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CONTENTS

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Argentina – holdout settlement in sight

Argentina's long dispute with its holdout creditors seemed to be moving into its final stages during the course of February. On 2 February the country's negotiating team reached a pre-agreement with a group of Italian creditors, and on 5 February two out of six US-based hedge funds with court judgements against Argentina accepted a settlement. Negotiations with the remaining four hedge funds continued, but on 19 February Argentina's position was strengthened when New York Judge Thomas Griesa said he was minded to lift his *pari passu* injunctions, which prevent Argentina making normal debt service payments to the bulk of its creditors until it settles the dispute by paying the holdouts. It is these injunctions that have pushed the country into technical default since mid-2014.

Judge Griesa ruled in February that he would lift the *pari passu* injunctions on several conditions. One of these was that Argentina should repeal domestic legislation preventing it from paying the holdout creditors. This is a reference to the *ley cerrojo* which says that Argentina cannot offer better terms to the holdouts than those that were already offered and accepted by over 90% of the country's creditors in the rescheduling of 2005 and 2010, that followed after the country's late 2001 default. As lifting the *ley cerrojo* is implicit in the offers Argentina has already made, this should not be a problem for the government of President Mauricio Macri (although he will face the political challenge of getting a majority of the legislature to back repealing the law).

Griesa's second condition was that Argentina should also pay in full all of the holdouts with which it had reached agreements before the end of February. This second condition was clearly designed to put pressure on the 'hard core' of holdouts, including by NML Capital, a subsidiary of Elliott Management (owned by Paul Singer), and Aurelius Capital (led by Mark Brodsky). The implication was that if they did not settle by the end of February they risked being left out in the cold, facing a long legal struggle and much less leverage with which to get their money. It is clear that Judge Griesa, seen as an implacable enemy of Argentina during the presidency of Cristina Fernández de Kirchner (2007-2015), now believes the new government is acting in good faith. In his ruling he said: "Put simply, President Macri's election changed everything. The injunctions must not be turned through changing circumstances into an instrument of wrong."

While it does look as if the possibility of a full settlement is the strongest it has been in the last decade, things can still go wrong. Griesa acknowledged that he lacks jurisdiction to lift the injunctions because of an outstanding appeal, but his ruling should be taken as an indication of how he intends to proceed when that matter is resolved and he does have full jurisdiction. The remaining hedge funds could also appeal against his decision, dragging out further the long legal proceedings.

But it does look as if the remaining differences are narrowing. The US-based hedge funds are claiming a total of US$9bn and Argentina has offered to pay US$6.5bn. The Argentine offer consists of three options. Bondholders who have a claim upheld by the New York court are being offered 72.5% of the court-ordered payment. Holdout creditors without a court judgement but whose bonds have *pari passu* clauses are also being offered 72.5% of the total. A third category – holdouts without a court judgment or a pari passu clause – are being offered 150% of the face value of their bonds. Prior to Judge Griesa's ruling NML and Aurelius said that Argentina's offer was "ambiguous" and its attempt to set a deadline for agreeing a settlement was akin to an "ultimatum".

REGIONAL ECONOMY REVIEW

VENEZUELA

Maduro devalues

The battle over economic policy within the radical left-wing government led by President Nicolás Maduro seems to have been won – for the moment anyway – by the more pragmatic wing. Two days after appointing Miguel Pérez Abad to replace Luis Salas as vice president and minister for the productive economy, Maduro announced devaluation and the first increase in petrol prices the country has seen for 17 years.

"The steps announced by Maduro on 17 February can be described as a significant U-turn in economic policy terms, although they are unlikely to be enough to address the gravity of the country's economic crisis."

The precise reasons for the removal of Salas, who had been in office for just over a month, remain unclear. President Maduro said Salas was being moved at his own request for "family reasons" and would be given other unspecified tasks. But it does seem that other members of the economic team were resisting the outgoing minister's policy positions. Salas is on record as claiming that monetising a fiscal deficit does not cause inflation. When the deficit is running at 20% of GDP – according to independent estimates – that view is problematic, to say the least. He was also reportedly urging further nationalisations, price controls, and an interruption of foreign debt servicing. Pérez Abad, a former president of business lobby Fedeindustria and the first member of the private sector to lead the economic team under Maduro, had a different position.

The steps announced by Maduro on 17 February can be described as a significant U-turn in economic policy terms, although they are unlikely to be enough to address the gravity of the country's economic crisis. There were five key announcements. First, the Bolívar has been devalued and the multiple exchange rate system has been simplified. The official rate has gone from VEN6.30 to VEN10.00 per dollar, equivalent to a devaluation of 37%. The SICAD rate (VEN13 to the dollar) has been eliminated. A new floating rate was due to start at VEN203/US$1, in place of the SIMADI rate. The net result is that Venezuela will now have two official rates instead of three, as well of course as the black market rate (which stood at just over VEN1,000/US$1 when the announcements were made).

> “Critical economists Ricardo Hausman and Miguel Ángel Santos have argued that the immediate danger facing the country is a collapse in food supplies. They say that at current oil prices Venezuela will not be able to export more than US$22bn this year.”

In second place, petrol prices have been increased. High-grade 95-octane petrol jumps from VEN0.097 to VEN6 a litre, a 6,085% increase, which nevertheless still leaves Venezuela having some of the lowest petrol prices in the world (60 US cents a litre at the official exchange rate, half a cent a litre at the black market rate). Third, price controls are being relaxed, although it was not immediately clear by how much (Maduro said they would be adjusted to cover real production costs). Fourth, Maduro admitted that Abasto Bicentenario, the network of state-owned food distribution outlets that has been at the centre of corruption claims, was “rotten” and needs to be replaced by a new system. Fifth, and finally, in an attempt to limit the effects of the devaluation on living standards, the president said there would be a 20% increase in minimum wages and increases in pensions and in the food supplement (known as the *bono de alimentación*).

Although the change to a more realistic approach is significant, the package of measures is not sufficient to fully address the gravity of the Venezuelan crisis. One example of this is that the petrol price subsidy is widely estimated to cost the country somewhere between US$12.5bn and US$15bn a year. Maduro said the price increases he had authorised would save the country US$800m – meaning that 90% of an energy subsidy that Venezuela can ill afford remains in place. Likewise, unless the government makes further changes, the real effect of the price and minimum salary adjustments are expected to be quickly eroded as the country slides towards hyperinflation.

Critical economists Ricardo Hausman and Miguel Ángel Santos have argued that the immediate danger facing the country is a collapse in food supplies. They say that at current oil prices Venezuela will not be able to export more than US$22bn this year. Taking into account US$10.3bn worth of debt service and assuming a roll-over of some US$6bn owed to China, Venezuela would only be able to afford US$12bn worth of imports, 25% of the already sharply reduced import level registered in 2015. They conclude “this would lead to an economic contraction of unseen proportions…a level of destruction matched only by enormous natural disasters or world wars”. Writing just before the latest announcements they described devaluation and exchange rate unification as “necessary, but not enough”. Their conclusion is that whatever the politics of the government in Caracas, Venezuela needs major debt rescheduling and a US$40bn-$50bn international rescue package led by the IMF.

VENEZUELA

The price of putting the bondholders first

The government of Venezuela and state owned oil giant PDVSA can avoid defaulting on their foreign currency bonds in 2016, provided that other parties accept the consequences.

Observers of Venezuela in financial markets and the media have concluded that the government and/or PDVSA are going to default this year as a result of the ongoing weakness in the price of oil – the source of almost all export earnings and much of the government’s revenues.

The financial problems of the government and PDVSA have been brought into focus by the needs of the former to find a little over US$2bn for interest and principal payments that are due on 26 February. Over the rest of the year, around US$8bn must be paid. This includes around US$5bn in interest and principal that is due from PDVSA in the final quarter of 2016.

Production volumes of PDVSA have been trending downwards over recent years. In 2014, the company produced just under 2.9m barrels of oil per day (BOPD), or about 1bn barrels through the year as a whole. Of this, 80% was exported as crude oil and refined products. The exports included around 1.0m BOPD that had been committed to servicing borrowings from China (630,000 BOPD) and obligations to other member countries of Petrocaribe.

In short, the gross revenues of PDVSA in 2016 should be around US$30bn, provided that the average price received across its 'basket' of products is US$35/barrel. In 2014 (ie the last year for which accounts are available), operating and sales & administration costs amounted to US$25bn and US$9bn respectively – and had been rising. PDVSA had also purchased about US$38bn in oil for its refineries, which should be reduced by two-thirds in 2016. The government has been extracting around US$30bn in cash annually from PDVSA, mostly taxes and royalties but also for contributions to the FONDEN development funds.

