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CONTENTS

**LEADER** 1
Clouds over Nafta
**SPECIAL FOCUS**
**Mexico** 4
Trump detonates North American car wars
**REGIONAL ECONOMY REVIEW**
**Region** 6
IMF more cautious
**Argentina** 8
Green shoots
**Brazil** 9
Reforms on the radar
**Cuba** 10
Fiscal acceleration ahead of 2018 transition
**Chile** 13
Central Bank shifts to monetary easing
**Trinidad & Tobago** 15
Slightly brighter prospects ahead for 2017
**Venezuela** 16
Official shake-up as recession deepens
**REGIONAL BUSINESS REVIEW**
**Region** 18
Tolerance for corruption is fast eroding in Latin America
**Peru** 21
The cost of Odebrecht
**Panama** 22
Another Odebrecht blow
**Venezuela** 23
The cost of corruption – a big unknown
**Region** 24
Corporate Radar

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# Clouds over Nafta

**The North American Free Trade Agreement (Nafta), in place for almost a quarter of a century, is going to be renegotiated, or abandoned. That much seems clear from Donald Trump's first weeks as US president, which he has used to achieve a radical deterioration in bilateral relations with Mexico by committing his administration to building a border wall, deporting undocumented Mexican workers, and renegotiating trading arrangements.**

To try and understand what may happen next, it is useful to make a distinction between Nafta – the free trade agreement struck between the US, Canada, and Mexico in 1994 – and the close integration that has developed over the years between the three economies. One may have helped to cause the other, but they remain separate things. Nafta could disappear quite quickly. On the other hand, the close integration between the three economies, built up over decades, may also change, but is likely do so at a much slower rate. In fact, under the terms of the Nafta agreement (Article 2205), governments can withdraw simply by giving six months' notice of their intention to do so (on the surface at least, an easier exit route than the lengthy and legally complicated process of leaving the European Union, as the UK has discovered). Some analysts believe that having railed against Nafta so long and so loudly during the election campaign, President Trump, at the very least, will try to get rid of the name. "I think they want to retire the name Nafta, say they got rid of it, and then put it in the history books" said Gary Hufbauer of the Peterson Institute for International Economics (in reference to officials in the Trump team).

The key point about the high level of economic integration between Mexico, the US and Canada is that it is big, it is embedded in the North American business culture, and it can't be dismantled overnight.

- Trade flows between the three countries reached US$1.1trn in the year to November 2016. This represents almost twice the value of US trade with China, and ten times the value of US trade with the UK.

- Mexico is the US's third largest trade partner. Mexico's total exports in 2015 were worth US$380.6bn, and US$309bn, or 81.3% of them, went to the United States.

- Imports totalled US$395.2bn and US$187.3bn or 48.2% came from the US.

- As a result, trade across the Mexican-US border comfortably exceeds US$1bn a day.

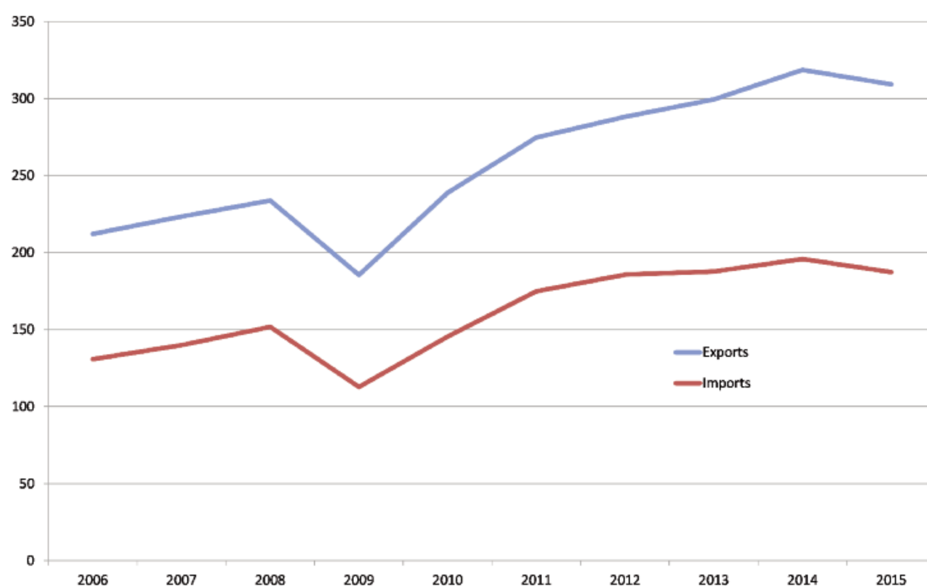
- A lot of infrastructure and investment in productive capacity and logistics by world-class companies has been built up on both sides of the

frontier to support that level of trade. Even if new tariff or non-tariff barriers are rapidly put in place to throw integration into reverse, they will take time to have an effect.

Trump is widely believed to have a mercantilist view of the world. He conceives of trade as a win-lose, or zero-sum game. Because the US runs a deficit in its bilateral trade with Mexico, therefore it must be losing and Mexico must be winning. Crudely, he wants to switch that round. The counter view is that trade is often a win-win, rather than a win-lose relationship, and that integration brings benefits to both countries. **On average, Mexican exports to the US contain 40% US-made content.** Manufacturing processes frequently involve components travelling back and forth across the border. **It is calculated, for example, that around 5m US jobs depend on exports to Mexico**. A trade war would hurt Mexico, but it is also likely to hurt the United States. Interestingly, it may hurt the United States in some of the "rust belt" areas where there was support for Trump. One example: **the Detroit metropolitan area exports more than US$17bn a year to Mexico.**

**The graph that Donald Trump wants to change**

*Mexican trade with the United States, US$bn*




***Source:*** *International Trade Centre/WTO*

Beto O'Rourke, a Democratic Party member of Congress for El Paso in Texas, has highlighted the mutual interdependence of the bilateral relationship. "It is not as if Mexico goes away if we wall it off. At best, we push it into the arms of some other trading partners. At worst, we trigger a destabilising crisis. We really will have a problem if Mexico's economy collapses" he has said.

So what are the options facing Mexico's President Enrique Peña Nieto? He does have a weaker negotiating hand, simply because of the realities of the situation. To put it in negative terms, because of its sheer size and power, the US can hurt Mexico much more than Mexico can hurt the US. And if the Trump administration is determined to head in a protectionist direction, Mexico does not ultimately have the power to stop it. That said, there are a number of steps the Mexican government can take to try and minimise the damage and adjust its own economic development model.

A first point to note is that after the initial fusillade of tweets, executive orders to build the wall and tighten immigration controls, along with the cancellation of the planned end-January Trump – Peña Nieto summit, it seems some kind of Nafta renegotiation phase has now begun. Contacts between the two governments have not been broken off, despite many analysts describing this as the worst point in bilateral relations in a generation. At the beginning

of February, Mexico's foreign and economy ministries published a joint statement marking the beginning of a 90-day consultation period with the private sector on renegotiating Nafta. The 90 days would "start simultaneously with the internal process being carried out by the government of the United States" the statement said.

While there has been little official information on what that "internal process" might be on the US side, trade economists point out that under existing legislation the US president can exercise fast track authority to negotiate a new trade agreement, providing he gives Congress 90 days' notice of his intention to do so. Trump could therefore be following a twin-track policy. One track would be to scrap Nafta entirely, setting the scene to use fast-track authority to negotiate new and separate bilateral trade deals with Mexico and Canada. The other track might be to seek a tripartite renegotiation of Nafta to secure terms more acceptable to the US.

One potential response by Mexico is simply to fight its free trade corner as vigorously as possible, invoking the rules of Nafta and the World Trade Organisation (WTO). In a speech on 2 February Peña Nieto did just that, saying his country was "doubling its bet" on having an open economy. That policy had shown Mexican products were able to compete in price and quality with the rest of the world, he said. While not stated explicitly in the speech, this means Mexico is likely to challenge the legality of some of Trump's trade proposals, on the grounds that they are discriminatory, or against WTO rules. This may not stop them happening, but it will increase the diplomatic and economic cost to the US of enforcing them.

Mexico has some tactical experience in trade disputes with the US. In a dispute over the liberalisation of road haulage in Nafta, Mexico applied countervailing tariffs to a series of products, carefully selected to hurt the constituencies of the more protectionist members of the US Congress.

A second response is to diversify trade. This is a sensible strategy, but will take time. It will also be hard to replace the nearshoring advantage of close geographic proximity between Mexico and the US. One possibility is to increase trade with China, which might send a powerful political message to Washington. China was Mexico's third largest trade partner in 2015. According to Shawlin Chaw of consultancy Control Risks, "The mainland is a natural choice, due to its economic power and in return, Beijing will be able to increase the international market for Chinese exports and diversify its sources of raw materials".

However, there are limits to such a pivot to China. One is the very low starting base. Mexico exported US$4.9bn worth of goods to China in 2015, equivalent to only 1.5% of its exports to the US in the same year. A second problem is that while China is interested in buying primary commodities, it has a much more protectionist stance on the more sophisticated manufactured goods that Mexico now produces. China and Mexico have been rivals in the past, competing for access to the US market, so finding a mutually beneficial trade relationship between them may be difficult. Another possibility may be to turn to Latin America, particularly to fellow Pacific Alliance members (Chile, Peru and Colombia) or to a large economy such as Brazil, with which Mexican trade has traditionally been low. Here too, the challenge will be to find a fit between the two economies and to overcome high transport costs.

