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Time to take the China road?

Formally at least, China's ambitious One Belt, One Road (OBOR) initiative is all about building up trade, transport and investment links across Eurasia – and it doesn't reach as far as Latin America. But a new report points out that there could still be an important impact in the region, and potentially much to gain for countries concerned about the more protectionist stance now being taken by the United States.

On a global level, OBOR is big. Seen as Chinese President Xi Jinping's signature policy, it currently covers nearly 70 countries in Eurasia, Africa, and the Middle East, between them representing one-third of global GDP and two-thirds of the global population. Its main aim is to invest in transport infrastructure, build China's economy and international trade, use the country's excess industrial capacity, and increase the security of its energy and food supplies. A new report by BBVA Research seeks to examine the effects on Latin America (appropriately enough, the report is titled 'China – One Belt One Road – What's in it for Latin America?").

The report notes that since 2000 Latin America's trade with China has been growing at a faster pace than its trade with the rest of the world. Key commodity exports to China include oil, iron and steel, copper, scrap aluminium, precious metals, and meat. Trade with China is most important for Chile (representing 25% of that country's total trade flows), Peru (22%), Brazil (18%), and Argentina (15%). All these countries are primarily commodity exporters to China. Mexico, with a large manufacturing sector, is more of a competitor, and therefore has weaker direct trade links. Chinese investment and financing has also been growing in importance, and is concentrated in Brazil, Peru, and Argentina. Interestingly, however, Japan, not China, remains the main source of Asian foreign direct investment (FDI) flowing into the region.

BBVA says OBOR could bring three main benefits to the region. First, it could support renewed Chinese demand for Latin American commodities, which has dipped in recent years following the end of the commodities boom. Second, OBOR might help reduce Latin America's commodity dependence and move itself up the value chain. Third, it might increase bilateral financing opportunities. The report comments that "recent shifts in US foreign policy strategy towards greater protectionism and the related concerns over global economic instability has provided an opportunity for China to promote itself as the torch-bearer of globalisation, free trade, and open markets".

OBOR links and projects in the region may be assessed under the so-called '3 x 3' model proposed by Chinese Premier Li Keqiang in mid-2017. This envisages meeting Latin America's domestic demand through the supply of logistics, electricity, and information; achieving market-based cooperation between enterprises, society and government; and expanding financial links through funds, credit, and insurance.

There are various major projects that could bring Latin America under the OBOR umbrella, each with varying degrees of political and technical feasibility. It is now generally recognised that the hyper-ambitious China-backed US$50bn-plus plan to build a second canal through Nicaragua, linking the Pacific and Atlantic oceans, faces major obstacles and may never materialise. However, since China and Panama established full diplomatic relations in mid-2017, there have been further signs of Chinese investment in logistics and port projects around the existing and enlarged Panama Canal. Formal talks on a China-Panama free trade agreement are due this year. China is already the second-most important user of the Canal. Beijing officials say they are interested in using the Canal and Panama's associated infrastructure as a platform for wider trade with Latin America. The Chinese are also backing a proposed railway that would link Costa Rica and Panama – currently the only two countries in Central America that have formal diplomatic relations with Beijing. As and when other countries switch diplomatic recognition from Taiwan to the Peoples' Republic, a bigger freight rail network may be on the cards.

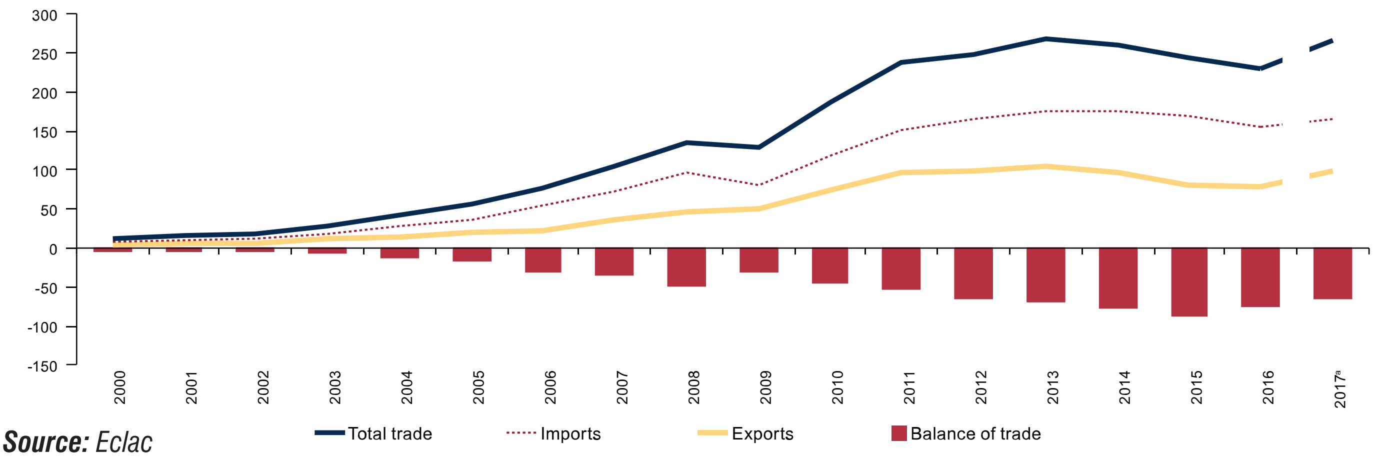
OBOR might be invoked to get another big project back off the drawing board: the proposed transcontinental railway that would link Brazil's Atlantic port of Santos with Peru's Pacific port of Ilo. The project, costed at around US$15bn, would allow for annual shipments of around 10m tonnes and cut journey times by nearly four weeks. It would particularly benefit Brazilian iron ore and soya exporters to China. The governments of Peru, Paraguay, Bolivia, and Argentina have expressed support for the project. Brazil's original enthusiasm was dampened by fiscal austerity and the country's recession and political crisis of 2015-2016: conceivably, depending on the outcome of the October presidential election, it may yet revive.

