia Brasileira (PSDB). But over the weekend of 15 and 16 November, the trickle turned into a flood. Under a plea-bargaining deal Costa had turned state witness and began naming names. A total of 22 senior Petrobras and private sector executives – leaders of Brazil's big construction companies prominent among them – were arrested. Even those Brazilians who had suspected some kind of wrongdoing were shocked by the extent of what was uncovered.

> “Costa, nicknamed ‘the human bomb’ because of his ability to unleash explosive allegations, had alleged that Brazil's top construction companies, including OAS, Odebrecht, Mendes Junior, Queiroz Galvão and Camargo Corrêa, among other household names, were regularly paying bribes to secure multi-billion dollar contracts from the oil company.”

The official police investigation goes by the name of ‘Operação lava jato’ (‘operation car wash’) a reference to the various types of money laundering believed to be involved. At least three areas of the company's operations had already attracted suspicions of managerial incompetence, corruption, or both. First, there was a purchase of a refinery in Pasadena, Texas, in 2006, at what appeared to be massively inflated prices (Petrobras is reported to have taken a US$500m loss on the operation). Second, there were unprecedented cost overruns in the construction of the Abreu e Lima refinery in the north-east of the country (which has a final price tag of around US$20bn, five times the original estimate, in part because Venezuela's state oil company Petróleos de Venezuela had to bow out of what was meant to be a joint venture). And third, there were suspected kickback payments of US$100m made by Petrobras to a Dutch tanker company, SBM Offshore. This is subject to an ongoing enquiry by the authorities in Brazil, the Netherlands, and the US.

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For some, the Petrobras scandal is nothing more than confirmation of a culture of corruption that runs through much of the Brazilian public sector. Brazilian businessman Ricardo Semler, internationally renown among management theorists for his experiments in employee participation, was particularly cutting. Writing in the daily *Folha de Sao Paulo* he said, "Not being a member of the PT but supporting the tucanos [PSDB] I want to make clear that the wave of arrests of executives is a historic step for this country. Our company stopped selling equipment to Petrobras in the 1970s. It was impossible to sell directly without bribery. We tried again in the 1980s, the 1990s, and even more recently. In 40 years we were unable to do anything".

The scandal has political repercussions for President Rousseff. As energy minister in 2003-2005 she was also chair of the Petrobras board, during a time when these illegal payments were being made. Trying to find a positive angle on a difficult story, Rousseff initially reacted by saying that the scandal would "change Brazil for ever", because "it could end impunity." "I think this will change forever the relations between Brazilian society, the Brazilian state, and private companies", she declared. In a recent survey by Datafolha, 68% of respondents said that the president must shoulder a degree of responsibility for the scandal (although her approval rating has remained fairly stable at 42%).

The Petrobras chief executive, Maria das Graças Foster, in the post since her nomination by Rousseff in early 2012, is trying to soldier on, announcing further internal investigations and a management shake-up. "We are going through a very difficult moment in the company, but we are convinced that we will have better management after we structure and implement all of these managerial processes" she said. The daily *O Globo* noted that managers responsible for the Pasadena refinery acquisition, the Abreu e Lima refinery project, and the project to build another refinery in Rio (Comperj) have all been removed.

"As a state-owned company, Petrobras cannot fail. However, it is highly indebted, and the blow to its reputation may be financially significant."

In the eyes of investors, the Petrobras scandal may be seen as yet another example of the over-hyping of Brazil's energy and mining potential. Brazil's version of the boom-and-bust commodities cycle has already been playing out in the rise and fall of the one-time billionaire Eike Batista, whose group of energy and mining companies surged high on stock markets and then dramatically crashed, some of them going into bankruptcy in 2013. In November Batista's court trial began; he is accused of stock manipulation and insider trading.

As a state-owned company, Petrobras cannot fail. However, it is highly indebted, and the blow to its reputation may be financially significant. In a research note, Marc Chandler of BBH analysts suggested that the company would not be able to return to bond markets immediately because of the size of the scandal. "Petrobras does have cash, as well as some implicit government support, but this looks ugly", he wrote.

The wider economic implications are also serious. International confidence in Petrobras has taken a body blow. By early December, the share price had plummeted to an almost ten-year low. A study by Brazilian consultancy Economática said that the market value of Petrobras had slumped from US$149bn at the end of 2010 to US$71bn in November 2014. Wall Street investor Jim Chanos called Petrobras "a scheme, not a stock". To make matters worse, in late November the US Securities and Exchange Commission (SEC) said it had opened an investigation into Petrobras and was issuing subpoenas for key documents. Because Petrobras is also listed on the New York Stock Exchange (NYSE), the SEC has the right to intervene in this way. The Brazilian company said it would cooperate with the SEC and had hired US lawyers to assist investigations. The US Justice Department has also opened an investigation under the Foreign Corrupt Practices Act (FCPA), according to *Reuters*.

Impact

There could be a particularly serious fall out on the construction industry in Brazil. Eight of Brazil's top ten construction companies are implicated in the 'lava jato' allegations. Under Brazilian regulations, companies facing accusations of corruption or bribery must be disqualified from public sector contracts. In a worst-case scenario, the scandal could bring the government's large infrastructure programme, worth BRL871bn (US$335bn) and considered critical to boosting productivity, to a halt. Fitch Ratings adjusted its outlook on six of the construction companies to negative, reflecting concern over the possible "financial and business impact upon these corporates of corruption allegations regarding contracts between Petrobras and multiple companies in the sector". Marcelo Carvalho of BNP Paribas has warned of the knock-on effects if Petrobras is forced to cancel some of its contracts. "There'd be a cascading effect, forcing Petrobras contractors to also reduce investments", he said. Jason Marzak of the Adrienne Arsht Latin America Centre at the US based Atlantic Council commented: "This is a huge problem. Infrastructure is both one of the biggest challenges to the future of the Brazilian economy and the biggest opportunities for investment in Brazil".

The aggressive role and the political campaign contributions of the construction companies has frequently been criticised within Brazil (see '*Big engineering on the attack*' in our June 2014 edition), so some now believe that there will be a backlash against them. According to Mario Engler of the Fundação Getúlio Vargas (FGV), "the country should not be held hostage to its large construction companies". However, Julio Bueno, Rio de Janeiro's state economic development secretary, noted that Brazilian builders "are the same as banks – too big to fail".

"The aggressive role and the political campaign contributions of the construction companies has frequently been criticised within Brazil (see '*Big engineering on the attack*' in our June 2014 edition), so some now believe that there will be a backlash against them."

There is a strong possibility that the judicial investigation will continue for years. Some experts say that this is a bigger and more complicated case than the 'mensalão' congressional cash-for-votes bribery scheme uncovered late in Lula da Silva's first term (2003-2006), which dragged on for eight years from late 2005 before firm convictions were reached in 2013. According to Matthew Taylor, an expert on the Brazilian legal system at the American University, the Petrobras scandal could expand to involve 150 defendants and more than 2,200 witnesses (the mensalão case had 40 defendants and 600 witnesses).

MEXICO

New bidding round for high-speed rail

The US$3.74bn procurement process for the construction of a high-speed rail link between Mexico City and Querétaro, cancelled in November, will be re-run in the immediate future. But questions are still being asked about the process.

The contract was originally awarded on 3 November, but in a matter of days hit major political problems. Mexico's transport and communications ministry said that the only bidder, a consortium led by China Railway Construction Corp (CRCC) and including a number of Mexican construction companies, among them a unit belonging to Grupo Higa, had won the contract for the 210kms link. Rival groups such as Siemens of Germany and Bombardier of Canada had expressed interest; the ministry refused their request for more time to prepare a bid, so they had dropped out of the race.

However, on 6 November the government then cancelled the contract, with Transport and Communications Minister Gerardo Ruiz Esparza saying that this was to "avoid any doubts over the transparency and legitimacy of the process" and that the bidding would be re-run at a later date. During the course of November and December investigations by journalists indicated that there were potential conflict-of-interest concerns because Grupo Higa, a beneficiary of government contracts, had built and sold houses to Angélica Rivera, the President's wife, and to Luis Videgaray, the finance minister. All have denied any impropriety.