A third response might be to develop and strengthen Mexico's domestic market. While Mexico's middle classes have expanded in the last 15 years, they have done so mainly in the north and centre of the country, leaving large pockets of poverty in the south. Mexico's record on poverty reduction is not impressive. According to the latest available World Bank figures (for 2014), 53.2% of the population (over 60m people) were classified as poor, an increase from 49% in 2008. It is conceivable that more effective poverty

reduction might bolster domestic demand and allow a reallocation of resources from export to home markets.

And then there is the politics. In January, President Peña Nieto's approval rating dropped to a historic low – for any Mexican president – of 12%, according to a survey published by newspaper *Reforma*. Corruption, human rights violations, a sluggish economy and unpopular petrol price increases all took their toll. It is possible, however, that one single decision – Peña Nieto's decision to cancel his planned meeting with Donald Trump at the end of January – has changed the trend, at least for now. A wide group of Mexican political parties and business leaders rallied round what they saw as Peña Nieto's assertion of national dignity in the face of Trump's bullying tone. With significant state-level elections due in the middle of this year, and the presidential elections looming in 2018, the stand-off with the US may be altering Mexico's political dynamic. This does not change the country's economic dependence on the US, but it does suggest that Peña Nieto and other political leaders may see a domestic political advantage in taking a harder line in trade negotiations.

## SPECIAL FOCUS

### MEXICO

## Trump detonates North American car wars

**As candidate, as president-elect, and now as president, Donald Trump has insisted that automobile industry jobs, allegedly snatched away by Mexico under the Nafta free trade agreement, must be brought back home to the US. A fusillade of tweets in January singled out big automotive companies and threatened them with punitive tariffs if they failed to bring jobs back north of the border. At least one, Ford, appeared ready to toe the new line, announcing the cancellation of a US$1.6bn plant planned for San Luis Potosí. Others wavered. Here, we look at some of the issues, and how things might play out for the auto sector for the rest of this year.**

Trump's *Twitter* onslaught kicked off in January. He threatened a range of carmakers operating in Mexico with "big border taxes" if they didn't move production back to the US. Trump at different times has spoken of slapping a 35% import tariff on Mexican-made automobiles, or of a 20% border tax on all Mexican exports to the US. General Motors (GM) was accused of sending its "Mexican made model of the Chevy Cruze to US car dealers tax-free across the border. Make it in the USA or pay big border tax!", Trump tweeted. Toyota was singled out for building the Corolla in Baja California, Mexico (although it actually assembles it in Guanajuato). Ford appeared to be the first to crumble, announcing it was cancelling its planned US$1.6bn plant for San Luis Potosí. Fiat Chrysler Automobiles (FCA) also looked as if it was shaking under the *Twitter* storm. Chief Executive Sergio Marchionne told reporters, "It's possible that if the economic tariffs imposed by the US administration on anything that comes into the United States are sufficiently large, it will make the production of anything in Mexico uneconomical and therefore we will have to move on. It is quite possible". But German carmakers such as BMW, Audio and Volkswagen said they had no plans to reduce their investments in Mexico.

It is, in any case, not a simple story. Ford's decision has come under quite a lot of scrutiny. Originally, the company had said it was transferring production of the Ford Focus from Flat Rock in Michigan to San Luis Potosí to save costs, investing US$1.6bn in a new factory and creating around 2,800 direct jobs in Mexico. But after the Trump onslaught, Chief Executive Mark Fields announced that the project was being cancelled, and that Ford would instead

invest US$700m in Michigan, creating 700 new jobs there. Fields said the decision was a "vote of confidence" in the pro-business environment being created by Trump. However, some analysts believe that the change, presented as a victory for the new US President, was actually motivated by other factors.

In particular, they cite falling US demand for smaller cars such as the Escort (the result in part of lower petrol prices) and Ford's decision to invest heavily in a new generation of electric and self-driving cars. The company says that it is investing US$4.5bn to 2020 in the development of electric vehicles. Analysts suggest that the people needed to build the cars of the future are more likely to be US-trained scientists and engineers, rather than Mexican manual workers. Ford will still build the Escort in Mexico (at an existing plant in Hermosillo), so it will continue to take advantage of Mexico's more competitive manual labour costs (Mexican autoworkers earn about US$5.50 an hour, compared to US$28 an hour in the US). According to Bernard Swiecki of the Centre for Automotive Research in Michigan, the decision "does make a heck of a lot of sense for business reasons. Political favour is an advantageous by-product."

Many auto sector analysts critical of Trump make the point that the integration of the North American automobile industry has been much more of a 'win-win', than a 'win-lose' story. Rather than seeing net job losses in the US and net job gains in Mexico, companies point out that there has been growth in both countries. Ford says it is currently employing 85,000 people in the US – an increase of 28,000 (or nearly 50%) on five years ago. In Mexico, it employs 8,800. Toyota makes the same point. It is planning to invest US$1bn in a new Mexican plant in Guanajuato, but says output at its Corolla plant in Mississippi will not be reduced, and no jobs will be moved from the US to Mexico. The point is also made that automation and the use of robots may be reducing labour intensity in the sector as a whole – and in effect causing more job losses than any competition from foreign cheap labour.

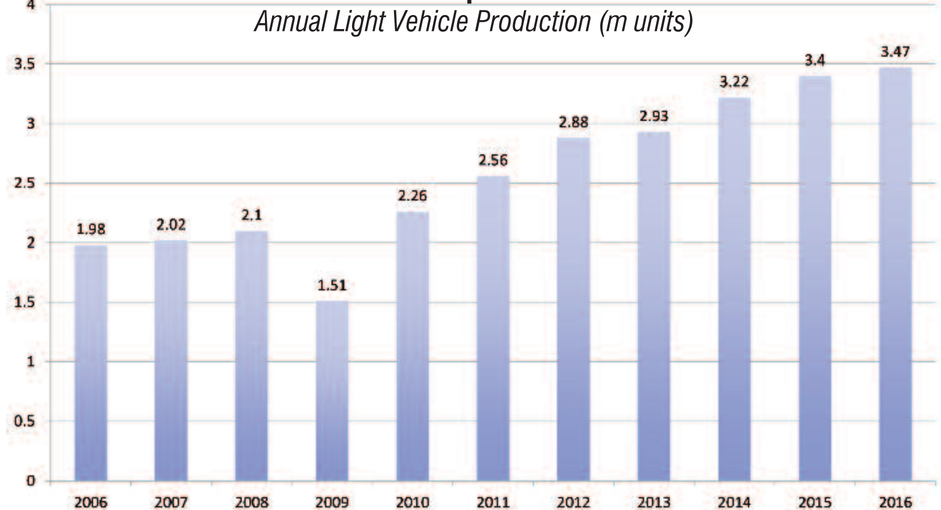
The prospect of a trade war over cars is a serious threat to Mexico, not least because of the industry's importance to the country. Mexico is now the seventh-largest carmaker in the world. The auto sector employs about 1.7m people directly and indirectly. Raymundo Tenorio, director of the finance programme at Tecnológico de Monterrey, says that the current crisis could be a first example of the difficulties Mexico will face in a protectionist era ushered in by Trump. "The Republican government and Donald Trump are willing to negotiate any sort of tax incentives so that companies remain in the United States," he said.

Mexico's total exports in 2015 were US$532bn, and about 80% of that was shipped to the US market. Automobile and component exports to the US totalled around US$100bn in value. About 20% of all light vehicles produced in North America now come from Mexico. Much of the auto and auto-parts industry is clustered around four states in Central Mexico: San Luis Potosí, Queretaro, Aguascalientes, and Guanajuato.

The Asociaición Mexicana de la Industria Automotriz (AMIA), which represents the main carmakers in Mexico, says that despite the threats from Trump, it is maintaining its overall target to take production up to 5m vehicles by 2020. Planned investments in capacity expansion total around US$22bn: an impressive pipeline even if Ford's US$1.6bn is deducted from that total. Production in 2016 rose by 2% to reach an all-time record of 3.465m vehicles. Exports rose by 0.2% to 2.768m units. Just over 77% of exports went to the US, with the remainder being shipped to Canada, Germany, Colombia, Brazil, and China. Asked about Trump's threats to slap on punitive tariffs, AMIA representative Eduardo Solís said he would not speculate about the industry response other than to point out that such a measure would violate the terms of the Nafta agreement, and would also be at odds with World Trade Organisation (WTO) rules.

**Mexico: Will the car production boom end?**

*Annual Light Vehicle Production (m units)*




***Source:*** *El Economista*

It is still not clear how far Trump will go down the protectionist road, how severe the impact will be on the Mexican industry, and what realistic diversification or damage-control measures it may be able to take. An optimistic assessment came from Roy Campos of Consultora Mitofsky. He suggested that Mexico should develop other export markets and its own domestic market for cars. He argues that "sooner or later, because of the nearness of the border, the personal relationships, the human relationships, the Mexico-United States relationship is going to return to what it was, or even better than before." It therefore would make sense in the meantime to develop other markets. Others say that whatever the politics, Mexico remains highly attractive to the big car companies. According to Manuel Molano of the Instituto Mexicano de la Competividad (IMCO), "Mexico's comparative advantage isn't so much in its labour force or low wages, but rather its liberal trade relations with 44 countries. The United States is far less open than Mexico." Sergio Ornelas, organiser of the annual Mexico Auto Industry Summit, observes, "It would take at least five years to modify Nafta. Starting a trade war or leaving Nafta would be crazy. It could even cause a recession in the US itself".