Clearly, at current market prices for oil, something has to give if PDVSA is to avoid default. Possible courses of action include:

"In short, an aggressive approach to ensuring that there is no default runs a significant risk of a social explosion as the country sinks further into economic slump and suffers from shortages of basic goods and hyperinflation."

- **Renegotiation of the terms of the borrowings from China (US$50bn).** Given that roughly one quarter of oil exports are committed to servicing these borrowings, this should be the top priority. The Chinese government may agree to an alteration to the schedule of repayments, but it may demand substantial concessions in return.

- **Making arrangements with creditors to roll over around US$4bn in PDVSA bonds** that are maturing in the last months of 2016.

- **Squeezing of trade creditors and delaying tax payments.** Over the three years to the end of 2014, PDVSA generated US$30bn in cash by running down working capital. This process involved delaying payments of tax and amounts due to other creditors – and at a time that oil prices were US$90-$100/barrel.

- **Dramatically reducing royalties and payments to the FONDEN.** Contributions to the FONDEN had been falling thanks to the depreciation of the bolivar. Lower extraction of cash from PDVSA would compel the government to cut spending and/or to increase the deficit – which would further fuel inflation.

- **Further running down foreign exchange reserves, which are held substantially in gold.** According to the central bank, foreign exchange reserves have declined from US$16.4bn to US$15.0bn since the beginning of 2016. In the meantime, the government needs to discourage imports at a time when shortages of goods in Venezuela's shops and supermarkets have reportedly intensified.

In short, an aggressive approach to ensuring that there is no default runs a significant risk of a social explosion as the country sinks further into economic slump and suffers from shortages of basic goods and hyperinflation.

Nevertheless, the government cannot afford to allow PDVSA to default. The company is not just (by far) the largest source of export earnings and government revenues. It is the vehicle through which the Venezuelan government has access to global financial markets. Further, it has substantial assets outside the country – such as its Citgo refinery operation in the United States – which can be seized by aggrieved creditors. Finally, it is not clear that PDVSA's bonds include collective-action causes (CACs). It would probably not be possible to force a restructuring deal on all bondholders. Negotiations with 'holdout' creditors could take years.

Apparently, most of the government's bonds – which account for about half of Venezuela's US$64bn in foreign currency debt, the remainder being owed by PDVSA – do include CACs. However, a default by the sovereign would come with enormous political cost, given the sacrifices that have already been demanded from voters.

The bottom line is this: the government of Venezuela and PDVSA will likely do everything that they can to avoid a default in 2016 and should be able to do so although the economic, financial, and political costs will be very high.

BRAZIL

Stabilising or not?

There have been mixed signals from Brazil's troubled economy in the last month. Some indicators and some analysts say there are signs that the recession may be stabilising or even bottoming out. Others say the worst is far from over.

According to the index of composite leading indicators (CLIs) prepared by the OECD, there are signs that the Brazilian economy may be stabilising. The CLIs are statistical trackers that have been shown to anticipate the business cycle. However, the OECD has not yet identified what it calls a CLI "turning point" in Brazil: it says that CLI turning points tend to precede turning points in real economic activity, relative to trend, by approximately six months. So even if a turning point is identified in the next few months, it looks like being at best late 2016 or early 2017 before a real recovery might start, and that presupposes that there are no further negative shocks to the system.

"Consultancy Capital Economics says its own "GDP tracker" is revealing "early signs that the recession may actually be starting to ease". This is based on some signs of strength in consumer confidence and retail sales in late 2015 and early 2016."

Consultancy Capital Economics says its own "GDP tracker" is revealing "early signs that the recession may actually be starting to ease". This is based on some signs of strength in consumer confidence and retail sales in late 2015 and early 2016. The consultancy is predicting that the recession will ease in the first half of this year and that the economy will stabilise in the second half. Overall it projects GDP contraction of 2.3% in 2016, better than last year, and better than the consensus for this year. But it mentions many caveats. It warns that "private debt levels are high, the fiscal position is dire, and the political and policy backdrop is a continuing concern".

Ranged against these views are more pessimistic assessments. The consensus view on GDP this year, as revealed in the Central Bank's 14 February weekly survey of around a hundred analysts, worsened to -3.33% from -3.21% the preceding week. The prediction for 2016 inflation also rose, to 7.61%. Another setback came on 17 February when US ratings agency Standard & Poor's, which had already downgraded Brazil from investment grade last September, cut it further into junk territory (to BB with negative outlook), citing what it said was the government's inability to get to grips with the fiscal deficit, which totalled 10.3% of GDP last year. "We now expect a more prolonged adjustment with a slower correction in fiscal policy, as well as another year of steep economic contraction" S&P said.

In an attempt to stimulate the economy, at the end of January finance minister Nelson Barbosa had announced a BRL83bn (US$20bn) expansion plan, equivalent to 1.4% of GDP. State banks such as BNDES and Banco do Brasil were ordered to use cash surpluses to open new credit lines at preferential rates for housing, infrastructure, and capital goods. Barbosa claimed the programme would have a "zero fiscal cost". However critics note that state banks are themselves already facing a degree of financial stress and high non-performing loan indicators. The package has therefore had an unenthusiastic reception. Ultimately, economic stabilisation seems at this point to require improved business and consumer confidence, which in turn remains conditional on political developments. As Congress reconvenes after Carnival, the question is whether the government can take meaningful measures to improve its fiscal accounts.

MEXICO

Monetary and fiscal tightening

Two decisions announced on 16 February send a defensive signal about the state of the Mexican economy this year. Banco de México (Banxico – the central bank) announced a surprise tightening of interest rates on the same day as Finance Minister Luis Videgaray said government spending would be cut by US$7.2bn.

"The last Banxico interest rate hike came in January, when it matched a 25bps increase announced by the US Federal Reserve. While some analysts had expected Banxico to mirror upward moves by the Fed, in February it moved on its own."

The common theme behind both decisions was the need to respond to the slump in oil prices, which has been eroding government finances and contributing to volatility on Mexico's foreign currency markets. Banxico said it was increasing its key interest rate by 50bps to 3.75% and setting up a mechanism for direct foreign currency sales to defend the value of the peso in exceptional situations. All five Banxico directors unanimously supported the interest rate hike. The peso depreciated by 17% against the US dollar during 2015, and in the first month and a half of 2016 it fell by a further 6%. Banxico president Augustín Carstens said that in Banxico's view the peso-dollar rate had become "misaligned". The increase did not necessarily represent the beginning of a tightening cycle, but the Bank would monitor the situation – including any further upward moves in the US Prime rate, and act accordingly. The last Banxico interest rate hike came in January, when it matched a 25bps increase announced by the US Federal Reserve. While some analysts had expected Banxico to mirror upward moves by the Fed, in February it moved on its own

At the same time finance minister Videgaray announced a second reduction in the government's spending budget for 2016, totalling MXN132,200m (US$7.2bn) or 0.7% of GDP. Most of the cut – around MXN100,000 – will fall on state oil company Pemex. The minister said Pemex was suffering liquidity and cash flow problems, but was solvent. The government has been looking at a possible capital injection for the company as part of a restructuring of its activities. According to existing budget projections, Mexico, one of the world's top ten oil producers, will see its hydrocarbon export revenue fall by 30% this year, an amount equivalent to 4.5% of GDP. But given the strength of other sectors of the economy the budget still predicts positive GDP growth in a 2.6%-3.6% range. Videgaray said the cut in government spending would have a "marginal" effect on growth because it was concentrated on reducing administrative costs and was not targeting priority projects.

Policy moves from the other central banks

Venezuela and Mexico are not the only countries in the region where the authorities have taken important policy decisions in recent weeks.

On 19 February 2016, the board of Banco de la República (BanRep – Colombia's central bank) increased its key policy rate by 25 basis points to 6.25%. This is mainly because of high inflation and inflation expectations. Thanks in part to the impact on food prices of El Niño and in part to the passing on to consumers of increased costs associated with the past depreciation of the peso, headline annual inflation in January was 7.45%, while core inflation was 5.73%. Bond markets indicate that investors are looking for inflation of 4.5%-5.0% annually over the next two-to-five years. BanRep's inflation target is a 2.00%-4.00% band. BanRep began increasing the key rate in September last year, prior to which it had stood at 4.50%.

In the meantime, declines in the price of oil have boosted risk premiums for financial assets in Colombia and other Latin American countries at a time when economic recovery in Colombia's main trading partners through 2016 is likely to be weaker than had previously been expected.

> "The announced cuts in public expenditure and the firm commitment of the government to submit a structural tax reform in 2016 are necessary measures for the economy to adjust to the new income levels."
>
> – *BanRep*

As is the case in Mexico, tighter monetary policy is supporting fiscal policies. In Colombia's case the deterioration in the terms of trade (ie from lower energy prices) is seen as being likely to be long lasting. As BanRep has said, "The announced cuts in public expenditure and the firm commitment of the government to submit a structural tax reform in 2016 are necessary measures for the economy to adjust to the new income levels."