The problem, however, is how to get the procurement process back on track. Officials have had to carry out a damage limitation exercise with China. *Xinhua*, China's official news agency, initially said the decision was a "surprise" that had "exceptionally impacted" CRCC, which would consider legal action. President Enrique Peña Nieto, who attended the Asia Pacific Economic Cooperation (APEC) forum in Beijing in November, appears to have reassured his hosts, and by early December it was being reported that CRCC would re-submit a bid. Although Mexican officials are on record as recognising the need to compensate CRCC for the costs it incurred in the cancelled bid, they have denied a report in the *South China Morning Post* that an initial payment of CNY100m (US$16m) had already been made. That claim was made by Professor Wang Menshu, a scientific adviser to the Beijing government on high speed rail projects, who also said that CRCC would bid again and hoped to win because, "our high-speed railway with its high technology, safety standards and low costs, will compare favourably with any other company in the world".

Mexican officials said the procurement round would be re-launched in December, with the same terms, and with contractors having six months to prepare their bids. One of the outstanding questions is whether anyone else apart from the Chinese will compete the second time round. Bombardier's executive president, Pierre Beaudoin, sounded cautious. "They are offering six months, which is not very much time. Usually projects of this type need a year to prepare, because it is a very big technical challenge and we need to do things correctly" he told *Reuters* in November, adding, "I'll review it with my team and we'll take a decision". Another question is whether the CRCC-led consortium will again include the Grupo Higa unit or not. Either way, the handling of the re-run bidding process will be subject to intense scrutiny in Mexico.

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NICARAGUA

The 'Grand Canal' enigma

Dogged by unanswered questions about its feasibility, funding, and environmental impact, many have doubted whether the proposed 'Grand Canal' project in Nicaragua – the construction of a second inter-oceanic waterway across the Central American isthmus – will ever get off the ground. Yet in December the Nicaraguan government insisted that all was going to plan, and that building work would begin that same month. A national protest demonstration against the Canal was held on 10 December.

The basic outlines of the project – and many of the unknowns – remain unchanged since it was first announced. What is proposed is the excavation of a 278kms waterway linking the Atlantic and Pacific oceans and running through Lake Nicaragua (one of the world's largest freshwater lakes). Its proponents say that the Nicaraguan 'Grand Canal' will be longer, deeper and wider than the existing100-year old Panama Canal. It will therefore accommodate the new generation of mega-container ships (with capacity to carry 18,000 twenty-foot equivalent units or TEUs), which are too large to pass through the Panama Canal, even after the US$5bn project to widen it is completed in 2016. Without holding a competitive tender, the Nicaraguan government led by President Daniel Ortega granted an initial 50-year build-operate concession (which can be extended to 100 years) to HKND, a little-known Hong Kong-based company led by a Chinese businessman, Wang Jin. The cost of the project - which also includes two ports, a free trade zone, an international airport, new roads, cement and steel plants, and a power station - is loosely estimated at US$50bn, more than four times Nicaragua's annual GDP (US$11.3bn in 2013, on World Bank data). Construction work, employing up to 50,000 workers, is expected to take at least five years.

Government officials are keen to stress all is going well. Paul Oquist, an adviser to the president and chair of the Grand Canal Commission has described the launch of the project as "a big Christmas present" for the

Nicaraguan people. He says the Canal will double Nicaraguan GDP and eradicate poverty. "There is nothing else in Nicaragua that could achieve that within our lifetimes – and it is within grasp. It has never been closer than it is now." Oquist is also keen to stress that proper feasibility and environmental studies have been commissioned, claiming that some US$900m is being spent on them, including some commissioned from the London-based consultancy Environmental Resource Management (ERM) and the US-based McKinsey consultancy. Bill Wild, chief project adviser for HKND, says, "In the first year we'll build the infrastructure to build the project – the roads and other means of access. The biggest challenge is not the technical engineering. This has all been done before. It is the logistics."

But none of this reassures the critics. Concerns range from the source of the funding and the apparent lack of a public business plan through to questions about the engineering and the environmental impacts. On the funding, there is still little clarity over how Wang will raise the money: many suspect he is covertly backed by the Chinese government, and that Beijing sees in the project an opportunity to gain a valuable strategic asset and project its global trade interests. Following a visit to Managua by Russia's President Vladimir Putin last July, there has also been speculation about potential Russian financial involvement. But both Wang and Nicaraguan officials have denied any financial participation by either the Chinese or Russian governments.

"Some business observers lament the lack of competitive bidding for the overall project and its various sub-components, which they say limits transparency and increases the risk of corruption."

Some business observers lament the lack of competitive bidding for the overall project and its various sub-components, which they say limits transparency and increases the risk of corruption. China's Xuzhou Construction Machinery Group, (XCMG), for example, appears to have the exclusive rights to supply all equipment to the project. According to the Nicaraguan current affairs magazine *Confidencial*, a 'web' of fifteen companies registered in Hong Kong, the Netherlands, the Cayman Islands and Nicaragua supports HKND. Writing for *CNN*, journalist Frida Ghitis has noted that the Grand Canal is "almost an Ortega family project" kicked off when the president's son Laureano visited China in 2012. And writing in *Latin Trade*, an analyst with a US military background, Evan Ellis, suggests that the project's backers may be focusing on developing a new Pacific Port at Brito, a lucrative project on its own, even if the wider Canal never gets built.

Among the engineering critics is Jaime Incer Barquero, a former environment minister in Nicaragua, who says the project "will lead to the contamination and death of aquatic life in Lake Nicaragua, which is Latin America's biggest tropical lake. It will also mean that Lake Nicaragua may lose forever its capacity to provide potable water for all of Nicaragua". Critical experts say repeated dredging of the Lake will be necessary to allow super tankers through, which would release millions of tonnes of mud and sediments, depleting oxygen and killing fish. Pedro Alvarez, a civil engineering specialist at Rice University in Texas, says his greatest fear is that the project could be abandoned before completion, leaving a legacy of severe environmental damage to the Lake. Ten Nicaraguan environmental lobbies (known as the Grupo Cocibolca) and the Nicaraguan Academy of Sciences have expressed opposition to the project. They are particularly concerned that work is beginning even through environmental studies by ERM and others have not been completed.

On 10 December several thousand demonstrators marched in the capital Managua to protest against the project. Among them were many farmers who have smallholdings on the shores of the Lake and along the proposed canal route, and who fear expropriation without fair compensation. The demonstrators chanted "Nicaragua for the Nicaraguans and not for the Chinese". But Oquist dismisses these concerns. "This entire issue has a short shelf life" he says. "It will expire when compensation kicks in. The criterion is that at the end of the day, everyone's going to be better off than they were before… the ones who complain will be the ones that miss out".

BRAZIL

Kicking off the new austerity

After winning a second four-year presidential term (2015-2019) in a run-off ballot in October, in late November President Dilma Rousseff appointed her new economic team. It is led by Joaquim Levy, who will take over at the finance ministry, along with Nelson Barbosa, who becomes minister for budget and planning, and Alexandre Tombini, who will continue for another term as president of the central bank (BCB). It is a line-up that has pleased the markets and has been taken as a sign that the president, struggling with a stagnant economy, has decided to follow more orthodox policies including a round of fiscal austerity. The big question is whether it will work.

Not for the first time in recent Latin American history, what a candidate says on the presidential campaign trail and does in office often turn out to be different things. Dilma Rousseff focused her campaign around promises to continue with the left-wing government's social and redistributive programmes. She promised not to scale back any of the social welfare schemes introduced by the ruling Partido dos Trabalhadores (PT) since 2003. Now however, the talk is of budget cutbacks and difficult choices. Flavia Cattan-Naslausky, of brokers RBS Americas, says the dilemma is familiar. "Once the campaign was over, Rousseff faced reality. She didn't need the markets to win the election, she needed voters. Now she realises that she needs the markets".