## REGIONAL ECONOMY REVIEW

### REGION

## IMF more cautious

**In its latest outlook for Latin America & The Caribbean, the IMF has lowered its forecasts for regional growth in 2017-2018, citing "persistent weakness" in some of the largest economies, even as others continue to register moderate growth.**

The Fund identified three fundamental changes in the global landscape since its last outlook in October:

- **An anticipated shift in the US policy mix, higher growth and inflation, and a stronger dollar.** While US potential policy changes remain uncertain, the Fund noted, fiscal policy is likely to become expansionary, while monetary policy is expected to tighten faster than previously expected because of stronger demand and inflation pressures. As a result, the Fund now expects growth of 2.3% in 2017 and 2.5% in 2018 – a cumulative increase in GDP of ½ percentage point relative to the October forecast. The expected change in the policy mix and growth has led to an increase in global long-term interest rates, a stronger dollar in real effective terms, and a moderation of capital flows to Latin America, it observed.

- **An improved outlook for other advanced economies and China in 2017–2018,** reflecting somewhat stronger activity in the second half of 2016 as well as projected policy stimulus.

- **Some recovery in commodity prices, especially metal and oil prices,** on the back of strong infrastructure and real estate investment in China, expectations of fiscal easing in the US, and agreement among major petroleum producers to cut supply.

The impact of these global currents on Latin America is mixed, the Fund notes, and domestic factors continue to dominate for some countries.

Among the reasons for this mixed impact is that a positive boost from higher anticipated demand in the US could be offset by higher global interest rates and uncertainty stemming from possible changes in US trade and immigration policy. This is particularly the case for Mexico and Central America. At the same time, higher commodity prices since early 2016 have benefited commodity exporters, mostly located in South America. Relative to their historical standards, nonetheless, commodity prices remain low.

Overall, the Fund now expects regional economic activity to expand by just 1.2% in 2017 and 2.1% in 2018, following an estimated contraction of 0.7% in 2016.

## Mexico

In relation to Mexico, the IMF says the economy continues to grow moderately "but is entering a difficult terrain". The outlook is clouded by "uncertainty about US trade policy which, along with tighter financial conditions, will be a drag on activity". To maintain market confidence and put public debt firmly on a downward path, the Fund recommends that it is important for the government led by President Enrique Peña Nieto "to persevere with fiscal consolidation". The Fund makes no reference to the growing political costs to the Peña Nieto administration of its fiscal efforts. Promises to the electorate that taking the bitter fiscal medicine would eventually deliver stronger economic growth have failed to materialise.

The Fund is also a little dismissive of the recent rise in inflation pressures in Mexico, now finally feeding through more strongly on the back of the persistent peso depreciation in 2015-2016, on top of which came January's 'gasolinazo', against which there was a strong public backlash. The Fund argued that expected monetary policy tightening should help keep inflation expectations under control. Going forward, it adds, "further tightening will only be needed to prevent any second-round effects, as the rise in inflation that is due to changes in relative prices of tradable goods will be temporary". Not all economists in Mexico are so sanguine about the situation, however – most private economists expect inflation to run well above the 4% target ceiling throughout 2017.

## Policy activity

To spur economic activity, countries in the region are easing monetary policy, where appropriate, using available space to calibrate fiscal adjustment, and, more importantly, pursuing much-needed supply-side reforms. In order to enhance resilience and boost long term growth, the Fund recommends that the region stick to flexible exchange rate policies. Amid increasingly volatile external conditions, it points out, exchange rate flexibility has served the region well and "should remain the first line of defence against shocks…Well-established monetary policy frameworks in the region are suited to limit the exchange rate pass-through to consumer prices. Strong risk management practices and policies facilitating corporate balance sheet repair are also critical to reduce vulnerabilities arising from a tightening of global financial conditions and sharp currency movements".

"Countries should continue to use available space to calibrate fiscal adjustment", it continues, as notwithstanding the recent uptick commodity prices are expected to remain low relative to historical levels. The needed pace of adjustment will depend on debt levels and market pressures. And beyond macroeconomic policy adjustment, structural reforms – such as decreasing informality and red tape, boosting infrastructure quality, and improving education and rule of law – are essential to support medium-term growth, it reiterates.

| Latest growth projections | | | | |
|---|---|---|---|---|
| *Projections for Latin America and the Caribbean have been revised down* | | | | |
| | **2015** | **2016** | **2017** | **2018** |
| Latin America and the Caribbean | 0.1 | -0.7 | 1.2 | 2.1 |
| | | | | |
| South America | -1.3 | -2.3 | 0.8 | 1.8 |
| Excluding contracting economies* | 2.9 | 2.4 | 2.9 | 3.3 |
| Central America | 4.2 | 3.8 | 4.1 | 4.2 |
| Caribbean | | | | |
| | | | | |
| Latin America | | | | |
| Argentina | 2.5 | -2.4 | 2.2 | 2.8 |
| Brazil | -3.8 | -3.5 | 0.2 | 1.5 |
| Chile | 2.3 | 1.6 | 2.1 | 2.7 |
| Colombia | 3.1 | 1.9 | 2.6 | 3.5 |
| Mexico | 2.6 | 2.2 | 1.7 | 2.0 |
| Peru | 3.3 | 4.0 | 4.3 | 3.5 |
| Venezuela | -6.2 | -12.0 | -6.0 | -3.0 |
| *Note: Regional aggregates are weigted by PPP-adjusted GDP.* | | | | |
| *South American contracting economies include Argentina, Brazil, Ecuador, Suriname and Venezuela | | | | |
| ***Sources:** IMF, World Economic Outlook database and IMF staff calculations.* | | | | |

## ARGENTINA

### Green shoots

**Politically, the government needs a recovery to take shape in 2017, an election year. There are some early signs that it is on its way.**

The monthly economic activity indicator (Estimador Mensual de Actividad Económica – EMAE), a GDP proxy compiled by the national statistics institute (INDEC), grew by 1.4% in November, relative to the immediately preceding month, on a seasonally adjusted basis. This was significant. According to a report by Banco Ciudad, this points to a positive fourth quarter, measured on a quarter-on-quarter basis. Assuming December growth continued at the same pace as in November, Q4 16 IMAE would be up by around 1.1% on Q3. This in turn would be the first positive quarterly reading after three consecutive quarters of negative growth. Taking the year-on-year comparisons, in January-November 2016 the IMAE was down by 2.5% over the first 11 months of 2015, but the picture was also improving: the November 2016 result was down by a smaller 1.4% year on year.

A private sector GDP proxy, the Índice General de Actividad de Orlando J. Ferreres (IGA-OJF), is telling a similar story. On a quarter-on-quarter basis, this showed growth of 1.1% in Q416. Banco Ciudad attributes these signs of green shoots to three main factors. First, the current wheat harvest is the largest in the last six years. Second, the automobile industry has picked up, on revived demand from Brazil. And third, the construction sector is beginning to benefit from increased spending on public works. Banco Ciudad expects these pro-growth trends to continue through 2017. The IGA-OJF

index suggests that overall activity levels will have dropped by 2.8% year-on-year overall in 2016, but again this was narrowing on a monthly basis, to just -0.8% in December. A return to year-on-year positive growth in early 2017 therefore seems plausible.

The IGA-OJF index also suggests that the much-needed pick-up in investment is beginning to materialise. The index detects an 11.4% year-on-year increase in investment in December, and an average 5.9% year-on-year increase in Q416. Banco Ciudad calculates that by late 2016, gross fixed capital formation had recovered to 22.6% of GDP.

There was also evidence of recovering export dynamism. Exports grew by 34% year-on-year in December. This partly reflected the low base of comparison (in December 2015, farmers were holding back their shipments in anticipation of the removal of currency controls and the elimination of export taxes). But after a year of a more competitive exchange rate and sharply lower taxes, wheat and maize sales are looking strong. Likewise, exports of manufactures were up by 10% in December, on the strength of rising automobile sales to Brazil.

There was also a strong year-end boost to the fiscal accounts, thanks mainly to windfall revenues from the government's tax amnesty programme (*blanqueo de capitales*), which encouraged citizens to declare previously unregistered assets at a reduced tax rate as an alternative to facing prosecution for tax evasion. Government revenues doubled in December (+104% on December 2015). The money was used to pay down some government debt, but also to bring forward some public works spending set out in the 2017 budget. In December, government spending was up by 85% year-on-year. Despite this increased expenditure, Banco Ciudad estimates that the fiscal deficit ended 2016 at around 4.6% of GDP, fractionally lower than the 4.7% target for the year, and otherwise on track with the government's 'gradualist' plan for reducing the deficit over time.