Banco Central de Reserva del Perú (BCRP – Peru's central bank) raised its key policy rate by another 25 basis points to 4.25% on 11 February 2016. BCRP had increased its rate in January and December as well. Like BanRep, BCRP has been concerned by the impact on inflation and expectations of the past weakness of the currency and higher food prices, as well as the volatility in global financial markets. The BCRP noted that there had been "mixed signals of recovery in terms of production and employment in the larger economies". BCRP noted that the output from Peru's economy had been below potential for much of 2015 but that it should return to potential over the course of 2016.

Also on 11 February 2016, the Banco Central de Chile (BCCh) kept its key policy rate unchanged at 3.50%, having increased it by 25 basis points in each of October and December last year. The accompanying commentary was hawkish. BCCh noted that headline and core annual inflation in January had been over 4% and nearly 5% respectively – or well above the medium-term target of 3.00%. Meanwhile, according to BCCh, "available data…continues to show limited growth in domestic output and demand".

After a long series of increases to the key Selic rate, the monetary policy committee (Copom) of Banco Central do Brasil (BCB) voted 6-2 on 20 January 2016 to keep the rate unchanged at 14.25%. The minority had advocated a 50 basis point rise in the rate to 14.75%. The latest indicators point to annual inflation in Brazil of 10.5%-11.0%. The Copom considers that high inflation is partly the result of liberalisation of previously regulated prices (which are rising as a result) and the convergence of domestic prices with international prices (again through movement in an upwards direction). The Copom is looking to reduce inflation to 4.5% in 2017.

Unlike their counterparts in Colombia, the majority of the Copom's members see the difficult conditions in global economies and markets as a reason to not tighten monetary policy. A minority in the Copom argued that it would be appropriate to adjust, immediately, the monetary conditions, in order to reduce the risks of non-compliance of the inflation targeting regime objectives, and to reinforce the process of anchoring inflation expectations. However most of the Copom members considered that the elevation of the domestic and, mainly, the external uncertainties justified waiting until the next meeting (on 1 March 2016) before deciding on its next move.

REGION

Calculating the cost of Zika

The outbreak of the Zika virus in Latin America has raised concern. Some see it as one more negative impacting the region's economies, coming hard on the heels of other setbacks such as the commodities slump and the El Niño cycle of disruptive weather. Seen from that point of view, the virus and the panic it may generate will make the Latin American recession go deeper and last longer. But there is a counter-view that holds that the impact of the disease, although negative, will be manageable.

> "There is as yet no known vaccine for Zika, and diagnosis tests are relatively unreliable. Various medical teams in Brazil, the United States, and elsewhere have accelerated the search for an anti-Zika vaccine, but this is widely considered to be a task that will take a number of years."

The mosquito-borne Zika virus has spread rapidly throughout Latin America. The first cases were reported in Brazil in May 2015, and since then it has appeared in at least 26 countries, with Brazil apparently remaining the epicentre but with Colombia, Mexico, Venezuela, and Paraguay all reporting significant numbers of cases. There have also been reports of a concentration of Zika cases along Colombia's border with Venezuela. On 1 February the World Health Organisation (WHO) declared the outbreak a "public health emergency of international concern" and estimated that by the end of this year there could be as many as 4m people infected throughout the Americas. Most concern has focused on the possible link between Zika infections in pregnant women and a spike in cases of microcephaly – children borne with abnormally small heads and brain defects. A positive scientific link has not yet been fully proven, but it is suspected and is being investigated. There is also a potential link to Guillain-Barre syndrome, a neurological condition that in the worst cases can lead to paralysis of the limbs and respiratory muscles.

There is as yet no known vaccine for Zika, and diagnosis tests are relatively unreliable. Various medical teams in Brazil, the United States, and elsewhere have accelerated the search for an anti-Zika vaccine, but this is widely considered to be a task that will take a number of years. Attention is meanwhile focusing on the carrier, the Aedis aegypti mosquito, which is also known to carry the dengue and chikungunya viruses. The Aedis aegypti is found in tropical and sub-tropical regions of the world and breeds mostly where there is hot weather and stagnant water pools, hence the fear that in those areas where the El Niño weather pattern has led to higher than normal temperatures, the disease may be most concentrated. Recently flooded areas are also at risk. Many Latin American countries have poor quality water supplies and drainage systems, meaning the battle against the mosquito is potentially very difficult and costly. The WHO has recommended intensified public health surveillance, research, data-sharing, public risk communications, mosquito control, and personal protective measures to prevent mosquito bites.

In Brazil the government has responded by deploying army units – over 200,000 troops in all – to find and fumigate likely mosquito breeding grounds. There has been a degree of controversy over the advice given to women in a number of countries that they should seek to avoid becoming pregnant. In El Salvador the government recommended that women should delay pregnancies for up to two years. Some have questioned the advice on the grounds that it could infringe personal freedoms, is not accompanied by sufficient data to permit informed choice, and may be impractical.

But some analysts argue that the Zika outbreak will be manageable in economic terms. Both SARS in southern China in 2003-04 and Ebola in West Africa in 2014-15 had major economic consequences with a negative impact on activity levels. But as far as is known – and despite worries over potential transmission through sex or blood transfusion – Zika is not directly transmitted from person to person and, setting aside the potential link to microcephaly for one moment, has relatively mild symptoms which last between two and seven days. In up to 80% of cases those carrying the virus present no symptoms at all and may be completely unaware that they are carriers. One crude calculation is that if the WHO is right and 4m people do contract the disease before the end of this year that will still represents under 0.1% of the region's working age population (the population aged between 16 and 64).

That said, there could clearly be a significantly negative impact on tourism. According to a *Reuters*/Ipsos poll among US travellers in early February 41% of those who had heard of Zika said they were less likely to visit Latin America and the Caribbean as a result of the outbreak. There have already been official requests that pregnant women not travel to Zika areas, and this may have a ripple effect, causing couples and families to change their travel plans and stay away. In the case of Brazil there were fears of a negative impact on the number of people attending the Rio Carnival in February (just concluded) and, perhaps more importantly, the 2016 Rio Olympics due in August. But, despite this, over a million people are estimated to have taken part in Carnival street parties in Rio, Salvador, and Recife. Some dressed as mosquitoes to help raise awareness of the struggle against Zika. However, it is still too early for a full assessment of the economic impact on Carnival. A number of airlines reported fairly normal passenger traffic. Moody's, the US ratings agency, said LATAM Airlines, through its Brazilian division TAM, together with the Brazil-based budget airline Gol Linhas Aéreas, would be the most exposed to the Zika risk. But on 8 February LATAM issued a statement saying "up to the moment there has been no impact on TAM bookings due to the Zika virus in Brazil or in other locations where the airline operates".

"There is also cause for concern over the impact of the disease in countries like Venezuela, which is experiencing a severe political and economic crisis, caused by acute shortages of foreign exchange. The country already has difficulty paying for imports of medicine."

There is also cause for concern over the impact of the disease in countries like Venezuela, which is experiencing a severe political and economic crisis, caused by acute shortages of foreign exchange. The country already has difficulty paying for imports of medicine. Nevertheless Luis Salas, the short-lived minister for the productive economy (he was replaced in mid-February after just over a month in office) claimed that available foreign currency would be managed to ensure funding for "the more immediate emergencies". Critics of the government believe the real extent of the Zika outbreak may be ten times more than the 5,000 cases reported by the authorities.

On average, tourism's direct contribution to Latin American GDP is around 2%, but including indirect contributions that number can go up to 10% (and higher in some Caribbean countries). There is a real prospect that Zika could have a negative effect on the tourism, and that it could dampen the expected positive economic impact of the Rio de Janeiro Olympic Games. Some international medical experts such as Doctors Lee Igel and Arthurt L Caplan, both of New York University, have suggested that the Zika outbreak is serious enough to merit cancelling or postponing the Games. Caplan questioned whether the city could simultaneously conduct an effective anti-Zika campaign on the one hand, which would include identifying stagnant water pools, and fumigating wide areas, while also on the other hand preparing effectively for the Olympics, reducing water contamination for the sailing events, taking effective anti-terrorism measures, and dealing with the budget crisis in the city's public hospitals.

But on 12 February Brazil's President Dilma Rousseff insisted that the Zika outbreak would not compromise the Olympic Games, with the government stepping up its efforts to combat the virus. She said that Rio itself would be given priority attention in the government campaign. Her head of civilian staff, minister Jacques Wagner, also said the games would go ahead, although he admitted that the number of tourists coming to see them could be lower because of fears over the outbreak.