"Not for the first time in recent Latin American history, what a candidate says on the presidential campaign trail and does in office often turn out to be different things..."

The government's latest moves seem designed precisely to win back the support of the markets. Levy is a University of Chicago-trained former treasury official (2003-2006), who served under Rousseff's predecessor Lula da Silva (2003-2010) and more recently has been head of asset management at Bradesco. He has a strong reputation for fiscal orthodoxy. His budget-cutting abilities have earned him the nickname 'Edward Scissorhands'. Luciano Rostagno, a strategist at Banco Mizuho do Brasil, says, "if you look at Levy's history, you can expect a radical move in the conduct of fiscal policy. The first impression is that Dilma's government will in fact undergo a significant change, which is quite welcome, given that the country is flirting with the risk of losing its investment-grade status". Standard & Poor's (S&P) downgraded Brazil to its lowest investment-grade rating in March 2014.

In his first public statements, Levy has stressed the need to boost confidence. There was a need to break with what one analyst, Luis Stuhlberger of Hedging-Griffo, described as "a sex and drugs and rock and roll agenda of abundant government spending". Levy quickly announced a challenging target: a 2015 primary budget surplus of 1.2% of GDP, rising to above 2% in 2016 and 2017. As he put it, "meeting these goals is fundamental to build confidence" and to "resume growth and consolidate the social advances of the last twenty years". Rousseff's outgoing administration failed to meet its 2014 budget target – a primary surplus of 1.9% - and in December was still squirming around congressional legislation so as to (once again) allow for some year-end 'creative accounting' around the target.

As part of the attempt to regain credibility, Levy has brought in more realistic forecasts. The 2015 budget is now built around forecast annual GDP growth of 0.8%, down from 3% previously (the lower the GDP growth assumptions, the tougher the fiscal targets become). An official who wished to remain anonymous told the *Reuters* news agency, "these are not magic numbers we're pulling out of a hat. They are the market's forecasts, so that we can show everyone and they can see that we are working with credible targets".

The government has also acknowledged that GDP growth in 2014 was almost negligible: 0.2%. Many analysts hope that under Levy, government finances will become more transparent, with the administration dropping its use of 'creative accounting' techniques. Levy also wants to reduce the government's gross debt as a proportion of GDP, which stood at 53.4% at the end of 2010 and is expected to continue rising to a peak of 64.1% in 2015, before beginning to fall in 2016.

Barbosa is a former deputy finance minister (2011-2013) who is also well regarded by the markets. While some say he has a less orthodox and more centre-left 'developmentalist' approach to economic policy, his first statements were very much 'on message'. He said he too would be working on the budget to ensure it supported a policy of "rigorous control of inflation, fiscal stability, and the generation of employment". His first priority, he said, was to bring the 2015 budget into line with the "new macroeconomic scenario".

Tombini, meanwhile, has reiterated the BCB's commitment to controlling inflation. He has indicated that the current situation, where the actual inflation has rate has been running just above the inflation band ceiling (6.5%) will not be allowed to continue, and that his key objective is to get it back down to the mid point target of 4.5%. Inflation was 6.56% in the 12 months to November. "The objective of monetary policy will be to avoid adjustments in domestic and international prices, and in tariffs for public sector utilities, feeding off each other to produce a persistent increase in the inflation rate" he stressed. As if to back this up, at the beginning of December the BCB's monetary policy committee (Copom) raised the Selic reference interest rate by 50bps to 11.75%, its highest level since August 2011.

"The new team faces a tough set of challenges. Will it succeed in turning round the Brazilian economy? Opinions are mixed. Some are still wary..."

In December, Rousseff announced another appointment – Armando Monteiro as the new minister for development, trade and industry. Monteiro is close to Brazilian manufacturers, having been head (in 2002-2010) of the Confederação Nacional da Industria (CNI), one of the main private sector lobbies in the country. Interestingly, he is a member of the Partido Trabalhista Brasileiro (PTB), which backed Aécio Neves, Dilma's defeated rival in the closely-run second round ballot in October. So his appointment too can be read as an attempt to reach out to the private sector, most of which had supported the more centre-right policies advocated by Neves.

The new team faces a tough set of challenges. Will it succeed in turning round the Brazilian economy? Opinions are mixed. Some are still wary. Lisa Schineller of S&P notes the government has just loaned BRL30bn (USD11.45bn) to BNDES, the national development bank. Some see this as a continuation of bad 'creative accounting' practices. "The question is: will these practices diminish going forward or will they remain?" she asks. But many analysts say the new team has a good chance of getting a grip on Brazil's fiscal accounts, and that fiscal stability remains an absolutely necessary condition for any Brazilian economic recovery. However, they also point out that on its own, it is not a sufficient condition. Other things also have to be in place, such as supply-side structural reforms, productivity gains, big infrastructure investments to improve Brazil's poor logistics and, some would say, a more supportive global economic environment. Significantly, to date no-one in the government has outlined a vision for a new wave of structural reforms. And, as we argue elsewhere in this report, the escalating Petrobras scandal could have a significant negative impact on the government's infrastructure investment programme.

There is some debate over how much autonomy the economic team will be given by the president who, as an economist herself, is notorious for seeking to micro-manage her ministers. There are fears too that the more left-wing members of the ruling PT, angered over an apparent turn to the Right, will

make Levy's job more difficult. Antonio Correa Lacerda, an economist at PUC-SP (the Catholic University in São Paulo) suggests that the president has made an unwilling concession to the markets "handing over her rings so as to be able to keep her fingers" as he put it. But Marcos Weigt of SH Global Capital is pragmatic. "We'll have two years of austerity followed by two years of spending. But I do believe Levy will have some autonomy – if not, he wouldn't have accepted the job".

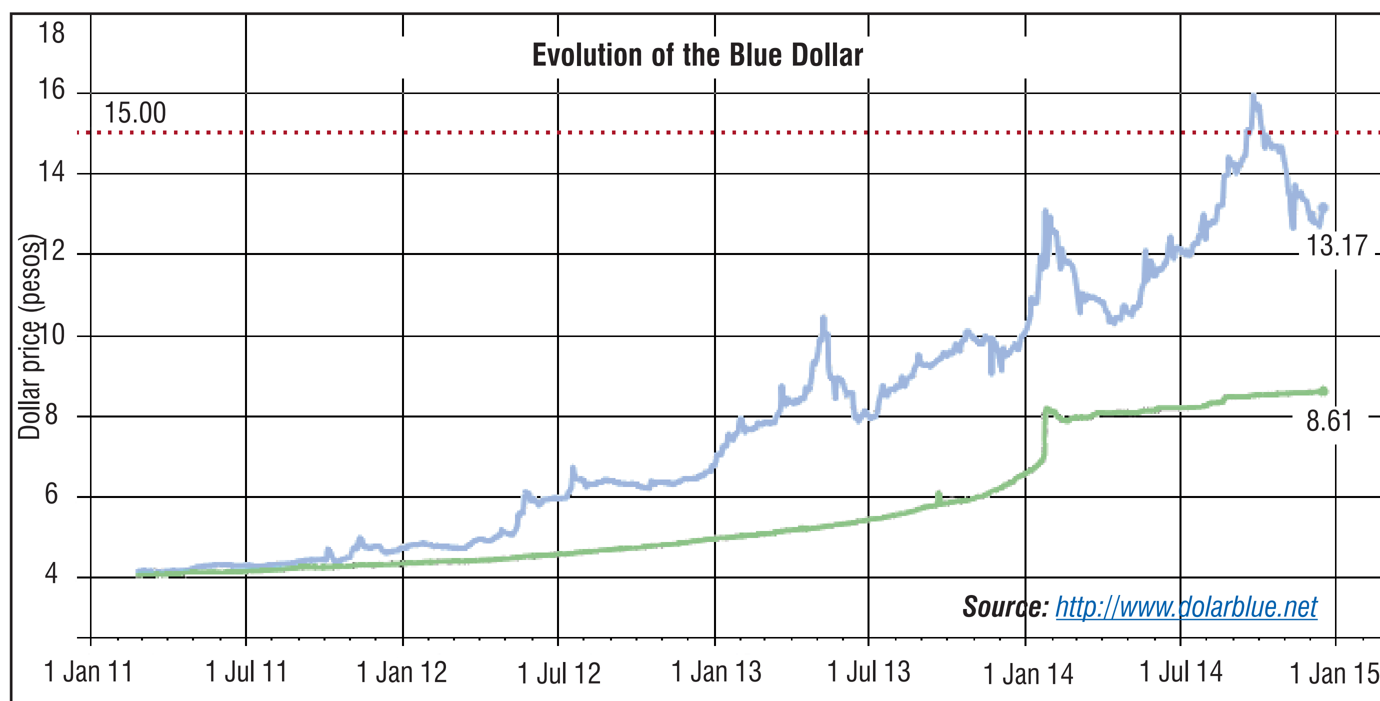
ARGENTINA

Towards a virtuous circle?