## BRAZIL

### Reforms on the radar

**January saw fresh political developments in Brazil, all with significant economic consequences. The net effect, however, is that President Michel Temer is still on track to push through further economic reforms in the first half of this year.**

At one stage in early 2017, it looked as though the long-running Lava Jato ('Car Wash') corruption investigations might suffer a major delay. This was prompted by the death of Supreme Court justice Teori Zavascki in a light aeroplane crash. Zavascki was in charge of those Lava Jato cases reaching supreme court jurisdiction. He was overseeing the plea-bargaining agreements negotiated between prosecutors and 77 executives from the construction company Odebrecht who had admitted to paying bribes. It was his job to review these cases, confirm or reject the plea bargains, and where necessary authorise legal action against politicians and officials implicated in wrong-doing by the witness statements. At least 200 politicians, including President Temer, some of his ministers, and leading members of Brazil's federal Congress, are said to be named in the files, which remain confidential but have been widely leaked. Because of the explosive nature of the allegations, it has even been speculated that Zavascki's death may not have been an accident (the Air Force continues to investigate the crash).

Initial fears that Zavascki's death would lead to a 5-6 month delay in legal proceedings proved incorrect, however. Supreme Court President Justice Carmen Lucía Antunes ratified the plea-bargains and has named Justice Edson Fachin to take over the Lava Jato cases previously being handled by

Zavascki. As if to confirm that there will be no let-up in the anti-corruption drive, on 30 January the one-time billionaire business tycoon Eike Batista was arrested. He faces charges of paying around US$16.6bn in bribes to the former government of Rio de Janeiro, Sérgio Cabral (2007-2014). The impact of corruption investigations on the business environment remains double-edged. Strengthening the rule of law is a long term positive, but continuing uncertainty over the investigations is a short term negative.

In separate developments, pro-government figures were elected to lead both the Chamber of Deputies and the Senate. In the Chamber of Deputies, Rodrigo Maia of the small centre-right Demócratas (DEM, a member of the governing coalition) was re-elected with 293 of 513 votes. In the Senate, Eunicio Oliveira, of Temer's Partido do Movimento Democrático Brasileiro (PMDB), was elected by 61 votes to 10. The elections have been taken as sign that the governing centre-right coalition remains strong in Congress. While President Temer – like most prominent Brazilian politicians – remains exposed to potential corruption charges, his government appears to have the necessary political strength to push through some further economic reforms. A small ministerial reshuffle, which saw expanded powers for the justice ministry, the creation of a new human rights ministry, and a promotion to ministerial status for Wellington Moreira Franco (the president's key adviser on infrastructure investment projects), suggested that the government is growing in confidence.

What does this mean for the economy? The most important implication is that, having passed legislation late last year capping the growth in public sector expenditure (which henceforth cannot expand faster than the rate of inflation), the administration is now likely to tackle labour and pension reform, most probably before the middle of this year. Some analysts suggest that the government has a six-month window of opportunity for structural reforms. After the middle of this year, with attention focusing on next year's presidential elections, legislators may not want to take unpopular decisions. Labour reform will aim to make hiring and firing easier for employers, seeking to reduce costs and introduced greater flexibility.

Pension reform is likely to be the most controversial. The government is expected to cut retirement benefits and set a minimum retirement age, to start reducing the large unfunded deficit in the state pension system. The changes will face opposition from the trade unions. However, on present trends it looks as if the government will be able to muster the Congressional majority it needs to push them though.

Finance Minister Henrique Meirelles now expects the economy to return to positive growth in the first quarter of 2017, accelerating to 2% year-on-year expansion by Q417. This is more optimistic than the IMF's projection of 0.2% GDP growth this year. Luiz Carlos Trabuco, chief executive of Banco Bradesco, says consumer confidence and activity indicators signal "the worst is behind" after a recession lasting nearly three years. A slightly more nuanced view came from a senior member of the economic team speaking off the record to the *Reuters* news agency. This source said that if Congress approves a pension reform, Brazil could grow by more than 1% this year; but if there are no further reforms, there could be more recession. "The pension reform will be the real test. It either works or it does not. If it doesn't work, then we will have negative growth" the official said.

## CUBA

### Fiscal acceleration ahead of 2018 transition

**This year's budget document makes for particularly interesting reading, with last year's spending increases stepped up further. Even factoring in an**

**expected increase in fiscal revenue, the budget deficit is projected to reach eye-watering levels. With the government relying on state-owned banks to purchase new sovereign debt, financing is unlikely to be difficult in 2017, but with a limited pool of resources in the domestic banking system, such a strategy is not feasible in the long term.**

It is a reflection of Cuba's one-party political system that the annual budget receives comparatively little press coverage, with the process of submitting proposals and debating the package occurring right at the end of December, only a few days before the start of the 2017 financial year. Given the one-party political system, the budget bill is passed without delay or difficulty. The budget is subsequently published in the Gaceta Oficial, as well as on the homepage of the National Statistics Office (ONE), but the comparatively low-key nature of the build-up means that changes in the government's fiscal policy stance can attract relatively little attention, particularly since the timing coincides with the period between Christmas and New Year.

## Deficit set to reach 12% of GDP

This has been the case with the 2017 budget, but delving into the detail of the budget package unveils some surprising findings. The most prominent headline figure is the government's projected fiscal deficit: at Ps11.5bn it is almost double the level pencilled it to the 2016 budget this time a year ago. Given the paucity of macroeconomic data, it is difficult to speculate about the size of the deficit as a percentage of GDP (nominal GDP data is available, but only up to 2015), but there have been reports that legislators estimate that the projected 2017 budget deficit will be equivalent to 12% of GDP.

This marks a continuation of a trend that began in 2015. The deficit ballooned sharply in 2008 as external conditions deteriorated sharply, but during 2009-14 the government kept spending under control in order to reduce the deficit to manageable levels. However, in 2015 the deficit quadrupled to nearly Ps5bn on the back of a step-up in expenditure growth. The deficit widened further in 2016, to Ps5.6bn.

The wider deficit is being driven exclusively by spending: what is notable is that income reforms have increased revenues in the past three years. According to the government's budget document, revenue is expected to increase by a further 0.7% in 2017. Given that tax income (the main source of budget revenue) is expected to increase by 4.5% in 2017, this overall growth appears mild, but it reflects the fact that non-tax income is expected to fall by around a fifth. This is likely to reflect a continued scaling back of assistance from Venezuela, with lower oil shipments (part of which are re-exported) cutting government revenue in this area.

Meanwhile, government expenditure is expected to rise by 11% in 2017. Capital spending is slated to increase by around Ps1bn. No details were provided on specific investment projects, but part of this is likely to reflect reconstruction costs after Hurricane Matthew hit eastern Cuba in October 2016. Current expenditure is projected to increase by a more significant Ps4bn. Health, education and social spending (including pensions) account for around half of current spending and the government expects these expenses to rise this year, as an ageing population increases the pension burden. However, other budgetary spending is also likely to rise, including the cost of subsidising basic goods.

## Spending hikes driven by political concerns

Although there has been speculation that the increase in spending is designed to bolster underlying economic growth, after the economy contracted by 0.9%, this fiscal stimulus will have a relatively muted impact on the broader economy. This is because disposable incomes are low and private consumption accounts for a comparatively small share of total GDP. Higher government spending is therefore likely to be driven by the need to

maintain social indicators (such as health provision) in the run-up to a political transition. With President Raúl Castro set to stand down next year, the country's leadership will be keen to prioritise those areas important to public opinion, which include health and education, in order to smooth the process of shifting to the first non-Castro leader in nearly sixty years.

The rise in public spending is also likely to reflect the fact that fiscal decentralisation and economic reforms are proceeding much more slowly than anticipated. Several years ago, it was anticipated that the government's dominant role in terms of both revenue and expenditure would fall, as the private sector grew in size. However, this has not happened: while the number of workers in the private sector has increased, this has occurred gradually and the tax system has been slow to adapt. In a system with little experience in tax administration, it has been difficult to strike the right balance between raising revenues through income and corporate tax, while also maintaining incentives for private-sector workers. Meanwhile, the persistence of US sanctions has meant that few foreign companies have boosted investment significantly and, coupled with still-tight regulation by the Cuban government, little competition and liberalisation in key sectors is emerging. This means that the government remains responsible for the lion's share of spending. The failure to develop competitive markets and raise income levels also makes it politically-difficult to scale back the subsidisation model.

### State-owned banks foot the bill

Such a large projected fiscal deficit raises significant questions over financing. Although Cuba has recently settled long-standing disputes on much of its defaulted debt, some claims remain outstanding. Coupled with concerns about the political and economic backdrop and the extreme paucity of economic data, this means that Cuba is unable to tap international capital markets. The government has traditionally monetised its fiscal deficit, printing money to finance the budget shortfall, but officials have been trying to scale back monetisation in recent years because of the upward impact on inflation and the destabilising effect on the local currency.

Although there is insufficient interest on the part of international investors, Cuba has been issuing sovereign bonds to the domestic market in recent years, with state-owned banks purchasing the issuance. This appears to be the government's main financing strategy for 2017, with the budget document authorising the finance ministry to issue new bonds this year with a term of between one and twenty years and an average annual interest rate of 2.5%.

However, this may set alarm bells ringing. The deficit is large and issuing sovereign debt to state-owned banks is a risky and unorthodox strategy, with the debt likely to be secured against banking deposits. There is no financial sector data available to provide an insight into the amounts of funds held in the banking system, but given that the sector is underdeveloped, there are unlikely to be significant amounts of funds available. The lack of data makes it impossible to assess how exposed these banks now are to the public sector. Given that the government is also trying to increase bank credit to the private sector, in an attempt to foster investment by budding entrepreneurs, borrowing extensively from state-owned banks will make fewer funds available to others.