"Other factors, such as commodity prices and the fate of China's economy, will play a much more important role [than Zika] in the region's economy in 2016. In Brazil, the risks to the economy from further fiscal slippage and the possible impeachment of President Rousseff are likely to be much bigger drags on the beleaguered economy this year."

– Capital Economics

Consultancy Capital Economics has taken the view that although clearly a factor of concern, Zika is a relatively minor risk. In a research note, the consultancy said: "Other factors, such as commodity prices and the fate of China's economy, will play a much more important role in the region's economy in 2016. In Brazil, the risks to the economy from further fiscal slippage and the possible impeachment of President Rousseff are likely to be much bigger drags on the beleaguered economy this year." A World Bank study published on 17 February estimated that the cost of Zika for Latin America and the Caribbean would be around US$4bn, or 0.07% of GDP this year, through loss of income and fiscal effects. The report said Mexico and Cuba could be among the most affected because of the impact on tourism.

HONDURAS

No longer the regional pariah

Honduras continues to consolidate an economic recovery and is slowly shedding its reputation as the most violent country in the region.

Like its Central American neighbours, Honduras is one of the beneficiaries of the global oil price rout, as a fuel importer, and is also enjoying the 'pull effect' of a stronger US economy and a stronger US dollar, which means a recovery in demand for its exports, and a more competitive rate for its goods on international markets. Remittances from Hondurans living in the US (worth about 20% of GDP) have also risen for similar reasons. On the downside, a stronger dollar makes non-oil imports more expensive, albeit the drop in fuel prices and low food prices appear to have mitigated any pass-through to inflation which this year has fallen steadily.

The IMF expects real GDP growth to accelerate from 3.5% in 2015 to 3.6% in 2016 and 3.8% in 2018. Overall, GDP in 2015 should touch US$20bn.

Concerted government efforts at fiscal reform (under the auspices of the IMF programme) are ongoing, with the deficit reducing from 4.3% of GDP in 2014 to an estimated 2.5% in 2015. In light of this, however, central government gross debt was expected to rise to 48.4% in 2015, up a little from 45.7% in 2014.

According to Banco Central de Honduras (BCH), real GDP rose by 0.6% in the second quarter over the first, and by 3.0% year-on-year over the second quarter of 2014. The growth was broadly based, with an expansion in activity in the telecoms sector (by 1.2% relative to the first quarter); retailing, hotels and restaurants (+1.1%); financial services (+0.6%); and construction (+1.5% thanks to both public works and spending on residential housing in Tegucigalpa and San Pedro Sula). There were smaller rises in activity in manufacturing (+0.3%) and agriculture (+0.1%).

Competitiveness

In the World Economic Forum's latest (2015-2016) Global Competitiveness Report, Honduras' overall competitiveness ranking was 88/140 – a marked improvement over 2014-2015 (when it ranked at 100/144) and 2013-2014 (111/148). In spite of the progress made by the Juan Orlando Hernández administration in improving public sector expenditure control, the country was ranked a poor 124th for wastefulness of government spending, however.

In terms of expenditure, second quarter growth was driven by exports of goods and services (which rose by 1.8% over the first quarter) and domestic consumption spending (which increased by 0.6%). However, investment fell by 4.2%.

There were some significant changes in the country's balance of trade through the first half of 2015. Thanks to the fall in the global price of energy, imports of fuel and power were valued at US$721m, or US$345m less than in the first six months of 2014. The trade deficit nonetheless increased by US$235m to US$2.6bn, mainly due to higher imports of raw materials for industry and consumer goods (indicative both of the strengthening domestic demand but also the higher cost of imports on the back of the depreciating exchange rate). Remittances in the first half of 2015 came to US$1.82m, up by 10.3% on the previous corresponding period.

The BCH cut its key policy rate by 25 basis points on each of 9 February, 23 March and 6 July. The rate currently stands at 6.25%. In April 2015, the IMF assessed the BCH's monetary policy as being "broadly appropriate", bearing in mind the inflation target and the central bank's desire to allow the lempira to depreciate relative to the US dollar by around 5% over the course of 2015. In the 12 months to June 2015, broad money (M3) and deposits from the non-bank public both rose by 13.7%. Bank lending to the private sector rose by 9.2%. Inflation ended the year at a low of 2.36%, down from 5.8% in December 2014.

Corruption in government still an issue for donors

On 9 November, the US embassy in Tegucigalpa indicated that Honduras had failed to qualify for a second year running for inclusion in programmes offered by the Millennium Challenge Corporation (MCC), which provides US development aid and financial assistance to developing countries.

The MCC published its annual policy performance scorecards, used to select countries eligible for MCC programmes in 2016, on 6 November. According to a US embassy statement, the country's performance on ruling justly, investing in people and economic freedom as measured by 20 indicators in this year's scorecard were similar to last year, and Honduras once again did not pass the indicator on control of corruption, "a key criterion for passing the scorecard and being considered for eligibility to develop an MCC Compact". While there had been "a modest improvement in control of corruption and rule of law", there was still "weaker performance on regulatory quality", the statement noted.

Homicide rate down again in 2015

Honduras' homicide rate in 2015 was 56 per 100,000 inhabitants last year, according to preliminary government figures, another sharp improvement over 67 in 2014. There were 5,047 registered homicides over the year, down from 5,891 in 2014. The murder rate peaked at 90.4 in 2012, when Honduras earned the ignominious title of most dangerous country in the world, inclusive of active war zones.

The MCC is currently supporting Honduras with a three-year US$15.6m good governance Threshold Program. Signed in August 2013, it is designed to improve transparency and efficiency of government. The embassy stressed that "many of the reform efforts underway in Honduras with support from this Threshold Program will help reduce opportunities for corruption. They include reducing payment arrears and increasing prompt government payments, improving oversight and capacity in the procurement process, increasing the ability of the TSC to conduct performance audits, and support for the implantation of the Transparency International/ASJ initiative".

Honduras is very keen to qualify for a new MCC Compact, a more substantive aid package. According to John Wingle, director of the MCC's evaluation unit, Honduras is about half way towards eligibility for a second MCC Compact. It now scores 26 points, up from 21 last year but needs 50 to become eligible.

Despite the disappointment for the Hernández government, which has made a concerted effort since taking office in January 2014 to improve public sector management (including tough fiscal reform measures in order to secure an IMF lending facility), the US ambassador to the country, James D. Nealon, stressed that efforts are moving in the right direction, noting that "Honduras is still paying the bill for budgetary and policy decisions of years past". Honduras' improved fiscal policies, follow-through on its commitment to Transparency International to improve governance, and continued efforts to lift the regulatory burdens on small businesses will pay dividends down the road – not just by improving Honduras' chances of developing a new Compact with the MCC to spur economic growth, but in direct benefits to the Honduran people", he emphasised.

SURINAME

The IMF sends a mission to Paramaribo

Suriname is an early test case of how the International Monetary Fund (IMF) will work with countries hard hit by the global slump in commodity prices.

On 22 January 2016, the IMF announced that it had been approached by the government of Suriname for financial assistance. An IMF mission concluded its visit to Paramaribo on 11 February.

Suriname's main exports are alumina (32% of the total in 2013), refined petroleum (10%), and gold (24%). Falls in the prices of alumina and energy over the last year, and the slippage in the price of gold prior to 2014, have hit both the economy and government revenues hard.

The most pressing problem facing the authorities has been the steady fall in foreign exchange revenues, which dropped from US$631m in January 2015 to US$596m in April and to US$308m in January 2016. Fitch Ratings anticipates that reserves will be boosted when the Merian gold mine commences production and begins to generate new export revenue, however this will not happen before late 2016.

As the **[chart]** shows, this is in the context of a nearly stagnant economy with total GDP of just over US$5bn (or a little more than US$9,000 per capita). There has been a very sharp deterioration in the current account. The IMF is looking for the deficit to widen from 7.4% of GDP in 2014 to 9.4% of GDP in 2015. Suriname's current account had been in surplus in 2010-2012.

Suriname: key economic metrics			
	2013	**2014**	**2015**
GDP (US$bn)	5.13	5.21	5.05
GDP per capita (US$)	9,375	9,427	9,052
Total investment (% GDP)	46.4	54.0	50.1
Savings (% GDP)	26.0	25.9	26.4
Current account balance (% GDP)	-3.9	-7.4	-9.4
Government revenues (% GDP)	24.7	23.5	21.2
Government spending (% GDP)	31.5	28.7	30.2
Government deficit (% GDP)	-7.3	-5.3	-9.0
Average CPI inflation (%)	1.9	3.4	3.8
Unemployment (%)	8.5	8.9	8.9
Source: *IMF*			

"In mid-November 2015, the CBVS devalued the Surinamese dollar by 21%, moving the rate at which the currency is pegged from US$1:SRD3.30 to US$1:SRD4.00. The CBVS also made the currency regime more flexible, in that the currency will be allowed to fluctuate by 5% either side of the central rate."