Overall, the report is positive about the impact of Latin America's potential inclusion in OBOR. In general, it notes, "closer Asia-Latam links can serve as a tailwind and promote sustainable growth for Latin American economies, which face sluggish growth and high political uncertainty". But it does sound some warnings. One is that the region itself needs to become more closely integrated, if it is to negotiate successfully with China. Specifically, the continent's two main trade blocks Mercosur (Argentina, Brazil, Paraguay, and Uruguay) and the Pacific Alliance (Chile, Colombia, Mexico, and Peru) need to work together. One example is that there needs to be a consensus position on regulatory standards, customs norms, and rules of origin. Countries in the region also need to overcome public sector fiscal deficits, and the corrosive effect of political and corruption-related scandals: there is also a need to raise the quality of engineering and environmental assessment of major infrastructure projects.

China trade and investment targets reaffirmed

The second meeting of representatives of the Chinese government and the Community of Latin American and Caribbean States (CELAC) was held in Santiago, Chile, in January and reaffirmed bilateral trade and investment targets set during the first meeting held in Beijing in 2015. That had set a target of lifting total trade to US$500bn by 2025. "According to our estimates, trade between the region and China multiplied 22 times between 2000 and 2013, and in 2017 reached US$266bn. This means progress of 53% toward the goal with seven years to reach it," said Alicia Bárcena, the executive secretary of the UN's Economic Commission for Latin America and the Caribbean (ECLAC). There is also a target to raise the stock of bilateral foreign investment to US$250bn, also by 2025. Officials said that as of last year, the stock of Chinese FDI in Latin America was US$115bn.

Latin America and the Caribbean: goods trade with China, 2000-2017
(Billions of dollars)



Source: *Eclac*

While this represented good progress, Bárcena argued that more needed to be done to diversify Latin American exports to China. At present only five products – soya, iron ore, copper ore, refined copper, and crude oil – represented 70% of the total value of Latin American shipments to China. Chinese FDI also tended to be concentrated in particular countries (Brazil, Peru, Argentina) and sectors (mining and energy). Bárcena stressed the importance of OBOR, noting that in the first place, by spurring the economies of Asia and Europe, it would increase aggregate demand for Latin America's exports. The Chinese initiative also offered "a unique opportunity to shorten the great territorial distance that separates us, through better air, maritime, and especially digital connectivity, to tighten our trade, investment, tourism, and cultural ties".

REGIONAL ECONOMY REVIEW

EL SALVADOR

Assessing the economic impact of TPS termination

On 8 January the US government served 18 months' notice of its intention to terminate the temporary protected status (TPS) visa programme that benefits approximately 200,000 citizens of El Salvador, raising the prospect that many of them will have to return home. Some consider this a potential catastrophe in the making for the Salvadorean economy; others think the impact will be manageable, and may even have some upside effects.

The TPS programme was introduced in 1990, allowing temporary residence rights in the US for immigrants from a variety of countries unable to return home because of armed conflict or natural disasters. The programme was extended to Salvadoreans after the country suffered two devastating earthquakes in 2001. At present there are around 2m Salvadorean migrants in the US. Of that total, nearly 200,000 of them come under the TPS regime. They now have 18 months – running to 9 September 2019 – in which to apply for permanent residence in the US, emigrate to a third country, or return home to El Salvador.