In the short term, the Cuban economy is unlikely to suffer noticeably from the sharp increase in public spending and the recourse to state-owned banks for financing, but it adds to the challenges for the first post-Castro administration. The external backdrop is already challenging, with the Venezuelan economy on the brink of collapse and the likelihood of still-difficult relations with the Trump administration in the US. Domestically, it will be difficult to continue relying on state banks for large-scale budget financing in the longer term, since they will have a limited pool of resources to draw from. Alternative sources of financing will be necessary in order to avoid politically-difficult spending cuts.

## CHILE

### Central Bank shifts to monetary easing

**Relatively weak economic activity and low inflation prompted the Banco Central del Chile (BCCh) to cut interest rates for the first time since 2014 in mid-January, with the bank also implying that a further easing of monetary policy is likely later in the year if recent economic trends persist. Given the proximity of the November general election, the leftist government led by President Michelle Bachelet will be hoping that a recovering economy will boost its chances of retaining power, amid rising levels of public frustration.**

The cut in interest rates did not come as a huge surprise. Although it had initially been believed that the BCCh, alongside many other Latin American central banks, would begin hiking interest rates in line with US monetary policy tightening, this assumption gradually lost resonance over the course of 2016. In Chile's case, the BCCh first shifted towards a neutral stance mid-year 2016, before giving growing indications in the fourth quarter of the year about a potential cut in interest rates.

#### The tipping point

It seems that December's inflation result was the tipping point, with the consumer price index falling for the first time in over a year. Monthly inflation contracted by 0.2%, with annual inflation falling to 2.7%, significantly lower than the 4.8% registered at the start of the year and falling into the lower-half of the official 2-4% target range. The fact that economic activity had been weak for several months is also likely to have played a role in the BCCh's decision: the monthly economic index that serves as a broad proxy for GDP growth rose by a weak 0.3% year on year in October and by 1.1% in November, compared to growth of over 2% early in the year.

Against this backdrop, the BCCh chose to increase the benchmark interest rate by a relatively mild 25 basis points on 19 January, to 3.25%, although the published minutes from the BCCh committee meeting show that a rate cut of 50 basis points was considered. The BCCh has also indicated that an additional 25 basis points cut is likely in the first quarter of 2017 if current economic conditions persist (which appears likely, in the absence of the prospect of any immediate domestic or external economic stimulus).

The government will hope that the start of a period of moderate monetary easing will help boost domestic demand. At around 2% during 2015-16, real annual GDP growth is healthier than some flagging countries in the region, but the pace of expansion remains significantly lower than rates of 4-6% recorded in 2010-13. Final data from 2016 are as yet unavailable, but GDP growth is likely to have slipped well below the 2% mark (averaging just 1.6% in the first three quarters), from 2.3% in 2015. Having previously fuelled strong GDP growth, private consumption has been weak since mid-2014.

#### Consumer confidence remains low

This is mirrored by fairly weak levels of consumer confidence. The economics department of the University of Chile compile a quarterly survey of economic expectations and, according to the latest seasonally-adjusted results, consumer confidence contracted by 1.5% in December compared with September (and by 2.3% year-on-year). The index level remains well below the historic average.

When asked about expected income levels during the coming 12 months, the share of respondents anticipating a pay cut or a pay freeze rose from 66.4% in December 2015 to 67.8% in December 2016. The number of people considering a purchase of durable goods in the next three months fell from 16.7% to 13.1% over the same period. Meanwhile, confidence in the future direction

of the economy has also weakened, with the share of people believing that economic conditions in 12 months' time will be better than currently fell from 40% in December 2015 to 31.2% in December 2016.

These data were published in late January, but were collected at the end of 2016, prior to the interest rate hike. The authorities will hope that in cutting interest rates, these responses will begin to improve, particularly in the context of the looming November general election.

Chile's benchmark interest rate remains low by regional comparison, but relatively high compared with developed economies, implying scope for more extensive or prolonged monetary easing if domestic conditions remain weak.

Much will depend on inflation, however, with the BCCh likely to prioritise price stability over boosting weak GDP growth. The exchange rate will play a role in price developments, with the fall in inflation registered during 2016 being aided by a steady appreciation of the Chilean peso, from Ps710:US$1 at the start of the year to Ps667:US$1 at the end of the year. This helped alleviate import costs, with tradable inflation falling from 4.8% in January to 1.8% in December (by contrast, non-tradable inflation edged down from 4.9% to 4%, but remained elevated).

The Chilean peso has continued to appreciate in 2017, trading at around Ps640:US$1 in early February. This is largely the reflection of broad losses incurred by the US dollar, which shed around 4% of its value against several currencies (Chile's included) during January as markets became increasingly concerned about the policy stance of the newly-inaugurated US President Donald Trump. Futures markets imply a further depreciation of the US dollar in coming months. As such, this should support continued appreciation of the Chilean peso, which in turn is likely to keep domestic inflation suppressed. This will create scope for further cuts in the benchmark interest rate.

### Copper price uncertainty

The economic outlook will also be affected by copper prices. Copper mining accounted for around 8% of GDP directly in 2015 (down sharply from levels of 15% during the peak of the commodity boom), but the sector also has a significant impact on export and investment demand. Copper prices have risen since the lows recorded in late 2015 and early 2016, but remain a far cry from their 2011-13 highs. Moreover, copper production has either been stagnant or falling since early 2014, with full-year production in 2016 coming in at 5.5m tonnes, the lowest level since 2012 and sharply down on nearly 5.8m tonnes in 2015.

The state copper commission, Cochilco, in late January stated that it was forecasting production to recover by around 4% in 2017, but given that copper reserves at many large mines are falling, fresh investment is needed to reverse the slide in production. Unless prices continue to rise in the coming months, significant new inflows seem likely. In the meantime, workers at BHP Billiton's Escondida mine (the largest copper mine in the world) voted on 31 January to go on strike in early February over pay and working conditions. The industrial action has not yet been confirmed, with government efforts to mediate the dispute ongoing, but the issue has the potential to affect copper production in the near term, as well as affect investment decisions going forwards.

### Wildfires affect forestry

Against this backdrop, Chile was hit by its worst ever wildfires in January. The government lifted the state of emergency in early February, with most continuing fires under control and no significant new ones spreading, but the fires have caused an estimated US$333m worth of damage, killing 11 people and destroying over 1,600 houses. Forestry output is likely to be affected in 2017 as a result, while unemployment in affected regions is also likely to rise. The government has pledged to re-allocate US$100m from

budget funds in order to address the crisis and will tap rainy-day funds for the remaining US$233m. However, primary-sector GDP output and agricultural exports are both likely to be affected this year, even assuming a rapid government response.

## TRINIDAD & TOBAGO

### Slightly brighter prospects ahead for 2017

**From being the Caribbean's star performer for much of the commodity boom years, with GDP growth on occasion hitting double-digits, Trinidad & Tobago has struggled in recent years from the energy price slump. Yet after a dismal 2016, the authorities are showing some indications that they expect a partial recovery in 2017. In late January, the central bank stated that it was keeping benchmark interest rates on hold, but that domestic economic output was expected to increase, on the back of rising gas production.**

After a poor performance in 2015-2016, the authorities are showing somewhat more optimism about economic prospects for 2017. In the central bank's 27 January monetary policy announcement, in which it kept the benchmark repo interest rate on hold at 4.75%, the Bank admitted that conditions had been difficult, with energy production declining markedly. However, it stated that prospects for 2017 appear brighter, with officials projecting a recovery in oil and gas production as new fields come on stream and maintenance work subsides. That said, despite the note of optimism, the press release accompanying the announcement struck a fairly negative tone, with officials flagging up the risk of weakening international trade flows from the US and acknowledging the weak state of domestic retail and construction.

#### Data from 2016 paints a gloomy picture

The available quarterly data relating to 2016 certainly reinforce this gloom. Real GDP data is available for the first half of the year and shows a 5.4% year-on-year contraction in the first quarter and an 8% fall in the second quarter. Although this was led by the energy sector (which shrank by 9.1% and 12.6% respectively), the non-energy sector also contracted, albeit less sharply. The Central Statistical Office (CSO) in October said that it expected real GDP growth to shrink by 2.3% in full calendar year 2016, but given the depth of the downturn in the first half, this appears optimistic.

The brighter outlook for energy production in 2017 reflects the expectation that several recently-completed projects will see gas production increase in the coming months. Other projects are due for completion soon and will also help boost gas production. Collectively, these include BHP's Angostura Phase III, BP's Juniper field, EOG's Sercan and BP's Trinidad Onshore Compression (TROC) project. In addition, extensive shutdowns for maintenance work that occurred during 2016, hampering energy-sector output, are not expected to be repeated in 2017. These combined factors are likely to reverse some of the slide in gas production, which has fallen from 4.2bn cubic feet/day in 2013 to 3.3bn cf/d in 2016. Although structural problems remain, which will cloud the longer-term outlook – including a low replacement ratio, owing to disappointing exploration results in recent years – these concerns are unlikely to hamper the near-term recovery in gas production, particularly if gas prices retain the gains of late 2016.