The fall in mineral prices has also had a damaging impact on public finances, with the overall budget deficit expected to blow out from 5.3% of GDP in 2014 to 9.0% in 2015. The government's revenues from minerals exceeded its non-mineral deficit in 2011. Over the next three years, the non-mineral deficit amounted to 13%-15% of GDP.

However, the government's situation is far from disastrous. While government borrowing has been rising, the overall level of indebtedness remains low. Over the four years to the end of 2014, domestic debt remained broadly unchanged at a little over 12% of GDP, while external debt grew from 15% to 21%. The IMF estimates that total debt grew to just under 37% of GDP through 2015.

In addition, the Centrale Bank van Suriname (CBVS – the central bank) has kept inflation under control, in spite of the persistent budget deficit. Average inflation peaked at nearly 18% in 2011 but has since fallen to 3%-4%. Over the course of 2015, the CBVS increased the amount of liquidity that is available to the banks. As of mid-2015, the banks had net foreign assets that were equivalent to 11% of GDP. These assets were mainly foreign currency holdings and net foreign currency deposits with banks outside Suriname. The banks' net foreign assets more or less offset the currency mismatch that arises because their foreign currency deposits (about 55% of the total) exceed their foreign currency loans within Suriname.

And the authorities have already taken steps to address the challenges. In mid-November 2015, the CBVS devalued the Surinamese dollar by 21%, moving the rate at which the currency is pegged from US$1:SRD3.30 to US$1:SRD4.00. The CBVS also made the currency regime more flexible, in that the currency will be allowed to fluctuate by 5% either side of the central rate. The government has also announced that it will phase out water and power subsidies, which amounted to 4.3% of GDP in 2014, and said that it would reduce capital expenditure in its budget for 2016.

The government's reduction in the subsidies represents a major turnaround. In its previous (October 2014) Article IV consultation with the government, the IMF had highlighted fiscal slippage as a major problem.

"The coming months will provide useful pointers in relation to two issues. One is the general approach of the IMF to countries that have run into serious economic and financial problems as a result of the slump in mineral and energy prices. The other is the attitude of the government to fiscal discipline and structural reform, given its tendency to dodge hard decisions in the past."

It remains to be seen what assistance is provided by the IMF to the government of Suriname, and on what terms. Possible initiatives include the introduction of a value added tax (VAT), which the government has been considering since 2014; a review of the new health insurance system (which was introduced in 2013) and whose financial sustainability has been questioned by the Managing Director of the country's largest insurance firm; and a review of the new General Pension Plan, which was to have been funded largely on a pay-as-you-go (PAYG) basis.

It is also reasonable to expect that the IMF will push for changes that make Suriname an easier place in which to do business. In its *Doing Business 2016* report, the World Bank gave Suriname an overall ranking of 156 (down from 154 in 2015) out of 189 countries considered. Suriname performs particularly poorly in terms of starting a business (183), enforcing contracts (186), registering property (176), and getting credit (174). Except in relation to trading across borders, for which Suriname's ranking improved from 95 to 77, there was no improvement in any of the aspects considered.

The coming months will provide useful pointers in relation to two issues. One is the general approach of the IMF to countries that have run into serious economic and financial problems as a result of the slump in mineral and energy prices. The other is the attitude of the government to fiscal discipline and structural reform, given its tendency to dodge hard decisions in the past.

REGIONAL BUSINESS REVIEW

BRAZIL

Corporate debt warning light

Brazil has become a difficult operating environment for a number of large domestic and for some international companies. It is in year two of one of the steepest recessions experienced in a generation. The Brazilian real is depreciating sharply, inflation has pushed up into two digits, the country has some of the highest interest rates in the world, and the investigation of a major corruption scandal around state oil company Petrobras has spread like a spiders' web to compromise many of its private contractors and suppliers. Companies are taking a battering, and doubts are rising over their ability to service high levels of corporate debt. How bad is it?

All the signs are that Brazilian companies are hurting. According to Debora Jalles, a director at credit rating agency Fitch, "declining demand, increasing unemployment, persistently high inflation and interest rates, depressed commodity prices, foreign exchange volatility and tight credit markets have collided to create a perfect storm, with Brazilian corporates smack in the middle". Among the companies in Brazil that Fitch covers, 53% have a negative outlook and only 6% have a positive one. Fitch expects credit downgrades to exceed upgrades by 10-to-1 this year, compared to 4.4-to-1 in 2015. It also expects there to be more corporate defaults, saying that sugar producer USJ and retailer General Shopping Brasil are among the companies at risk.

One sign of trouble is that equity and bond markets have gone eerily quiet. Back in booming 2010 almost US$50bn was raised by companies through IPOs, convertible bonds, and follow-on share issuance. Last year the total was under US$5bn, and so far this year almost nothing is happening. In early February Bradesco, the country's second largest bank, cancelled a BRL3bn (US$757mn) share sale because of stock market volatility. New bonds sales to date have totalled US$680mn, the worst start to a year in the Brazilian bond market since 2003.

Put crudely, the problem is that with heavy debt burdens, Brazilian companies are finding it harder to raise money either for debt service or for new investment, because both operating profits and cash flow are down, and raising new capital is just getting more difficult. Debt levels have grown rapidly across both the public and private sectors of the Brazilian economy. Government debt is estimated to have grown to just over 66% of GDP and Alberto Ramos, head of Latin American research at Goldman Sachs, estimates that government annual debt service costs are running at over 20% of GDP (part of this debt carries interest at the high Selic rate, currently 14.25% per annum). The relatively good news is that only a small proportion of this government debt total, equivalent to around 2.4% of GDP, is denominated in foreign currencies.

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But there is also a second pile of corporate debt, estimated at an additional 63% of GDP. Most of this is in local currency, with a smaller amount in dollars. The two categories partially overlap since a number of corporates are in fact state-owned enterprises like oil company Petrobras, and if they get into trouble they will ultimately need to be bailed out by the Brazilian taxpayer. Expressed in dollars, Brazil's corporate debt mountain peaked at over US$1trn in 2014 but has since come down to around US$850bn. The fall is attributed to the depreciation of the real, which has lowered the dollar value of the debt, and to the fact that many companies have lost the ability or the willingness to borrow additional amounts. On the government side Ramos says "the current debt picture is on an unsustainable path". Of course, government difficulties have big knock-on effects on private sector companies.

One measure of the sustainability of corporate debt levels is the ratio of net debt to a company's Ebitda, which is considered manageable at a multiple of 2.0 to 2.5x. However analysis of 141 Brazilian companies carried out by Morgan Stanley revealed the average was a worrying 3.4x. The bank's equity analysts concluded, "In five sectors – construction, oil and gas, transportation, basic materials and utilities – a combination of weaker debt ratios and greater exposure to the slowing economy implies greater debt-payback risk compared to other sectors".

A specific area of concern is the health of Brazil's banks, which are experiencing a knock-on effect from the difficulties encountered by their customers. In December the 90-day non-performing loans (NPLs) rate rose to 5.3%, according to the Central Bank, the highest rate since 2012. Total bank loans grew by 6.6% in 2015, the lowest rate of expansion since 2008. Morgan Stanley equity analysts say they remain bearish on Brazilian banks and advise against buying shares in the belief that prices have bottomed out. As they put it "we think it is still early to step in as the worst of the asset-quality cycle is yet to come, earnings per share expectations and company guidance are too high, and macro fundamentals continue to deteriorate". Craig Botham, an emerging markets economist at Schroders, warns that "a lot of the problems are concentrated in the state-owned banks". He says: "They have been leaned on to do credit easing and it will get even worse now they are being leaned on to lend more to struggling small businesses."

“Brazil does not have a particularly good record for bringing companies successfully out of bankruptcy and getting them back on a growth path. The Brazilian Corporate Recovery Institute believes around 50% of the companies that sought court protection last year will probably go bankrupt this year, due to failed turnaround processes.”

In 2015 a total of 1,287 Brazilian companies, mainly oil and gas equipment suppliers, construction, and manufacturing companies, sought court protection from creditors. The total was up by 55% on 2014. According to credit consultancy Serasa Experian, bankruptcies were up by 30% in January. Serasa Experian attributed the rise to high interest rates, the deepening recession, and the deteriorating financial health of companies. The growth in distressed corporates has attracted an inflow of international restructuring consultancies. Salvatore Milanese, a former KPMG executive who has set up his own consultancy, Pantalica Partners, estimates that this year Brazilian companies will be seeking to restructure some BRL150bn (US$37bn) worth of debts. He says they are likely to include mining firms, medium-sized banks and even some soya producers.