With its options restricted by the low (if fairly stable) level of foreign reserves, Argentina's government has been proactive in terms of its debt management. As a consequence, the likelihood that the government is able to 'muddle through' to the elections that are due to take place next year without a major crisis is significantly improved. With further issues of US dollar-linked bonds and careful messaging from Banco Central de la República Argentina (BCRA, the central bank), the country might be able to escape the long-standing and vicious cycle of monetised budget deficits, inflation and devaluation in 2015.

As of mid-December 2014, the Argentina's official exchange rate stood at ARS8.60/US$. The unofficial Dólar Blue rate available from moneychangers in central Buenos Aires was trading at ARS12.85/US$. The 50% premium reflects the costs (and risks) of carrying large amounts of cash and the value that Argentines place on ready access to US dollars.

Crucially, though, the Dólar Blue rate has fallen (meaning that the peso has appreciated) to the level of January 2014. At that time, the Dólar Blue rate had spiked upwards following the devaluation of the official rate, amid widespread expectation of a major currency crisis.



Another metric that has been broadly unchanged over the past year is Argentina's level of foreign reserves. As of 5 December 2014, they stood at US$28.9bn, or 4.8% less than on the same day in 2013. Over the longer-term, reserves have been falling. They slipped from US$42.9bn to US$30.6bn over the course of 2013.

Over the course of this year, the authorities therefore appear to have managed to stabilise the reserves. They have also stabilised the Dólar Blue rate, with a significant reduction in the premium between the Dólar Blue and the official rate in spite of a consistently difficult financial, economic and political environment. These challenges have included, weakness in the domestic economy, the recession in Brazil, a key trading partner; periodic volatility in global financial markets, a change of central bank governor; and lack of progress with the 'holdout' bondholders (creditors of defaulted bonds).

The continuing dispute with the 'holdouts' has meant that the government has not had any access to global capital markets. According to the IMF, the government should run a primary (i.e. before interest payments) budget deficit of around 1.2% of GDP in 2014. The overall deficit should be 4.8% of GDP. As in previous years, the spending has been monetised, with the result that Argentina continues to suffer structurally high inflation, which, unofficially, is estimated at about 40% over the year to October. This figure has been boosted by the devaluation of the peso. In the recent past, prices have been increasing by around 2% each month.

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In order to ensure that exporters do not become uncompetitive as a result of the real appreciation of the peso, the government has normally run a sliding peg regime. The International Monetary Fund (IMF) is looking for a current account deficit of 0.8% of GDP this year.

The chart highlights key monetary metrics as of 5 December. The growth in loans and deposits confirms that the underlying rate of inflation is 25%-30% per annum. Past crises and ongoing challenges mean that the overall banking system is small relative to the overall economy. At around US$139bn, the M3 money supply (the broadest monetary measure, which includes US dollar deposits) is equivalent to about one quarter of GDP. Only around two thirds of peso deposits (and a much smaller percentage of US dollar deposits) are recycled as loans to non-bank clients.

In short, issuance of bonds and proactive debt management by the government can have a greater impact on the monetary aggregates (and actual and expected inflation) in Argentina than in a similarly sized economy run in an orthodox fashion.

There have been three key developments in recent weeks. One is the announcement of a debt swap involving US$6.7bn worth of 7.0% Boden bonds that are due to mature in October 2015. Holders will have the opportunity to exchange these for 8.75% Bonar bonds that mature in October 2024. The Bonar bonds were originally issued by the government as a part of the February deal 2014 to compensate Spanish energy group Repsol for the expropriation of 51% of its Argentine subsidiary Yacimentos Petrolíferos Fiscales (YPF), and have since been popular with investors. In spite of the more attractive coupon, take up of the offer was low. However, few investors took advantage of the opportunity to cash in their Bodens early – which suggests that most expect that the government will be able to make payment next year. The second development is a currency swap between BCRA and the People's Bank of China.

The other key development in recent weeks has been the successful sale of US dollar-linked bonds in two tranches. In late October, the government placed US$983m in 1.75% notes due to mature in 2016. In mid-November, the government raised an additional US$654m in 2.40% bonds due to mature in 2018.

The US dollar-linked bonds pay the holders in pesos according to the prevailing exchange rate. If current trends continue, and the official exchange rate is allowed to slide by around 20% per annum, then the amount payable to the holders in pesos will rise at that rate. The bonds provide protection against the fall of the value of the peso in foreign exchange markets and, to a significant degree, inflation.

Since being appointed BCRA governor in October, Alejandro Vanoli has stressed several times that there will not be a devaluation of the peso in 2015. The success of the sale of the US dollar-linked bonds and the recent fall in the Dólar Blue rate (i.e. appreciation of the peso) means that he is widely believed. Indeed, a devaluation of the peso would result in a corresponding increase in the burden of US dollar-linked debt.

The IMF anticipates that the stock of government debt will rise from about 41% of GDP in 2013 to 49% this year and 54% in 2015. By most standards, the absolute level of government borrowing is not particularly high.

This means that the government retains significant ability to place US dollar-linked bonds with domestic investors. In the event that it were to sell, say, US$1.5bn in these bonds each quarter, the government would roughly halve the growth rate in M1. This should have a material impact on inflation expectations, particularly if the authorities continue to reiterate that there will be no devaluation.

Overall, it therefore seems reasonable to expect that the government will be able to 'muddle through' to the elections that are due late next year without a major financial crisis. It is also possible that government is able to end the vicious economic cycle that has long been a feature of Argentina, with the result that the country is seen as moving towards lower inflation, a stronger currency and more orthodox public finances. This positive outcome would require some good luck – such as improvement in Brazil's economy, a better-than-expected soya harvest and, perhaps, progress in negotiations with the 'holdout' creditors.

Argentina: Key Monetary Metrics - 5 December 2014			
US$mn		**Pesos mn**	**Year-on-yearChange %**
63,367	Peso loans to the private sector	542,739	20.3%
95,556	Peso deposits	818,435	22.3%
37,677	*of which private sector sight deposits*	*322,701*	*30.4%*
32,937	*of which private sector term deposits*	*282,102*	*27.6%*
22,555	*of which public sector deposits*	*193,182*	*28.8%*
3,306	US$ loans to the private sector	28,316	-12.9%
8,578	US$ deposits	73,471	6.0%
62,805	M1 (Peso cash in circulation and current accounts)	537,926	28.1%
84,018	M2 (M1 + Peso savings accounts)	719,610	28.0%
129,809	M3 (M2 + Peso time deposits)	1,111,814	22.3%
138,669	M3* (M3 + US$ deposits)	1,187,697	23.6%
28,931	Foreign Reserves	247,427	-4.8%
Source: *BCRA*			
536,155	Memo: GDP (2014)	4,413,310	
Source: *MECON/IMF*			

Urgent action to counter the oil price shock

On 29 November, two days after the Organization of the Petroleum Exporting Countries (Opec) failed to cut production quotas in response to the global oil price slump, Ecuador's President Rafael Correa sent down a 26-page tax reform document to the national assembly marked 'urgent'. The same day, Venezuela's President Nicolás Maduro announced budget cuts starting at 20%.