#### A return to growth?

The government hopes that a recovery in energy output will have spill-over effects in the non-energy sector, helping reverse the fiscal deterioration of recent years and providing some support for a recovery in domestic demand. These considerations explain the government's GDP growth forecast of 1.6% for 2017: modest given the extent of the contraction in recent years, but if achieved would represent the best result since 2013.

The central bank gave no indication in its most recent monetary policy announcement of the likelihood of shifting to a more accommodative stance, but it is possible that interest rates might be cut later in 2017 if economic growth does not recover as expected. With the benchmark rate at 4.75%, inflation low (standing at 2.9% in November) and credit growth weak, the monetary authorities might be tempted to cut interest rates in an attempt to shore up domestic demand.

## VENEZUELA

## Official shake-up as recession deepens

**The last month has seen a shake-up in the senior echelons of government, the Banco Central de Venezuela (BCV), and the state oil company Petróleos de Venezuela (Pdvsa), amid growing signs that the economic crisis is deepening. A leaked report from the central bank (BCV) contained data stating that GDP contracted by a huge 18.6% last year, with inflation spiralling to 800%. Yet there is little sign that President Nicolás Maduro's new appointees are either capable or willing to address the crisis, raising questions about how much worse conditions are likely to get in 2017.**

If the data is real, the leaked BCV report is a damning indictment of the current state of the Venezuelan economy. Most forecasters were projecting a third consecutive year of recession in 2016, but nobody expected the depth of contraction to be so marked. Both the International Monetary Fund (IMF) and World Bank were forecasting GDP to fall by around 10% year-on-year, but that was among the most pessimistic of economic projections. According to the leaked report, the oil sector shrank by 12.7%, while non-oil activity collapsed by 19.5%. Meanwhile, inflation reportedly jumped from 181% in 2015 to 800% in 2016.

### Government silence is telling

The government has declined to comment on the veracity of the report, although the new economy vice minister, Ramón Lobo, stated that the leaked inflation figure was "totally crazy". The authorities' failure to publish most monthly and quarterly data series makes it impossible to assess whether the figures leaked to the press are unrealistically negative, but the government's silence on the issue (and the fact that it has not come back with its own ballpark figures) suggests that the report is indeed credible.

One figure that has been confirmed is that of imports: President Maduro stated on 9 January that import spending had more than halved last year, to US$18bn. Moreover, this marked the fourth consecutive year of decline, from a peak of just under US$66bn in 2012. According to the president, this was mainly due to lower oil prices, with Venezuela's oil export price plummeting from around US$105/b in 2012 to around one-third of that level in 2016. President Maduro also blamed a heavy debt repayment schedule, stating that the country was unable to prioritise imports of crucial consumer goods because of commitments to bondholders.

### 2017 prospects looking poor

With 2016's apparently economic results coming in much worse than anyone expected, all bets for 2017 are off. The IMF's inflation forecast, at an eye-watering 1,660%, had been widely viewed as unrealistically high, but if inflation did indeed average 800% last year, a move to quadruple-digit inflation is not out of the question, particularly when minimum wage hikes are becoming more frequent and larger.

This is substantiated by comments made by the labour minister, Francisco Torrealba, in early February, when he said that there would be as many minimum wage increases as necessary to protect purchasing power from the impact of "criminal" inflation. This is a direct reference to the govern-

ment's belief that inflation is being driven by private sector "speculators", who are hoarding goods in order to drive up prices, rather than acknowledging that the BCV's policy of printing money is the main driving factor behind hyperinflation.

Lending substance to the latter explanation, growth in monetary aggregates continues to accelerate, which will increase demand-side inflationary pressures. The amount of currency in circulation and instant-access deposits was rising by around 170% year-on-year in late January, up from around 125% in late November. Once all of the new larger-denomination bank notes have entered circulation, this figure is likely to accelerate further.

There is less consensus over the depth of the contraction in GDP likely in 2017. The IMF has not updated its forecast (which anticipates a 4.5% fall in GDP) since the leaked central bank report, but in any case, inflation of 1,660% would imply a sharper recession, since hyperinflation would sap purchasing power. The government has optimistically stated that the economy will grow again in 2017, referencing higher oil prices, but it is highly uncertain whether the mild increase in global oil prices will be in any way sufficient to reverse the recession. Although it appears that average oil prices will be higher this year, Venezuelan oil production is still slipping. Given reports of extensive corruption, there is a risk that any additional oil earnings might not be efficiently channelled towards productive economic activity. Meanwhile, the highly complex exchange rate system will continue to distort the economy and dissuade investment.

### Cabinet reshuffle is unlikely to improve matters

Neither do the raft of personnel changes introduced in January provide much hope that the new appointees are capable, or willing, of addressing the root causes of the economic crisis. In a broad-based cabinet reshuffle at the beginning of the month, Ramón Lobo was appointed new vice president for the economy, while Nelson Martínez, of Pdvsa's US subsidiary Citgo, was appointed energy minister, replacing Eulogio del Pino. Del Pino had combined the role with the presidency of Pdvsa, a position that he retained, despite ceding control of the energy ministry to Martínez.

Another raft of changes within Pdvsa later in the month provided another shake up, bringing in political and military people with little direct oil market experience. Among these, Maduro placed Rear Admiral Maribel Parra in a newly-created post of executive vice president. Parra already sits on the leadership of the military-run oil services company, Compañía Anónima Militar de Industrias Mineral, Petrolíferas y de Gas (Camimpeg), but apart from that is not an energy sector expert.

Maduro also placed a trusted member of his inner circle as the company's new vice president for finance, Simón Zerpa Delgado. Since 2014, Zerpa has been at the helm of both the Venezuela-China fund (Fondo Chino), through which the left-wing Caracas government has borrowed upwards of US$10bn from Beijing in the past decade, as well as the off-budget (and very opaque) national development fund, Fondo de Desarrollo Nacional (Fonden). Incidentally, Zerpa's father, Iván, is Venezuela's ambassador to China.

Zerpa's promotion suggests that Maduro is seeking to exercise tighter control over Pdvsa finances, while overall these latest appointments may also imply that Maduro is distributing ministries to a combination of close political allies and the military, most likely in order to retain army support and head off any threat of a coup.

### Fitch warns on Pdvsa

Underlining the still-critical state of the economy, in late January the sovereign credit ratings agency Fitch Investors Service stated that the financial challenges facing Pdvsa were very serious and that default was "probable"

this year. According to Fitch, this view reflects the company's weak cash position, its relatively heavy amortisation schedule this year (even after a swap deal concluded in late 2016 eased repayments moderately) and falling oil production. However, that is not a view echoed more broadly by financial markets, with the implied default risk as calculated by credit default swaps (CDS) data falling to 44% in January, compared with 59% at the end of December. CDS data implied that default was highly likely within a 5-year horizon, however, with this probability standing at 89%.

The uncertainty highlights a broader difficulty with regard to Venezuela's economic outlook. There appears a widely-held consensus that complete economic collapse, most likely accompanied (or caused by) a debt default, is likely at some point in the future, because the government's distorted economic policy model is untenable in the long term. However, determining when this is most likely to happen is extremely difficult. Financial markets seem to believe that the recent partial recovery in oil prices will reduce the likelihood of a default this year, but this assumes that the government will continue to cut back drastically on import spending in order to continue making debt repayments. International reserves, at US$10.5bn in early February, are relatively low given that much of this is held in gold and that over US$9bn falls due this year. The public's tolerance levels have so far proved surprisingly high, with many observers surprised that the government has managed to cling onto power given the depth of last year's recession, but frustrations are likely to boil over at some point unless domestic conditions begin to improve.

# REGIONAL BUSINESS REVIEW

## REGION

### Tolerance for corruption is fast eroding in Latin America

**Latin America remains one of the most corrupt regions in the world, according to the latest Global Corruption Perceptions Index (CPI), compiled annually by the Berlin-based NGO Transparency International. Yet as the past 18 months have demonstrated, public tolerance for the practice – and for the impunity that has allowed it to thrive unchecked – is falling right across the region. While the current fall-out from the major corruption scandals in Brazil has contributed to an unscheduled change of government there, and created widespread regional ripples, eventually the result of this painful upheaval should be more transparency and accountability, stronger institutions and better governance. That's good not only for voters, but also for investors and the general business environment.**

"In too many countries, people are deprived of their most basic needs and go to bed hungry every night because of corruption, while the powerful and corrupt enjoy lavish lifestyles with impunity", wrote José Ugaz, a respected Peruvian jurist and the chair of Transparency International, upon the release of the latest (2016) Global Corruption Perceptions report. "Collusion between businesses and politicians in grand corruption denies national economies of billions of dollars of revenues siphoned off to benefit the few at the expense of the many. This kind of systemic grand corruption violates human rights, prevents sustainable development and fuels social exclusion".