Brazil does not have a particularly good record for bringing companies successfully out of bankruptcy and getting them back on a growth path. The Brazilian Corporate Recovery Institute believes around 50% of the companies that sought court protection last year will probably go bankrupt this year, due to failed turnaround processes. The problem is that the courts move very slowly and the regulatory framework makes it difficult to lend new money to companies emerging from a troubled period. In January existing creditors of construction company Grupo OAS blocked a BRL800mn recovery loan from Brookfield Asset Management of Canada, which would have allowed the company to emerge faster from bankruptcy. Ricardo Knoepfelmacher, a restructuring consultant who was involved with the BRL46bn restructuring of Eike Batista’s Grupo EBX, says it is best to try and avoid formal bankruptcy filings altogether and to put together private deals.

REGION

Knocking the NOCs

With oil and gas prices at record lows, Latin America’s national oil companies (NOCs) are losing money and facing high levels of economic stress. Mexico’s Pemex and Brazil’s Petrobras – which usually top the rankings as the largest companies in Latin America – are having a particularly tough time. Here we summarise how they are faring.

On 8 February Mexican President Enrique Peña Nieto appointed José Antonio González, until then the head of the national social security institute, as the new head of Pemex, unexpectedly replacing Emilio Lozoya Austin, who had been running the company for the preceding three years. It is clear that the Lozoya years have not been deemed a success. The plan had been for Pemex to metamorphose from an overstaffed and high-cost monopoly into a leaner, more efficient, and more commercial company, operating in a mixed hydrocarbons market alongside private sector players. But no-one had expected such a sharp slump in oil prices during the desired transition. Pemex has in fact not transformed itself, the government has not reduced its dependence on the state oil company for fiscal revenues, and, despite investor interest, the development of high-cost non-conventional hydrocarbons has been paused in the hope of better times.

Pemex has been losing money on a massive scale. After-tax third quarter 2015 losses were US$9.9bn. Full-year 2015 results are due for release in late February and are widely expected to be bad. Moody’s has downgraded Pemex’s credit rating from A3 to Baa1, which leaves it only two notches above the minimum investment grade level. There are signs that Pemex's troubles are impacting Mexico's wider financial profile. The cost of 5-year default protection on Mexican sovereign bonds has gone up twice as fast as other comparable sovereigns with BBB+ ratings from Standard & Poor's. Alejandro Padilla of Grupo Financiero Banorte has said that worries over Pemex's financing gap are "being reflected in the risk premium we're seeing for Mexico".

The company owes an estimated US$100bn. Moody's says it expects the total debt/Ebitda ratio to worsen dramatically this year to over 10x. The ratings agency has also said that "Pemex would need to raise about US$23bn in 2016 to cover all spending, including maturing debt, if it reduces operating costs by 10% but does not adjust its roughly US$15bn planned capital for the year". That kind of money will only be available with explicit government support, which finance minister Luis Videgaray says will be forthcoming – but only if the company comes up with an acceptable restructuring plan. Videgaray has said Pemex should "concentrate on what's profitable and let the market do other activities". Looking forward, new ceo González will face major challenges. He will have to take intensely unpopular decisions at a politically difficult time, with Congress and politicians facing important state elections in the middle of this year and planning for the next presidential race in 2018. The financial position may be even worse than thought, since Pemex is believed to have substantial unfunded pension liabilities.

"As both a significant oil exporter and as an importer, Petrobras has been able to offset some of its upstream losses with higher net earnings from its downstream operations. But despite that, the business clearly remains under pressure."

The Petrobras story is similar but different in some key respects. While Pemex has generally been seen as a troubled company that has also had a history of corruption issues, in the case of Petrobras it is the corruption story which now overshadows the state of the business itself. This is due to the spectacular *lava-jato* or 'car-wash' scandal centred on Petrobras which has dominated Brazilian politics for over a year now, and led to multiple waves of investigations into a network of bribery, kickbacks, and party political contributions.

Setting that to one side Petrobras also has experienced big losses, and it struggles with a heavy debt burden. As both a significant oil exporter and as an importer, Petrobras has been able to offset some of its upstream losses with higher net earnings from its downstream operations. But despite that, the business clearly remains under pressure. The Brazilian ministry of finance estimates that the state oil company's troubles subtracted two percentage points from GDP in 2015. Petrobras shares have steadily plummeted, with market value dropping 90% since its 2008 peak, to around US$18bn now. The last available results for the third quarter of 2015 show a loss of BRL3.759bn (around US$943m). Total debt at the end of September was estimated at around US$130bn, and Petrobras is widely described as the world's most indebted oil company. The government recently admitted it may need to bailout Petrobras by injecting new capital.

In this context it is clear that chief executive Aldemir Bendine and the government need to come up with an entirely new strategy for the company. The political fall-out from *lava-jato* is such that downsizing, restructuring, or, in the extreme case, some kind of break-up appears inevitable, with various activities (such as power generation) likely to be sold off.

The government also appears to be considering reducing the company's role in developing the pre-salt offshore deposits. Current legislation requires

Petrobras to have a minimum 50% share in pre-salt licences, partnering with international oil companies (IOCs). But Royal Dutch Shell, which after its takeover of BG has emerged as a major stakeholder in Brazil's offshore industry, has suggested that IOCs such as itself be allowed a greater percentage stake. The IOCs believe oil prices will eventually recover and, even in current times, may be willing to invest in new development. Royal Dutch's chief executive Ben van Beurden says: "I don't see how this is not beneficial for Brazil" since the government would benefit from higher royalty payments and from investments that cash-strapped Petrobras would otherwise not be able to make.

Another way of helping Petrobras is also under discussion. This would involve state-run banks swapping their loans to the company for an increased equity stake. Publicly owned banks BNDES, Banco do Brasil, and Caixa Económica Federal are said to be involved. A BNDES source quoted by *Reuters* news agency says: "Ideally we would like to convert the loans into stocks and have the freedom to sell them later when its value improves".

REGION

Corporate Radar

"Global bank HSBC faces a new and unprecedented legal challenge filed by US victims of Mexican drug violence in a Texas court..."

América Móvil profitability facing a squeeze. Mexico-based telecoms giant América Móvil reported a six-fold increase in profits to MXN15.7bn (US$835mn) in the fourth quarter of 2015. The improvement was largely due to a sharp reduction in exchange rate losses, which reduced financial costs. Profits represented MXN0.24 per share or US$0.28 per ADR. In contrast Ebitda, which many analysts see as a better indication of underlying profitability, was MXN63.9bn or US$3.39bn in the quarter, down 2.9% on the same year-earlier period. Fourth quarter revenues grew by 0.6%. Mobile data revenue grew by 10%, fixed line data was up by 7.9%, and pay-TV revenues grew by 6.6%, the company said. For 2015 as a whole profits were down by 24% to MXN35.05bn. In Mexico, the company's home market, which accounts for around 30% of total income, it is facing increased competition from AT&T and Telefónica, and a tighter regulatory regime. América Móvil said that at a global level it was a smaller company than its two main competitors, but that in spite of that they were effectively being subsidised by it on the local market, due to the nature of Mexico's "asymmetric regulation" which gave them an extra advantage over the incumbent. Separately América Móvil said it is likely to reduce its capital investment programme by around 25% in 2016 to MXN7.5bn-MXN8bn, given that it has completed most of the modernisation of its network. "Much of what needed to be done has been done, and that's why we are reducing the intensity of out investment programme over the next five years" said finance director Carlos García Moreno.

HSBC faces new drug money case. Global bank HSBC faces a new and unprecedented legal challenge filed by US victims of Mexican drug violence in a Texas court. The bank in 2012 agreed to pay the US authorities a US$1.9bn fine, after admitting that it failed to adequately supervise its Mexican subsidiary, which laundered US$881m of drug trafficking money for the Sinaloa drug-trafficking cartel. There the matter seemed to rest. But now a group of US victims of drug violence are suing HSBC saying that it can be held liable under the terms of the US anti-terrorism act, which says survivors of those killed in terrorist incidents may sue for damages. The plaintiffs include relatives of Jaime Zapata, a US Immigration and Customs

Enforcement (ICE) special agent murdered in northern Mexico in 2011, and of Lesley Enrique Redelfs, a US consulate employee who was shot dead in Ciudad Juárez in 2010. They argue that by laundering drug cartel money "HSBC materially supported the terrorist acts of cartels". Whether the case prospers is likely to depend on a number of key legal points. One is whether drug gangs can be considered terrorist organisations under US law – to date they have not. A second is the extent of liability: Redelfs for example was reportedly killed by the Juárez cartel, to which HSBC was not connected, as the bank was only known to be laundering money for the entirely separate Sinaloa organisation. If successful, however, the case could have far-reaching consequences as it would mean that many US organisations that have handled drug money, even indirectly, could be held liable for drug-gang violence. The list could include brokers, real estate agents, car dealers, and even drug users. HSBC has said it will "vigorously" defend itself and that it remains "committed to combating financial crime".