In his subsequent Saturday weekly TV show, President Correa said the package was in support of "national development, poverty eradication and the equitable distribution of resources", but the timing rather suggests an emergency effort to shore up budget finances. Finance Minister Fausto Herrero admitted in an official statement the following day that the proposals in the 'Ley Orgánica de Incentivos a la Producción y Prevención del Fraude Fiscal' (the organic law of production incentives and the prevention of tax fraud) were among anti-cyclical measures being planned in response to the fall in international oil prices.

January 2015 futures for West Texas Intermediate (WTI), the reference barrel for the Venezuelan oil basket and Ecuador's Oriente and Napo crudes (which trade at a discount of US$3-US$5 to WTI), were trading at a new low of US$54.85 per barrel (/b) on 16 December (while Brent crude fell to US$60/b for the first time since July 2009). Ecuador's approved 2015 budget is based on an oil price assumption of US$79.7/b; Venezuela's on a price of US$60/b. Market analysts now calculate that the Opec leadership (i.e. Saudi Arabia) is looking for oil to settle at US$60/b, which might slow down the US shale gas boom and restore some equilibrium to global markets. Saudi Arabia can handle lower oil prices for a period – the Opec minions less so.

"One of every three fiscal dollars in Ecuador comes from oil export revenues. Venezuela relies on oil revenues for about 40% of its fiscal income and for 96 of every 100 export dollars coming into the country."

One of every three fiscal dollars in Ecuador comes from oil export revenues. Venezuela relies on oil revenues for about 40% of its fiscal income and for 96 of every 100 export dollars coming into the country. Ecuador's left-wing government led by the US-trained economist Correa is pulling out all the stops to shore up budget finances for 2015 in the face of lower than anticipated oil revenue. Rolling anti-cyclical measures can be expected in coming months, but the budget position for 2015 is under significant pressure.

Details

Among the changes on the corporate side, the new reform proposes increasing the income-tax exemption for new productive investments in the basic industries sector to 10 years, as a way of attracting more private investment into areas such as petrochemicals, steel and metallurgy. Companies would be able to offset significantly more of their capital investment in equipment and machinery, as well as other productive investments, against their income-tax bills for a period of five years. Likewise, small firms and micro-companies investing in staff training or new export markets would be eligible for income-tax deductions.

Meanwhile, investments of over US$100m in the state-controlled metals mining sector would be guaranteed tax stability for five years, at an income-tax rate of 22%, with a rate of 25% for companies investing in other industrial sectors.

Mr Correa's threatened "fat tax" on sugary drinks and junk food did not materialise. Instead, the bill proposes that firms selling foods deemed 'harmful' (such as fast-food chains) will no longer be able to claim their advertising and marketing spend as tax-deductible. Other amendments affecting the corporate sector would impose higher taxes on financial-sector investments abroad, while income-tax loopholes that exempt returns on certain financial investments would be eliminated. In total, nine laws would be amended.

Mr Herrero noted that the new package sought to deliver fiscal stability and facilitate private investment, particularly in the mining sector. Tax policy consistency is not something yet associated with the Correa administration, which, in an effort to lift the country's historically low tax take, has made rolling changes to the tax system since taking office in 2007, with positive results. The corporate sector has adjusted to these (arguably needed) changes, but private investors remain cautious, as the government remains prone to the selective use of tax policy to suit its state-led economic-development agenda. As a result, foreign direct investment remains low (less than US$600m in 2013).

Budget adjustments likely

Mr Herrero indicated that, depending on new oil price projections, the government could make further changes to the 2015 budget, noting that the executive has leeway to amend the execution of 15% of funds without congressional approval. Mr Correa has stressed that social and welfare spending, as well as key capital investments in infrastructure, will be ringfenced. However, with revenue on the slide, the government is facing some tricky decisions. The primary budget deficit is already pencilled in at 5% of GDP, with total financing needs (inclusive of debt payments) approaching 10% of GDP.

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The government has been at pains to stress that the increase in the fiscal deficit will be temporary, lasting only for the 2015-2016 period. It insists that new hydro plants due to come on-stream in 2016 will generate savings of US$1.2bn a year, while the government is also hoping to cut generous gas subsidies that year.

Major new oil reserves from the 1bn-barrel Ishpingo-Tambococha-Tiputini (ITT) field in the Yasuní national park are also due to come on-stream in 2016. With more hydropower available for domestic energy, these can go for export (and to service Chinese loans). Mr Herrera said that the ITT field would add 100,000 barrels/day to exports in its initial phase. However, with prices falling and global demand stagnant, increased production may not generate the revenue windfall that the government hopes for ahead of the 2017 general elections.

Cap in hand to China

Finally, Herrero stressed that despite the unfavourable global outlook, Ecuador would continue meeting its internal and external obligations, saying that the government would also seek additional financing for 2015. To this end, President Correa is due to visit China in January to concrete credits already provisionally agreed with Chinese state lenders. Potentially, Ecuador could return to international capital markets in 2015, although this could be expensive amid the prospect of higher US interest rates.

Queuing up in Beijing

President Correa will have to get in line behind his Venezuelan friends. Venezuela's finance and education ministers, Rodolfo Marco Torres and Héctor Rodríguez, went to Beijing in early December, ostensibly to "strengthen bilateral accords relating to social issues".

With Chinese generosity reportedly not what it once was (although in October Beijing agreed to ease the payment terms of pre-existing cash-for-oil agreements), Torres was also bound for Russia and Iran afterwards, again cap-in-hand. Admitting that the 2015 budget would have to be slashed by at least 20% because of the oil price shock, but trying to take an optimistic tack, President Maduro said on 29 November that he saw it as "an opportunity to end superfluous, luxury, unnecessary spending". "The purchase of who knows how many cars and trucks…I ask: Is this really necessary?" he questioned, but emphasised that the left-wing government's flagship social programmes would be ringfenced from the cuts. Maduro and his new finance minister had previously boasted that Venezuela could "live with" oil at US$40/b.

As we went to press, Maduro was gearing up to announce new changes to the country's secondary fixed exchange rate system (Sicad), presumably opening the door to a new devaluation. Maduro has pledged "a blow to the parallel [black market] dollar, which does so much damage". The parallel dollar was trading at a new high of BF183.7/US$1 on 15 December, 30 times the main official rate of BF6.3/US$ and nearly four times the lower Sicad rate of BF49/US$.

And what of Petrocaribe?

Ahead of his emergency tour of Opec (and non-Opec) partners in search of support for Venezuela's (unanswered) call for Opec production cuts, Foreign Minister Rafael Ramírez insisted that Petrocaribe would not be affected by the oil price plunge. Few observers believe that. In the first place, the terms change once oil prices fall below US$100/b, with recipients obliged to pay slightly more in cash upfront, albeit the overall terms remain very generous.

Secondly, reports circulating in various US media outlets have suggested that Venezuela and two of the largest Petrocaribe member states, the Dominican Republic and Jamaica, have been in talks with the US investment bank, Goldman Sachs, on a potential US$7bn debt sale that would give Venezuela urgently needed cash now, with Goldman Sachs effectively pocketing Venezuela's loss. According to Dow Jones, "Under the proposed structure, Goldman would acquire the Dominican debt from Venezuela at a steep discount…The Dominican Republic would in turn sell bonds, using the proceeds to retire the debt now held by Goldman".

On some reports, Venezuela may be prepared to accept a discount of 60% on these multi-billion dollar debts. So, for example, Dominican Republic reportedly owes Venezuela US$4bn. Under the proposed deal Venezuela would accept US$1.6bn from Goldmans to take the debt off its hands. Goldman would then eventually collect the full US$4.0bn from the Dominican Republic, making a profit of US$2.4bn for taking on the debt. Goldman Sachs, it is worth noting, earlier this year did a gold swap deal with Ecuador (another proposed with Venezuela last year reportedly failed to materialise).

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COLOMBIA

Resilient in face of the falling oil price

Colombia's economy should continue to achieve steady growth without inflation in 2015 - in spite of the sharp fall in the oil price through 4Q14.