#### Regional results

The CPI ranks countries based on the perceived level of public sector corruption. The average score for the Americas in the 2016 CPI was 44 out of 100. Anything below 50 indicates that governments are failing to tackle corruption. Seven of the 21 Latin American countries included in the index scored 30 or below, which indicates 'rampant corruption'.

| Transparency International Corruption Perceptions Index 2016 (denotes change on 2015) | | |
|---|---|---|
| *Position* | *Country* | *Score* |
| 21 (=) | Uruguay | 71 (-3) |
| 24 (-1) | Chile | 66 (-4) |
| 41 (-1) | Costa Rica | 58 (+3) |
| 60 (-4) | Cuba | 47 (=) |
| 64 (+24) | Suriname | 45 (+9) |
| 79 (-3) | Brazil | 40 (+2) |
| 87 (-15) | Panama | 38 (-1) |
| 90 (-7) | Colombia | 37 (=) |
| 95 (+12) | Argentina | 36 (+4) |
| 95 (-23) | El Salvador | 36 (-3) |
| 101 (-13) | Peru | 35 (-1) |
| 113 (-14) | Bolivia | 33 (-1) |
| 120 (-17) | Dominican Republic | 31 (-2) |
| 120 (-13) | Ecuador | 31 (-1) |
| 123 (-11) | Honduras | 30 (-1) |
| 123 (-28) | Mexico | 30 (-5) |
| 123 (+7) | Paraguay | 30 (+3) |
| 136 (-13) | Guatemala | 28 (=) |
| 145 (-15) | Nicaragua | 26 (-1) |
| 159 (-1) | Haiti | 20 (+3) |
| 166 (-8) | Venezuela | 17 (=) |

Venezuela, with an overall score of just 17 (out of 100), was the worst performing country in the region in 2016, dropping eight places to rank at just 166, of the 176 countries included in the CPI. The biggest fall, however, was for Mexico, whose score slipped by 28 places to no. 123, to tie with Honduras, which itself fell 11 places. There were other significant falls by El Salvador, the Dominican Republic, Ecuador, Bolivia, Peru and El Salvador.

Uruguay retained first place in Latin America, finishing in 21st globally, three places above Chile. The biggest climbers in the region were Suriname, which rose by 24 places, and Argentina, which rose by 12 places. Colombia also posted an improvement of seven places.

"It is not always bad to have headlines about corruption", Transparency International said in its Americas summary. "From the Panama Papers in April to the record US$3.5bn Odebrecht settlement in Brazil in December, 2016 was a good year in the fight against corruption in the Americas".

TI highlighted the Panama Papers – which revealed that a Panamanian law firm, Mossack Fonseca, had helped set up thousands of secret shell companies, many used by corrupt politicians, criminals and tax abusers around the world – and the Odebrecht plea deal with the US Department of Justice, which lifted the lid on millions of dollars spent on bribes for politicians and political parties across Latin America to win and retain lucrative infrastructure projects.

"The wealthy and powerful were also increasingly placed under the spotlight", TI noted, observing that Argentina's President Cristina Fernández is now under investigation on corruption charges, while a daughter-in-law of Chile's President Michelle Bachelet has been charged in a corruption case. It pointed out that 2016 was also notable in that "large corruption investigations continued to operate across national borders". "In cases from Odebrecht to Petrobras and FIFA, there has been increasing communication and cooperation among regulators and law enforcement throughout the region and also with counterparts in Europe and the United States".

However, in many parts of the region, it stressed, impunity continues to be a major problem. And even in countries where cases of large-scale corruption are being tackled, the risk remains that this is the result of the efforts of a small group of crusading individuals, rather than a long-term plan, the NGO stressed, before concluding: "The fight against corruption has dominated discussion in the Americas for years now, from online and traditional media to mass protests. One thing is clear though: even if 2016 marks the start of a shift towards more active enforcement by authorities in response to these public demands, there is still a long way to go".

### Next steps

Reflecting the impact of the Panama Papers, commitments to continue anti-corruption efforts "were on display throughout the year", TI noted. For instance, at the London Anti-Corruption Summit in May 2016, officials from Argentina, Brazil, Colombia and Mexico offered commitments to increase transparency around the ownership of anonymous shell companies.

However, TI continues, "citizens must keep up pressure on leaders and continue to demand the transparent, accountable and functioning institutions the region needs to make sure these and similar commitments are delivered on. Authorities in every country should ramp up their efforts to stop powerful corporate leaders and public officials from getting away with acts of major corruption with impunity. This includes enhancing regional law enforcement cooperation".

Moreover, and as the Panama Papers showed, "the combination of whistle-blowers, big data and networked journalism is proving to be a powerful force for change. In coming years, governments in the Americas will have to become more transparent, or increasingly they will find transparency forced upon them", the NGO emphasised.

TI argued that 'technical fixes' to specific anti-corruption legislation are not enough. "What is urgently needed are deep-rooted systemic reforms that even up the growing imbalance of power and wealth by empowering citizens to stop the widespread impunity for corruption, hold the powerful to account, and have a real say in the decisions that affect their daily lives. These reforms must include the disclosure through public registries of who owns companies as well as sanctions for professional enablers who are complicit in moving corrupt money flows across borders".

#### Populism – not the answer

Ugaz also issued a warning about the rise of global populism, arguing that it would likely only exacerbate problems with corruption, impunity and lack of accountability. "In countries with populist or autocratic leaders, we often see democracies in decline and a disturbing pattern of attempts to crack down on civil society, limit press freedom, and weaken the independence of the judiciary. Instead of tackling crony capitalism, those leaders usually install even worse forms of corrupt systems. Only where there is freedom of expression, transparency in all political processes and strong democratic institutions, can civil society and the media hold those in power to account and corruption be fought successfully."

Interestingly, just a week after Donald Trump was inaugurated, the US featured two points lower on the latest CPI index (at no. 74), with TI citing concerns that money was influencing policy decisions. TI's Americas director, Alejandro Salas, told journalists there were concerns about the incoming Secretary of State, former Exxon boss Rex Tillerson. Salas noted that as a member of the American Petroleum Institute, Tillerson had worked against transparency measures in the 2010 Dodd-Frank Act calling on companies to disclose payments made to individual governments. In the 2016 election campaign, Trump pledged to scrap the Act. On 2 February, he signed an executive order to review the Act, calling it "a disaster". "We are going to do a big number on Dodd-Frank", he tweeted.

## The cost of Odebrecht

**The scene was set for Peruvian economic growth to accelerate this year. After a bunching of mining mega-projects in 2016, the job of firing up the economy in 2017 was set to pass to the US$7bn Gasoducto del Sur pipeline project, and to a number of other public-private partnership (PPP) transport infrastructure investment projects. But the eruption of the Odebrecht corruption scandal in Peru has put a spanner in the works. Economic growth forecasts for 2017 have begun to be reined in.**

As part of a December 2016 plea-bargain deal with prosecutors in the US, Brazil and Switzerland, the Brazilian construction group Odebrecht admitted paying large-scale bribes to secure contracts. According to the US Department of Justicem, Odebrecht paid US$29m to officials in three different governments in Peru in the period between 2001and 2015. The corruption scandal has now spread, with a number of former officials arrested. There are allegations that former President Alejandro Toledo (2001-2006) in particular received improper payments, and rumours that other companies aside from Odebrecht may have also paid bribes. The problem for the current government led by President Pedro Pablo Kuczynski is that the scandal is undermining its plans to stimulate the economy this year.

The big casualty to date is the Gasoducto Sur Peruano (GSP), a US$7bn, 1,000km gas pipeline project to transport gas from the Camisea fields to the Pacific coast. The consortium that won the contract was led by Odebrecht (with a 55% stake) and included two other partners, Enagas of Spain and Graña y Montero of Peru. The Kuczynski government, which says that as a result of the corruption revelations Odebrecht must now leave Peru, had expected that Odebrecht would sell its equity stake in the consortium to another company, allowing the concession agreement to stay in place. But despite interest in various quarters, no buyers could be found, and the consortium was unable to close its project funding by a required 23 January deadline. The government then cancelled the contract, triggering a US$262m penalty charge against the consortium for failure to meet the terms of the 34-year concession. The net result is that a new international tender will have to be organised, implying a delay of 12-15 months. The project is reported to be around 37% completed – money has mostly been spent buying the steel tubes for the pipeline. Whoever wins the new tender may have to negotiate a price to buy the pipes and other assets from the unsuccessful Odebrecht-led consortium.

There has been a negative knock-on effect. Finance Minister Alfredo Thorne has said that Peru may grow by 3.8% this year – instead of the 4.8% his team had been forecasting – because of the fall-out from the Odebrecht scandal, including the GSP delay and the negative impact on investor confidence. The government has nevertheless been working on measures to try and mitigate the impact. In addition to an earlier PEN3.89bn (US$1.19bn) funding package extended to regional governments to spend on infrastructure, the finance ministry was sending out a further PEN5bn (US$1.53bn) to top it up. Proinversión, the state investment agency, says that it has a total of 32 projects in its pipeline for 2017 and 2018, worth over US$14.4bn. For this year, it expects to award 16 of them, with a total value of US$4.1bn.

In late January, there was a further scare concerning another big project. It looked as if the long-standing US$520m project to build a new airport to serve the city of Cusco might also be paralysed by claims of corruption. An opposition-dominated congressional committee said that aspects of an addendum to the 40-year concession agreement – awarded in 2014 by the previous government to the Kuntur Wasi consortium – were prejudicial to the state. After a four-day delay, and protest demonstrations by supporters of

the project in Cusco, President Kuczynski decided to go ahead with the opening ceremony, dismissing the criticism. Because Kuntur Wasi was unable to raise sufficient financing, the bulk of the project (US$410m) will be funded by the state. The airport, a gateway to Macchu Picchu, one of Peru's main tourist attractions, is due to be completed by 2021.