SPECIAL FOCUS

PERU

The real problems of the pensions system(s)

"A new set of mortality tables and a new law that gives Peruvians who are members of the Sistema Privado de Pensiones (SPP – the private pensions system) free access to their retirement savings when they reach 65 years of age have made pensions a political issue in an election year. The real challenges (and opportunities) have been much less publicised..."

A new set of mortality tables and a new law that gives Peruvians who are members of the Sistema Privado de Pensiones (SPP – the private pensions system) free access to their retirement savings when they reach 65 years of age have made pensions a political issue in an election year. The real challenges (and opportunities) have been much less publicised.

Over recent weeks, two developments have generated a lot of news in relation to the Sistema Nacional de Pensiones (SNP – the basically Defined Benefit public sector pensions system) and, to a greater extent, the Sistema Privado de Pensiones (SPP – its Defined Contribution counterpart).

One of these developments is the publication in November 2015 by the Superintendencia de Banca, Seguros y AFP (SBS) of new mortality tables. These mortality tables show that life expectancy for Peru's pensioners has risen from 84 to 87 for men and from 87 to 90 for women. They are used to calculate monthly pensions, and took effect from January. Commentators have suggested that the effect may be to reduce monthly pension payments by 3%-11%, as pensioners will typically be receiving the money for longer. Some observers have suggested that employees' contributions to the SPP, which (along with much of the financial sector) is overseen by the SBS, should be increased from the current 10% of gross income to compensate. It may be that the revised mortality tables have implications for the determination of pensions that are paid by the SNP as well.

The other development is the passage in December 2015 by Peru's Congress of a new law that allows people who save for their retirement through the four Administradoras de Fondos de Pensiones (AFPs – pension fund administration companies) which constitute the SPP to withdraw 95.5% of their savings from the system when they turn 65 (or earlier in the case of terminal illness). The remaining 4.5% must be contributed to Peru's EsSalud public healthcare system. The new law allows people who are covered by the SPP to use up to one quarter of their accumulated savings as a down payment for a mortgage on the purchase of a first home.

Relative to the previous arrangements, which basically require that retirees purchase annuities with their accumulated savings, this represents a major liberalisation of the SPP. In advance of the general elections that are due to take place in April 2016, the new law has been as an irresponsible and populist measure, and one that threatens the integrity of the entire SPP.

However, it is far from certain that retirees' increased access to their savings will result in a massive outflow from the SPP. Only 1.5% of the 5.99m people who are covered by the SPP are aged over 65 years. People who are aged between 61 and 65 years account for another 2.7%, while a further 4.9% are aged between 56 and 60 years. Over 90% of the people covered by the SPP are more than a decade away from retirement. **[Chart 1].** Anyone who reaches retirement and who is depending on the money that has been accumulated in their AFP account could well decide that they are better off buying an annuity – as per the former arrangements. The alternative is to bear all the risk associated with choosing suitable investments. The vast majority of the US$35bn in assets under management (AUM) of the AFPs at the end of January 2016 were held in moderate risk balanced funds. Less than US$6bn was held in higher risk capital growth funds. It appears that most people who are covered by the SPP are fairly risk averse in relation to their retirement savings. **[Chart 2].**

Chart 1: Numbers of members of the AFPs - End of January 2016

		Age Group											Total	Gender Balance	% of Total
		<21	21-25	26-30	31-35	36-40	41-45	46-50	51-55	56-60	61-65	>65			
Habitat		**128811**	**270381**	**149818**	**63681**	**35997**	**20557**	**12790**	**8269**	**4980**	**2686**	**1714**	699684	100	11.68
	Men	73665	146038	82075	35557	19234	10638	6697	4663	3030	1708	1116	384421	54.94	
	Women	55146	124343	67743	28124	16763	9919	6093	3606	1950	978	598	315263	45.06	
Integra		**40**	**121293**	**264679**	**336336**	**359854**	**317494**	**243957**	**170260**	**111704**	**59712**	**29964**	2015293	100	33.65
	Men	25	71529	157226	201206	218777	193835	151946	109661	75601	42797	22497	1245100	61.78	
	Women	15	49764	107453	135130	141077	123659	92011	60599	36103	16915	7467	770193	38.22	
Prima		**2133**	**151397**	**236399**	**253571**	**234475**	**198571**	**145739**	**102855**	**69278**	**38522**	**21534**	1454474	100	24.29
	Men	1291	86620	132016	147898	146179	128526	97494	71179	49791	28945	16912	906851	62.35	
	Women	842	64777	104383	105673	88296	70045	48245	31676	19487	9577	4622	547623	37.65	
Profuturo		**135**	**91966**	**226462**	**296647**	**308157**	**291185**	**232519**	**164189**	**108099**	**60923**	**38367**	1818649	100	30.37
	Men	108	58631	145809	190309	199680	191059	156814	113803	77885	45731	29441	1209270	66.49	
	Women	27	33335	80653	106338	108477	100126	75705	50386	30214	15192	8926	609379	33.51	
Total		**131119**	**635037**	**877358**	**950235**	**938483**	**827807**	**635005**	**445573**	**294061**	**161843**	**91579**	5988100	100	
	Men	75089	362818	517126	574970	583870	524058	412951	299306	206307	119181	69966	3745642	62.55	
	Women	56030	272219	360232	375265	354613	303749	222054	146267	87754	42662	21613	2242458	37.45	
% of total in each age group		**2.19**	**10.60**	**14.65**	**15.87**	**15.67**	**13.82**	**10.60**	**7.44**	**4.91**	**2.70**	**1.53**	**100**		

Source: SBS

Chart 2: Assets Under Management (AUM) of the AFPs, End of January 2016 (US$mn)

	Habitat	Integra	Prima	Profuturo	
	Habitat Group	Sura Group	Credicorp Group	Scotiabank Group	Total
Type 1 (Capital Preservation Funds)	27	2,046	1,476	1,215	4,764
Type 2 (Balanced Funds)	365	9,893	7,532	6,573	24,363
Type 3 (Growth Funds)	56	2,169	2,028	1,531	5,783
Total	**448**	**14,107**	**11,036**	**9,319**	**34,910**
Memo: Of which foreign investments	*178*	*5,943*	*4,590*	*3,914*	*14,626*

Source: SBS

Further, the concept of using a portion of retirement savings as a down payment for a home works well in other countries. It has, for instance, long been a key feature of Singapore's Central Provident Fund (CPF) system. SPP savings that are used for down payments would essentially remain within the system and the AFPs could probably charge an administrative fee.

It is also nearly certain that the amount of money to be withdrawn from the SPP would be nothing like 25% of the total. Money would only be withdrawn where (1) a person had accumulated enough savings with his/her AFP that one quarter of the sum would make a difference in buying a first home, and (2) he/she was actually looking to buy a first home. The average person who is covered by the SPP has less than US$6,000 in savings with their AFP.

High informality in the labour market and low coverage

The discussion about the revisions to the mortality tables and the new law are irrelevant to the majority of the 20m or so Peruvians who are of working age. This is because the SPP and the SNP combined cover fewer than half of these people (and less than one third of the entire population). Further, only 1.58m of the 4.00m people who were covered by the SNP at the end of 2014 and about 2.54m of the 5.91m people who were covered by the SNP at the end of September last year were actually making contributions. Meanwhile, considerably fewer than 1m people are actually receiving pensions. The SNP is paying benefits to about 529,000 people; the SPP to about 160,000 (although this number has been growing at a double-digit rate).

> "In essence, the high level of informality in Peru's workforce means that the coverage of, and contributions to, the SNP and the SPP are low."

In essence, the high level of informality in Peru's workforce means that the coverage of, and contributions to, the SNP and the SPP are low. There are severe restrictions on entitlements to pensions from the SNP (with most people having to contribute for at least 20 years before they can receive a retirement benefit). A recent Ipsos survey found that only around 40% of Peruvians have trust in the long term solvency of the SNP and the SPP.

The burgeoning deficit of the SNP

In the meantime, both the SNP and the AFPs within the SPP face other challenges. In the case of the SNP, the main problem is financial. Contributions from employees have been growing, but have been much less than the amounts being paid out in pensions. In 2014, for instance, contributions from employees amounted to PEN2,836m. Even when added to PEN441m in transfers from the SNP's US$4,375m reserve fund, this was much less than pension payments, which had increased to PEN5,144m. The government had to pay in PEN2,836m (a little under US$800m at January 2016 exchange rates, but less than that at the time).