According to the International Monetary Fund (IMF), the oil and mining sector accounted for over half of Colombia's export revenues in 2013. Of all the challenges that policy-makers could face, slippage in the price of oil is the one that is the most problematic. A fall in the price of oil of even US$10/barrel can have a significant impact on exports and government revenues (see box entitled, 'What could go wrong?').

However, much of the shock has already been borne by the exchange rate. For almost all of the period from the beginning of 2013 to early September 2014, the Colombian peso traded between COP1,750/US$ and COP1,930/US$. Since then, the peso has declined precipitously, with the result that the exchange rate in mid-December was about COP2,400/US$ or so. The movement in the currency has more or less matched the movement in the price of oil.

Other factors are also underpinning financial and economic stability and should continue to do so. One factor is the two-year Flexible Credit Line (FCL) for the Colombian government approved by the IMF in mid-June. At prevailing exchange rates, the FCL was worth nearly US$6bn. This is in the context of a US$400bn economy and government spending of around US$116bn in 2014.

Another factor is the enshrinement of the concept of fiscal stability in the constitution and the legal system. As the box entitled 'Fiscal discipline - a central tenet of the policy mix' - explains, the government has announced a number of measures to fund the COP12.5trn gap between revenue and spending in the latest budget. As **Chart 1** shows, the IMF is looking for the government to run a primary surplus over the coming five years. The deficit should consistently be less than 1% of GDP. At a time when the economy appears likely to grow at an annual rate of about 4%-5%, with inflation of 2%-3%, the ratio of government debt to GDP should fall over time. In any case, at about 34% the ratio is not high. Meanwhile, at US$16bn or so, the current account deficit is of a scale that it can fairly easily be funded by inwards foreign direct investment (FDI).

Chart 1: Colombia's economy - as the IMF sees it*

	2012	2013	2014	2015	2016	2017	2018	2019
GDP, constant prices (% change)	4.05	4.68	4.81	4.53	4.52	4.53	4.50	4.50
GDP, current prices (US$bn)	369.79	378.42	400.12	427.14	453.63	482.18	512.73	546.9
GDP per capita, current prices (US$)	7,938	8,031	8,394	8,859	9,300	9,773	10,273	10,832
Current account balance (US$bn)	-11.59	-12.41	-15.41	-16.15	-16.19	-16.79	-17.48	-18.68
Current account balance (% GDP)	-3.13	-3.28	-3.85	-3.78	-3.57	-3.48	-3.41	-3.42
Total investment (% GDP)	23.96	24.64	24.98	25.03	25.25	25.62	25.82	26.05
Gross national savings (% GDP)	20.82	21.36	21.13	21.25	21.68	22.14	22.41	22.64
Inflation, end of period consumer prices (% change)	2.44	1.93	3.35	3.04	3.04	3.04	3.04	3.04
Volume of imports of goods and services (% change)	8.95	4.55	6.54	6.34	4.91	4.96	4.19	4.48
Volume of exports of goods and services (% change)	4.11	3.46	3.24	7.18	6.29	6.77	5.51	5.01
Unemployment rate (%)	10.38	9.65	9.30	9.00	9.00	9.00	9.00	9.00
Population mn.	46.58	47.12	47.67	48.22	48.78	49.34	49.91	50.49
Gen. Gov't. revenue (% GDP)	28.34	28.26	28.12	28.20	28.26	28.47	28.37	28.27
Gen. Gov't. total expenditure (% GDP)	28.26	29.21	29.58	29.54	29.20	29.41	29.25	29.20
Gen. Gov't. net lending/borrowing(% GDP)	0.08	-0.95	-1.45	-1.34	-0.94	-0.94	-0.88	-0.93
Gen. Gov't. primary net lending/borrowing(% GDP)	1.56	1.17	0.85	0.91	1.31	1.26	1.26	1.15
Gen. Gov't. net debt (% GDP)	22.82	24.92	23.93	23.75	22.93	22.06	21.23	20.30
Gen. Gov't. gross debt (% GDP)	32.02	35.75	34.00	33.14	31.65	30.16	28.76	27.27

Source: *IMF*

*Forecasts begin in 2014

The resilience of the Colombian economy is reflected in the minutes of the latest (28 November) meeting of the central bank (Banrep's) board of directors. The board kept the key policy rate unchanged at 4.5%. It noted that the fall in the peso on foreign exchange markets had not had a significant impact on actual inflation (3.29% in the year to October) or expected inflation (close to BanRep's 2%-4% target over two, three and five years).

BanRep expects that GDP growth of 4.5%-5.5% for 2014 as a whole, with 5.0% the most likely outcome. BanRep is, therefore, slightly more optimistic than the IMF. At its meeting, the Board noted that growth would be underpinned by domestic demand. "This is suggested by the behaviour of retail sales, consumption credit, consumer confidence index, and that of the labour market, which indicate that consumption would maintain a strong momentum. The increase in the external purchases of machinery and transportation equipment, and the trend registered by civil works, anticipate a good performance of investment, although at lower rates than those observed for the first half of the year. Growth in consumption has been underpinned by an expansion in credit that is faster than the increase in nominal GDP. The banking sector is well capitalised, well regulated and has been expanding internationally (mainly into Central America)."

As the box entitled 'Colombians are underbanked and unequal' shows, the banking sector has a lot more work to do to reach poorer households, who are still largely living and working outside the formal economy. Financial inclusion can and should be a part of a reduction in inequality, in a country where one fifth of the population receives just 3% of the national income.

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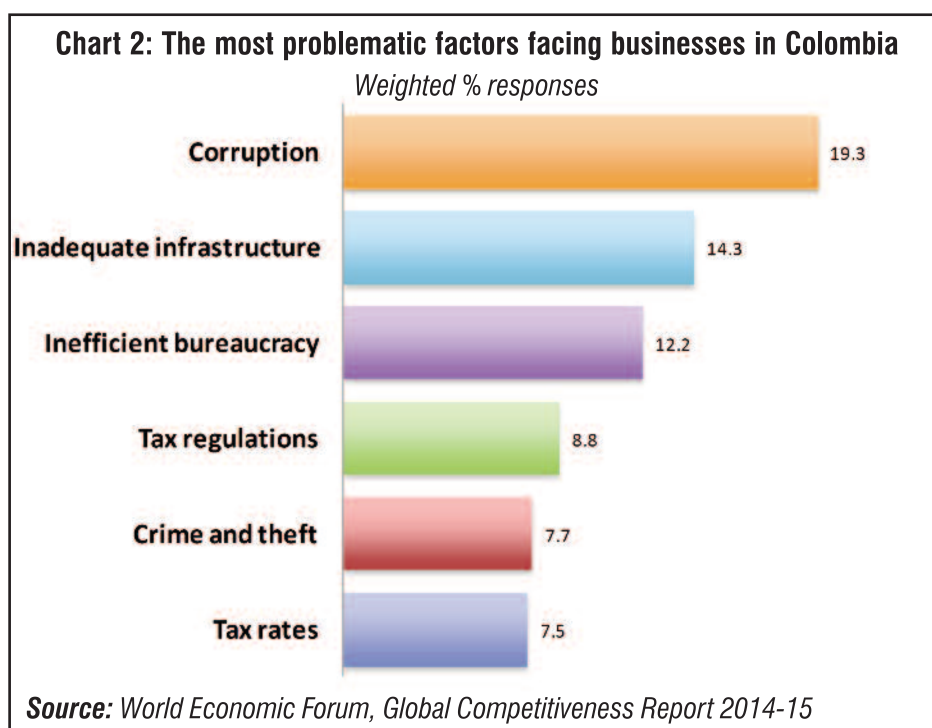
If reducing inequality is one challenge facing the government, perceptions of corruption are another. As **chart 2** shows, research undertaken for the World Economic Forum's latest (2014) Global Competitiveness Report found that corruption and inadequate infrastructure are the two most problematic factors for business in Colombia. The inefficiency of government bureaucracy was in third place. All three were seen as being significantly bigger challenges to doing business in the country than existing tax regulations, the level of tax rates and (perhaps surprisingly for a country that is home to a long-running insurgency) crime and theft.