It is clear, however, that the progress of infrastructure projects, and related spending, is slower than hoped. The research department of Scotiabank in Peru estimated that total transport infrastructure spending was just under US$900m in 2015, and dropped to just under US$700m in 2016. "Much of the infrastructure investment hoped for in 2017 won't be fully implemented until 2018," it commented.

## PANAMA

### Another Odebrecht blow

**Panama is another Latin American country where the Odebrecht corruption scandal is having a negative impact on this year's growth prospects. In its plea bargain deal with the US Department of Justice the company admitted paying US$59m in bribes to Panamanian government officials in 2010-2014. Kenia Porcell, a Panamanian prosecutor, opened a case file and said that Odebrecht had agreed to pay US$59m (an amount equivalent to the bribes paid) as an initial surety, pending the outcome of investigations. Unlike Peru, the Panamanian government has only formally banned Odebrecht from bidding for new government contracts and not issued a blanket ban on its participation in existing contracts. However, Odebrecht will still lose some of its existing US$3bn worth of contracts in the country. Job losses among its 8,000 employees are also expected.**

Odebrecht's continued participation in a number of Panamanian projects is in doubt. The financing for the US$1.9bn Metro Line 2 project, where the company is in partnership with other contractors, is still not fully in place, but the company may remain involved. Odebrecht is dropping out from Metro Line 3 (valued at US$2.6bn) and the fourth Panama Canal Bridge however, two projects for which it had reached the pre-qualification stage. The government says it is ending a contact to build a US$1bn 213MW hydroelectric project in Bocas del Toro that had been also awarded to Odebrecht. A particular cause for concern is the future of the US$800m contract to build a new terminal at Tocumen International airport (serving Panama City).

Alvaro Alemán, minister for the presidency, said in early February that the government was taking a "clear position". It expected Odebrecht to meet its contractual obligations on the Metro Line 2 project, on the Tocumen airport terminal, and on a contract to build 5,000 residential units at Lagos del Colón. Odebrecht, however, has formally withdrawn from the fourth Panama Canal Bridge, and Alemán said he expected it to announce a similar decision on Metro Line 3. The government's position is causing some controversy. Donaldo Sousa, a Panamanian lawyer, said that the government needs to prevent big projects from coming to a halt, and should ideally replace Odebrecht on all projects, hiring other companies to do the work. Guillermo Cochez, another lawyer, criticised the government for keeping Odebrecht in play on some projects, warning, "when Odebrecht goes bankrupt, Panama is going to have problems".

Jorge Fidanque III, the manager of Tocumen International Airport, commented, "Each day we are hearing of more accusations against Odebrecht, and that is a source of worry for Tocumen, because we need to complete the expansion work". He added that the airport was in a dilemma. The new terminal project was 60% complete, making it very difficult to change contractors at such a late stage. On the other hand, there was no guarantee that Odebrecht would be in a position to finish the job. "We need a Plan B" he added.

There are yet no detailed projections on the impact of cancelled or delayed projects on this year's economic growth rate, but it is an issue of concern. Economy Minister Dulcidio de la Guardia has remained upbeat, claiming that GDP rose by about 5.2% in 2016 and will grow "even more" in 2017.

## VENEZUELA

### The cost of corruption – a big unknown

**Of the many countries in Latin America plagued by corruption, Brazil clearly has stood out in the past 18 months. Transparency International and others believe that the situation in Venezuela, however, is also very serious; albeit in the absence of data it is almost impossible to know the true extent of the problem.**

Despite the US Department of Justice estimating that Brazil's Odebrecht paid US$98 in bribes in Venezuela (the highest amount in any single country outside of Brazil), the Venezuelan authorities have been mute on the matter. Following Odebrecht's record plea bargain deal in the US in December, Venezuela's opposition-controlled national assembly called for official investigations, but received no response from either the government or the attorney general. The local chapter of Transparency International, Transparencia Venezuela, separately called on the government led by President Nicolás Maduro and its ministries to account for all public-sector contracts signed with Brazilian companies in the past 12 years. Again, no response from the executive or ministries. It has since lodged a request with the supreme court, which is unlikely to be sympathetic.

According to reports compiled by deputies from the opposition coalition, Mesa de la Unidad Democrática (MUD), starting from 2000 Brazilian companies including Odebrecht, Camargo Corrêa, Andrade Gutierrez and Queiroz Galvão secured 42 projects worth over US$50m in Venezuela. Odebrecht alone won 32 of those 42 projects, worth an estimated US$41m. The MUD-controlled national assembly's audit commission is investigating potential irregularities estimated at US$16.6m relating to six of the Odebrecht contracts, including the Caracas metro expansion. Suspected irregularities include overcharging, commissions, bribes, embezzlement and a lack of due planning for works.

In a statement coinciding the release of the 2016 CPI, Mercedes de Freitas, the executive director of Transparencia Venezuela, stated: "Impunity and corruption form a perverse relationship that is growing. In Venezuela, an increasing number of laws create opacity. The comptroller general increasingly fails to sanction breaches of transparency norms. It is inexplicable that the chief prosecutor [Luisa Ortega Díaz] doesn't say anything about cases of such importance like Odebrecht, whose own directors have admitted before a court that they paid US$98m in bribes in Venezuela. This all indicates the little interest that there is in the fight against corruption."

Finally, on 26 January, Ortega Díaz revealed in a radio interview that Venezuelan authorities had requested an arrest warrant for an individual suspected of taking bribes from Odebrecht. The prosecutor added that the warrant would be passed also to Interpol, "in case the individual is outside of Venezuela". She added that her office had asked Swiss banking authorities to provide a list of Venezuelans who have received deposits from Odebrecht and was also planning to send an investigator to Brazil. In comparison to the response to the Odebrecht scandal by other regional countries, however, the Venezuelan effort to date seems rather dilatory.

Meanwhile, President Maduro – who in his annual state of the nation address on 15 January declared that "heads need to be cut"- has made sweeping

**Chinese mining companies pile into Peru:** According to the Peruvian minister of energy and mines, Chinese companies have commitments to invest US$10.2bn in seven mining projects in the country, mainly in copper. China is the single largest investor in planned Peruvian mining operations, with 21.7% of total future projects. The main new Chinese projects are in Pampa del Pongo (Arequipa), Galeno (Cajamarca), Don Javier (Arequipa), Explotación de Relaves (Ica) and Río Blanco (Piura). There are also expansion projects at Toromocho (Junín) and Marcona (Ica). The ministry said the figures excluded the US$10bn Las Bambas project, in which China MinMetals has an equity stake, and which is already in production. Companies from Canada are the second largest investors with US$8.8bn in new projects, followed by those from the US (US$6.1bn) and UK (US$6bn).

changes at the helm of the state oil company Petróleos de Venezuela (Pdvsa), which almost exclusively generates the country's entire foreign currency income. "We have to clean out the corruption that has incubated…I call on the oil workers to forcefully defeat corruption," Maduro demanded in the 29 January edition of his weekly TV show, 'Sundays with Maduro'.

Pdvsa has been in spotlight for corruption for the past couple of years. Last year, the opposition-controlled national assembly accused the former Pdvsa president and energy minister, Rafael Ramírez, of overseeing the loss of US$11bn to corruption in his decade-long tenure of the company (2004-2015), a charge he vehemently denied as lies. Ramírez was removed from his powerful dual role as energy minister and Pdvsa president in September 2015. In what was widely considered a demotion, he was made Venezuela's ambassador to the United Nations¬ in New York, and has since been much more low profile.

## REGION

## Corporate Radar

**United Airlines to buy into Avianca:** Avianca Holdings (which operates in Colombia, Peru, Ecuador and the Caribbean) and Avianca Brasil say they are discussing a merger, which would also bring in United Airlines of the US as minority partner. Two brothers, Germán and José Efromovich, hold the controlling stakes respectively in Avianca Holdings and Avianca Brasil. Avianca Holdings carried 29.5m passengers in 2016, reporting US$1.1bn in net revenue and US$102.1m in net profit in Q316. Avianca Brazil is the fourth largest Brazilian carrier, reporting H116 revenue of BRL1.4bn (US$448m) and a loss of BRL142.5m (US$45.6m) in the same half year period. United Airlines said it was talking with both Avianca Holdings and Avianca Brasil to "expand commercial and equity partnerships".

**Colombian retailers unhappy over VAT:** The Federación Nacional de Comerciantes (Fenalco), which represents Colombia's main retailers, says that January sales have been impacted by an increase in VAT, which has increased = to 19% (from 16%), as part of the government's fiscal reforms. Fenalco's president, Guillermo Botero, says that sales have fallen. He also expects inflation to rise, calculating an increase of about 0.9% in January, above the government target of 0.7%. He also cites a 7% increase in fuel prices, which will feed through to the price of consumer goods. Analysts say that consumers are already switching to lower cost items in supermarkets, such as own-brand goods. Retailers targeting this sector of the market, such as D1 and Justo & Bueno, are reported to be gaining market share, especially in food lines like rice, cooking oil, and prepared meats. Increased taxes on alcoholic drinks are also in play, with consumption of imported wines and whiskies expected to fall. Retailers of footwear, clothing, and personal hygiene products are also reporting weakness in sales. Botero says that the VAT increase has taken COP9bn (US$3.6bn) out of the pockets of Colombian consumers.

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