The Defined Benefit SNP has been underfunded for some time. Over the course of 2014, the total assets of the SNP increased from PEN13,292m to PEN14,642m. Liabilities – mainly the present value of pensions that will have to be paid in the future – increased from PEN83,382m to PEN91,206m. At the end of that year, the net liabilities amounted to PEN91,206m (US$25,537m at January 2016 exchange rates).

Financial market blues and poor investment performance

In the Defined Contribution SPP, the investment risks are borne by the employees who are contributing to the system. Data from the SBS confirms that the funds of the AFPs have been exposed to the volatility in global markets. Over the year to the end of September last year, the balanced funds that account for about 70% of the total sum contributed by employees had, on average, produced a real return of -2.8%. Over the 22 years since the system had been established, the balanced funds have produced an average real annual return of +7.2%.

High costs

Employees have traditionally paid administrative fees to their AFP that have been based on the employee's own income. The rate is determined by way of a biennial Dutch auction. Each of the four AFPs offers an administrative fee rate. The AFP with the lowest rate becomes the default provider for employees who join the SPP for the first time and who do not actively select an AFP. At around 1.8%, the annual fees are high by global terms. In Australia, for instance, costs for the most competitive Defined Contribution superannuation funds are 0.6%-0.7%.

The government recognises that the costs are high and that the current arrangements do not provide an incentive for the AFPs to deliver better service or investment performance. Since 2013, a part of the administrative fee has been set as a percentage of AUM rather than as a percentage of employee's income. By 2023, the fee will be set entirely as a percentage of AUM.

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Limited competition

Various commentators suggest that the poor investment performance (in the recent past) and high costs are indicative of a lack of competition within the SPP. They have argued that employees who are contributing would be better served if the system were opened up to competition from banks, insurance companies, and investment firms. In terms of AUM and numbers of contributors, Profuturo (a part of Canada's ScotiaBank group) and Integra (a part of the Colombian Sura group) are roughly the same size, each accounting for about one third of the market. Prima (a part of the Peruvian Credicorp group) is in third place, accounting for about one quarter of the market. Habitat, which is owned by the eponymous Chilean AFP, accounts for the remainder. The Chilean firm is listed on the Santiago Stock Exchange. US life insurance group Prudential Financial is completing the purchase of around 40% of the Chilean firm from Inversiones La Construcción (ILC), the investment arm of the Chilean Construction Chamber.

Over the recent past, relatively few employees have sought to change their AFPs. In the first nine months of 2015, a net 1,333 people left Integra. The main beneficiaries were Habitat and Prima, who each gained around 680 people. At Profuturo, the number of departures (4,352) was virtually the same as the number of entrants.

Opportunities

It remains to be seen how much the pensions are adjusted as a result of the new mortality tables. It also remains to be seen how much money is moved out of the SPP as a result of the liberalisation of access to funds by retirees. After the election, a more settled political environment should make it easier for the government to consider positive reforms to both the SPP and the SNP.

Over the long-term, both the SPP and the SNP should benefit from two factors. One is demographics. Around 27% of the population is aged under 15. In the next decade and a half, the number of Peruvians who are of working age will surge. Both the SPP and the SNP can expect strong growth in the numbers of contributors. The second factor is the (lack of) coverage by the two pension systems. Any real success by the government in reducing the informality of the labour market should also result in a rise in the numbers of contributors. Larger numbers of contributors should help reduce the deficit of the SNP and improve the cost efficiency of the SPP.

A glance at Peru's two pension systems

Peruvian employees have a choice in relation to their pension arrangements. They may join the Sistema Nacional de Pensiones (SNP – the public sector pensions system, which is run by the Oficina de Normalización Previsonal [ONP]). Alternatively, they may join one of the four Administradoras de Fondos de Pensiones (AFPs – pension fund administration companies) which constitute the Sistema Privado de Pensiones (SPP – the private pensions system). Contributions for the ONP are collected through the Superintendencia Nacional de Aduanas y de Administración Tributaria (SUNAT – the national tax agency). The ONP is overseen by the Contraloría General de la República (CGR – the national budget office). The AFPs are regulated by the Superintendencia de Banca, Seguros y AFP (SBS – the agency which oversees the country's financial sector).

If employees do not make a choice between the SNP and the SPP, they are assigned to the latter by default. They may switch from the SNP to the SPP but, in general, not in the other direction. Employees may switch between the AFPs. Some self-employed people may join the SNP. There are no restrictions on self-employed people joining the SPP.

"If employees do not make a choice between the SNP and the SPP, they are assigned to the latter by default. They may switch from the SNP to the SPP but, in general, not in the other direction."

Whether they are employees or self-employed, people who are covered by the SNP make a contribution that is equivalent to 13% of gross earnings. The minimum monthly wage defines the minimum contribution that may be made. There is no maximum wage that defines contributions. People who are covered by the SPP pay 10% of gross earnings, plus an additional 1.87% of gross earnings to cover administrative fees and another 0.96% to cover disability and survivor insurance. A maximum monthly wage (equivalent to a little over US$2,000) applies. In neither case do employers make contributions.

The SNP pays an old age pension to someone who reaches 65 years of age and who has been contributing for at least 20 years. Men and women can, respectively, retire and take a pension from age 55 if they have been contributing for 30 years or from age 50 if they have been contributing for at least 25 years. The SNP also provides a disability pension for someone who has been contributing for at least 36 months (including 18 months out of the last 36) and a survivor pension to an eligible dependent of someone who was entitled to receive a pension at the time of his/her death. The SNP also provides a funeral grant to someone who has been contributing in the months immediately before his/her death. Supplementary payments are made if the pensioner needs a full-time carer.

The SPP is much less restrictive in terms of the length of time over which someone needs to contribute. Someone may draw a pension from age 65 or from any age if his/her account has accumulated assets that will replace 50% (or more) of indexed earnings over the last 10 years. Regardless of the assets that have been accumulated, the SPP will pay a guaranteed minimum pension to someone who is at least 65, who was born before 1946 and who has made 20 years of contributions on earnings that are at least equal to the minimum wage. The SPP pays a disability pension to anyone who loses half of their earnings capacity (as assessed by a medical committee of the SBS). The SPP also pays a survivor pension where the deceased received, or was entitled to, a pension at the time of his/her death.

Old age pensions that are paid by the SNP are basically Defined Benefit in nature. The size of the payment depends on the recipient's age, his/her average earnings over a specified period prior to retirement, whether he/she is taking a pension prior to the normal pensionable age, and whether he/she

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has dependents. Supplementary payments to full-time carers are equal to the minimum wage. Pensioners may continue in paid employment provided that their total monthly income does not exceed a prescribed amount. Disability benefits are determined in relation to the length of contribution and salary. Survivor pensions are generally half of the pension that the dead pensioner would have been entitled to receive.

Conversely, the old age pensions that are paid by the SPP are basically Defined Contribution in nature. At the time of retirement, the money that has been accumulated could have been used to purchase an immediate annuity or a deferred annuity with periodic withdrawals. Under the new law, retirees have free access to all their savings when they reach 65. If the retiree is entitled to a guaranteed minimum pension, the government makes up the difference between the money that has been accumulated and the money that is needed for the pension. The size of disability benefits depends on the insured's average monthly earnings and the degree of the disability. Survivor pensions are based on the insured's average monthly earnings and are topped up with life insurance in the event that the deceased has not accumulated enough money within the SPP.

Depending on their age, people who are covered by the SNP may choose to hold their retirement savings in one of three types of funds that are offered by the AFPs. Type 1 funds emphasise capital preservation. These funds must hold at least 90% of their assets in fixed income investments. Cash/short term fixed income assets can account for no more than 40% of assets, while derivatives can account for no more than 10%. Type 2 funds are balanced. These funds can hold no more than 45% of assets in equities. Limits apply to long term fixed income (75%), cash/short term fixed income (30%), and derivatives (10%). Type 3 funds emphasise capital growth. These funds can hold up to 80% of assets in equities and up to 20% in derivatives. Limits apply to long term fixed income (70%) and cash/short term fixed income (30%). People who are aged over 60 are not allowed to hold a Type 3 fund and will normally be transferred by their AFP to a Type 1 fund unless they have expressly chosen a Type 2 fund. People who are covered by the SPP but who do not choose a type of fund will be transferred to a Type 2 fund by default.

Peru has a population of about 30.45m people. Some 66% of the population is of working age (15-64 years). Another 27% are under 14. One of the major limitations of the entire social security system is that it covers less than half of all people who are of working age. At the end of 2014, the SNP served just over 4.0m people, including nearly 1.6m who were actually contributing. It also provided benefits to 529,000 pensioners. As of the end of September last year, the SPP served just over 5.9m people, including a little more than 2.5m contributors. The SPP paid benefits to 158,000 pensioners. The numbers of members have been growing faster within the SNP than within the SPP. However the number of pensioners has been growing a lot faster (from a lower base) within the SNP.

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