Chart 2: The most problematic factors facing businesses in Colombia



Source: *World Economic Forum, Global Competitiveness Report 2014-15*

Overall, though, it is the strengths of Colombia's economy that stand out. The adjustment in the currency and other factors have ensured that the economy has remained quite resilient in face of a fall (of about 45% so far) in the price of oil, the most important export. Despite the challenge of a sustained decline in oil prices, this augurs reasonably well for 2015.

Colombians are underbanked and unequal

- At the end of 2012, the stock of credit amounted to 37% of GDP, which was below the regional average.
- In 2011, only 15% of people in the bottom 40% income share had an account with a formal financial institution: some 45% of people in the top 60% income share had such an account.
- In 2010, only 41% of small companies (with fewer than 20 employees) had a bank loan or a credit line. For large firms, the corresponding figure was 72%.
- The Gini index improved marginally, from 58.7% in 2000 to 55.9% in 2010, when 20% of the population accounted for 3% of national income.

Sources: *World Bank Global Financial Inclusion Database, IMF.*

The commitment to fiscal discipline

- Fiscal discipline is a central tenet of the government's policy mix. As a part of the Fiscal Transparency and Responsibility Law (#819 of 2003), the government is required to present the Medium Term Fiscal Framework (MTFF) to congress each year. In particular, the government has to confirm that it has met the fiscal targets set out in the previous year's MTFF: in the event of non-compliance, it is required to explain the deviation and what corrective measures will be applied.
- In June 2011, Colombia's congress approved a fiscal rule which requires the structural deficit (i.e. allowing for oil-related revenues and the output gap) to be below 2.3% of GDP from 2014, below 1.9% in 2018 and below 1.0% from 2022. If output growth is two percentage points (or more) lower than potential, the government can pursue an expansionary fiscal policy. Moreover, the rule can be suspended in the event that extraordinary events threaten Colombia's macro-economic stability.
- In 2011-12, the government outlined a strategy which tilts the composition of its debt in favour of local currency securities. In mid-September 2014, congress passed the National General Budget, in which spending exceeded revenue by COP12.5tn (roughly US$6.25bn at the prevailing exchange rate). As required by the law, the government then identified ways in which the deficit would be funded. It has announced five measures. One is the extension of the Gravamen a los Movimientos Financieros (GMF- the financial transactions tax) at the current rate of 0.4% for another four years. The GMF rate will decrease progressively by 0.1% each year from 2019 to 2021, after which it will remain at 0.1%. Second, the government has changed the rates of the wealth tax, and the bases on which they are levied. Third, the CREE - the corporate equality/ fairness tax, has been increased for companies with profits of over COP1bn. The overall CREE rate will be increased by 1 percentage point from 2016. Fourth, the Value Added Tax (VAT) rebate (of 2 percentage points) for payments made by credit card and mobile banking (which had been introduced to encourage people into the formal banking system will be ended. Finally, the government is looking to remove a lot of corporate tax breaks, which have resulted in an overly complicated system.

"The biggest challenge identified was a fall in the price of oil, which accounted for over half of total exports in 2013. Of all government revenues, about 16% of the total are oil-related: these oil-related revenues amount to around 4.5% of GDP."

What could go wrong?

In May 2014, the IMF looked at Colombia's vulnerability to external shocks in a Selected Issues Paper (Country Report No. 14/167). The biggest challenge identified was a fall in the price of oil, which accounted for over half of total exports in 2013. Of all government revenues, about 16% of the total are oil-related: these oil-related revenues amount to around 4.5% of GDP. The IMF also noted that lower oil prices could reduce FDI inflows, given the focus of foreign investors on the Colombian energy sector. The IMF assessed that a US$10 fall in the price of oil could reduce exports by US$3.3bn or so (0.9% of GDP) and fiscal revenue by around 0.4% of GDP.

The IMF also considered that a negative growth shock in major trading partners - the US, the European Union, China and a group of countries in Central and South America - would curtail exports. Such a shock - or any event that resulted in an increase in global risk aversion - could affect Colombia directly by reducing the

access of its banks to global capital market. Alternatively, the shock could affect the country indirectly, by bringing about a fall in the oil price.

Interestingly, the IMF assessed that the impact of a growth shock (i.e. growth in GDP in 2014 being 1% lower than projected) in Colombia's Latin American trade partners (other than Venezuela) would be greater than that of a similar shock in the US, the European Union or China. This was because of the growing trade links between Colombia and the other countries (particularly in manufacturing), the 'close association' of the various countries' economic cycles and the vulnerability of the other countries to similar shocks.

The IMF noted that Colombia is exposed to shocks in Central America for another reason. As at the end of 2013, the three largest banks (Bancolombia, Banco de Bogotá and Davivienda) had invested US$44.4bn through their subsidiaries in the region. The largest single apparent exposures were Panama (US$24.5bn), El Salvador (US$7.6bn), Costa Rica (US$5.4bn), Honduras (US$3.6bn), the British Virgin Islands (US$3.0bn) and Guatemala (US$2.2bn). In practice, the Panamanian subsidiaries operate across the region, which means that the effective exposure to Panama is lower, and to the other countries is higher, than these figures would indicate on their own. The banks' collective exposure to Central America amounted to 82.1% of their foreign investments and 22.0% of the total assets of Colombia's banking system. The IMF observed that 'exposure to shocks in Central America is mitigated by the strength of the balance sheets and soundness indicators of the subsidiaries in the region, which for the most part boast adequate capitalisation and robust profitability.'

The IMF was also fairly sanguine about the impact of rising interest rates in the US. The IMF assessed that any increase in the yield on US Treasury bonds would be matched by a similar rise in the yield of Colombian government bonds. However, such an increase would likely be accompanied by ongoing robust (or increasing) growth in the US economy, which would boost Colombian exports.

On 24 June, 2013, the IMF's Executive Board approved a two-year Flexible Credit Line (FCL) arrangement for the government of Colombia. The FCL was for the equivalent of SDR3.87bn (or US$5.96bn at that time). The IMF applauded the policy framework and the general resilience of Colombia's economy. The IMF also noted that the FCL arrangement would enable the government to maintain orderly financial market conditions, through providing a buffer against tail risks.

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REGIONAL MARKETS REVIEW

REGION

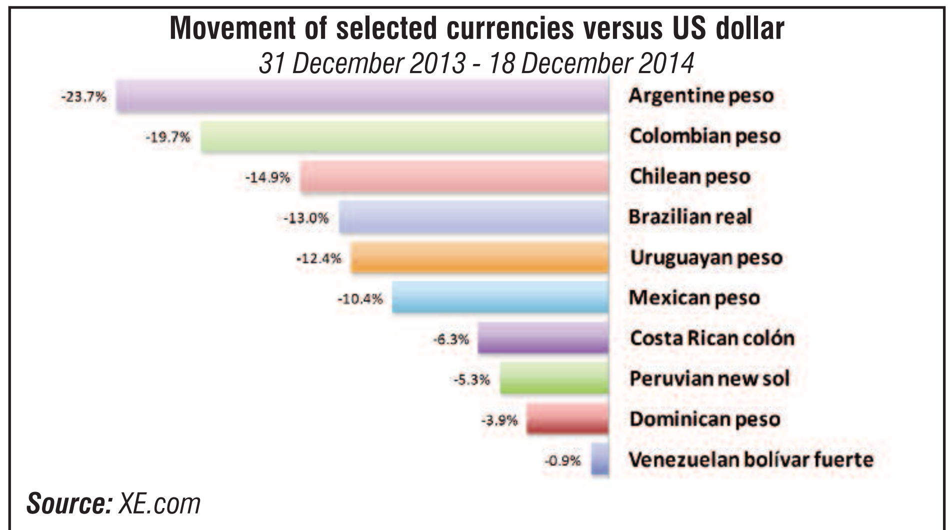
Adjusting to a new normal for energy, commodity prices

The sharp fall in energy and other commodity prices through Q4 14 has been by far the biggest driver of movements in regional currencies and financial asset prices this year. Overall, the year has been challenging but far from disastrous for investors and investment bankers.

At the beginning of the year, investors in Latin America's financial markets were aware of five challenges: the ending of the US Federal Reserve's asset purchase program in response to the strengthening of the US economy; the possibility of a 'hard landing' in China's economy; country-specific crises in Argentina and Venezuela; the anaemic growth (and marked deflationary pressures) in much of Europe and; the possibility of widespread investor aversion to emerging markets risk.

While the strength of the US economy and the change in Federal Reserve policy caused the US dollar to appreciate against most other currencies over the course of 2014, the biggest driver of returns this year has been the recent slump in the prices of oil (by around 45% since the middle of 2014) and some other commodities (such as iron ore). As **chart 1** shows, the slippage in commodity prices has had a significant impact on the currencies of

Colombia, Chile, Brazil, Uruguay and Mexico and a smaller effect on that of Peru. Argentina's peso has been the weakest of the major currencies. This is mainly due to the devaluation in January 2014 and the subsequent (and gradual) slide permitted in the official rate by the central bank.



Source: *XE.com*

The weakness in the major regional currencies has contributed to underperformance (in US dollar terms) of Latin America's stockmarkets, as **chart 2** shows. The exposure of the major Latin American economies and currencies to falling energy and commodity prices has been an important reason for the underperformance of emerging markets vs. developed markets (which have broadly tracked sideways in US dollar terms). In short, investors have basically taken the end of asset purchases in the US and potential problems in China's economy in their stride. Perceptions of particular emerging markets (such as Russia in the very recent past) have deteriorated. However, there has not been a general aversion to emerging markets risk.

Chart 2 highlights another important aspect. Except in Chile, where share prices have been slipping for much of the year (in US dollar terms), much of the fall in prices in the larger markets of the region has taken place since the end of September. In US dollar terms, markets in Colombia, Mexico and Brazil had very broadly moved sideways in the first three quarters of the year. Of the larger markets, Peru stands out as the regional outperformer.

According to data recently published by research firm Dealogic, 2014 has generally been a benign period for issuers of bonds in Latin America, and for the investment banks that have been working with them. In the first 11 months of 2014, bond issuances in Latin American debt capital markets (DCM) amounted to US$172.7bn, a new high, in 357 deals. In the corresponding period of 2013, DCM issues amounted to US$160.6bn, in 440 deals.

Dealogic's data highlights how political uncertainty in Brazil, and the perception of President Dilma Rousseff's administration as being anti-business, had a major impact on deal making in that country. In the first nine months of 2014, initial public offerings (IPOs) and other new raisings in equity capital markets (ECM) of Latin America as a whole amounted to US$18.6bn, or 34% less than in the previous corresponding period. The slippage was overwhelmingly due to the absence of IPOs in Brazil. In the first three quarters of the year, there were just two IPOs, which raised US$314m. In the first nine months of 2013, US$8.2bn was raised in nine IPOs.

Mainly because of the decline in ECM activity, total investment banking revenues booked across the region in the first three quarters of 2014 slipped to US$1.5bn. This was the lowest since 2009 (US$1.4bn) and was significantly below the total for the corresponding part of 2013 (US1.8bn).

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Looking forward, it seems that the global factors that pre-occupied investors in the region a year ago are less important today. The US Federal Reserve's asset purchase program is (basically) completed. Policymakers in Europe appear to have (just about) prevented a deflationary slump, while their counterparts in China seem to have stopped (or at least very much delayed) a 'hard landing.' Outside Latin America, it is quite easy to identify large emerging markets (e.g. Turkey, India and South Korea) that are natural beneficiaries of lower energy prices. As we explain elsewhere in this edition, it appears significantly more likely now that Argentina's government will manage to muddle through to the 2015 elections without a full-blown crisis. The same is not true of Venezuela; however, the direct linkages from that country to the rest of the region are limited.

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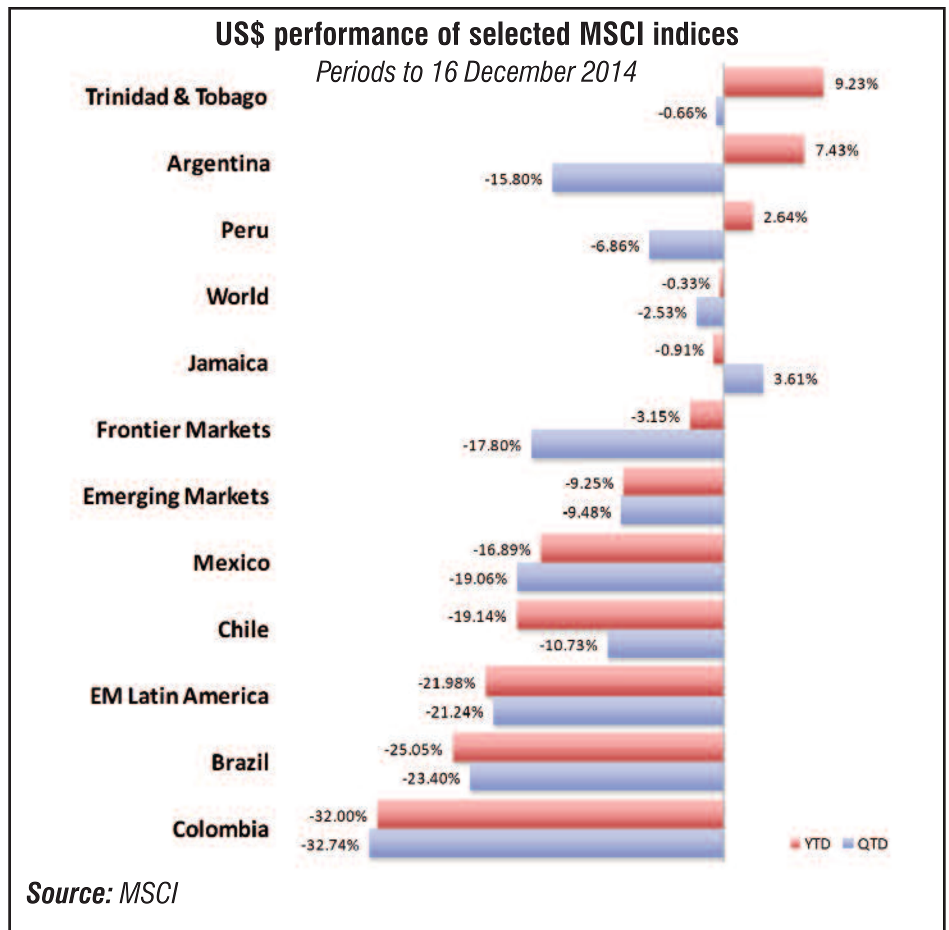

Source: *MSCI*

The major regional currencies and sharemarkets should stabilise once it becomes clearer that energy and commodity prices are near a floor and policymakers know the parameters within which they are operating. Business-friendly policies from President Rousseff's new administration would be good for wider investor perceptions of the region, and not just Brazil. In the meantime, growing intra-regional trade links and measures taken by policymakers in some countries (such as Colombia, as we discussed earlier) likely will be viewed favourably by investors. As in 2014, the coming year will bring challenges, but not insurmountable ones.

LATIN AMERICAN ECONOMY & BUSINESS is published monthly (12 issues a year) by **Latin American Newsletters**, 61 Old Street, London EC1V 9HW, England. Telephone +44 (0)20 7251 0012, Fax +44 (0)20 7253 8193 Email: subs@latinnews.com or visit our website at: **http://www.latinnews.com**. Subscription rates will be sent on request. Overseas subscription sent by airmail. **EDITOR: EILEEN GAVIN**. **CONTRIBUTORS: ANDREW THOMPSON, ANDREW HUTCHINGS.** Printed by Quorum Print Services Limited, Units 3&4, Lansdown Industrial Estate, Gloucester Road, Cheltenham, Glos. GL51 8P.

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