The US decision to terminate TPS for Salvadoreans has been widely criticised, and some suggest it may have catastrophic implications for the Salvadorean economy. Those with long memories remember how the US-born children of Salvadorean refugees in the 1980s and 1990s absorbed the gang culture of US cities like Los Angeles, made it more violent, and took it back with them to El Salvador. Gangs like MS-13 and Barrio 18 continue to have a major negative impact on the country. GDP growth has been sluggish (around 2% a year) meaning that making progress in the struggle against crime, unemployment, and poverty has been difficult. A sudden return of tens of thousands of uprooted and deported migrants would make matters worse. The pessimists add that expatriate workers are already propping up the economy by sending money home. Manuel Orozco of InterAmerican Dialogue, a Washington-based think tank, says research shows that one in 10 households in Salvador depend on remittances to survive. Remittances support domestic consumption and give the Salvadorean government improved access to foreign exchange. According to the central bank, remittances rose by 9.7% in 2017 to US$5.021bn, representing a record 18.3% of GDP. If that steady flow of remittances is reduced or removed, the Salvadorean economy could tip over into outright recession.

Those who say the impact will be more manageable cite a number of factors. A study by the Salvadorean central bank suggests there will not be mass deportations simply because Salvadorean immigrants are net contributors to the US economy. Some might in any case transfer out of TPS into other newer programmes that may emerge as part of US immigration reform. Rating agency Moody's Investor Service points out that only part of the overall flow of remittances is at risk. It acknowledges that the end of TPS is a medium- to long-term negative for the Salvadorean economy, but estimates that only around one in five US-resident Salvadoreans who send remittances home are TPS beneficiaries. This sub-group sends home an estimated US$600m, equivalent to 2.2% of GDP.

According to economist Claudio de Rosa, because many TPS beneficiaries are relatively highly skilled, a proportion might emigrate to third countries such as Australia, or in Canada or Europe, and continue sending money home to El Salvador from there. Those who return directly to El Salvador, he admits, can no longer be a source of foreign currency. But as he put it, "many will come back with capital, with years of accumulated savings and also with their knowledge, skills, and strength to work and support the Salvadorean economy". Another economist, Luis Membreño, agrees that many returnees will be entrepreneurial business people, ready to set up small businesses back in El Salvador. The challenge for the government will be to create favourable conditions for them to prosper, including offering the necessary access to credit. Some have suggested returning Salvadoreans with good English language skills could be employed in local call centres serving the US market. There are now around 70 call centres operating in El Salvador. Total employment in the sector has increased 50% over the last two years.

ARGENTINA

Macri working out the structural reform jigsaw puzzle

President Mauricio Macri did well in the October 2017 legislative elections, which he interpreted as a green light indicating electoral support for a structural transformation of the Argentine economy. Five months on, progress has been made on spending reform, tax reform, and pension reform. There have been political costs, which may intensify as the government again turns its attention to labour reform. Here, we look at progress so far, and at the somewhat mixed outlook for the president's strategy of gradual and incremental change.

Reforms often generate a lot of political noise for what at first sight appear to be relatively small changes, measured in terms of total GDP. A recent report by consultancy Capital Economics looks at the first three major reforms achieved by the Macri administration since last October's elections. After negotiations, a new law imposes a two-year temporary, real-terms freeze on total primary spending in the provinces, and after that, an ongoing freeze on current spending (excluding capital projects). This, it is estimated, could cut the overall public sector deficit by 0.25-0.50 percentage points of GDP. Pension reform, passed after violent protests outside congress, changes the way pension payments are indexed. This could deliver savings equivalent to 0.3%-0.5% of GDP. The third major initiative, tax reform, actually increases the deficit, since the government takes the view that the business sector has been over-taxed and that tax cuts are needed to stimulate enterprise and investment. Measures include a cut in taxes on reinvested corporate earnings (down to 25% from 35% previously) and reductions in payroll and sales taxes. There were also some tax increases (on beer and cigarettes) and a new capital gains tax on fixed income investments. Overall, Capital Economics estimates the tax changes add around 0.3 percentage points of GDP to the ongoing fiscal deficit.

The context is that President Macri, who inherited high inflation and a major fiscal deficit from the previous administration, has been following a policy of gradualist correction. The word 'ajuste' – which has become associated with sharp fiscal corrections and conventional austerity – is studiously avoided. For 13 years, including Macri's first full calendar year in office, Argentina's fiscal deficit widened relentlessly on a year-on-year basis. The primary deficit (excluding debt interest payments) hit 4.3% of GDP in 2016. The latest data show that the trend finally turned in 2017, with the primary deficit falling nearly half a point to 3.9% of GDP. Various factors helped, including one-off tax revenues on repatriated foreign assets following an amnesty, and significant reductions in subsidies. The target for this year is to narrow the primary deficit further to 3.2% of GDP, reducing it to 1.2% in 2019, the last year of Macri's term in office.

To help achieve that, the government has various further reforms lined up. At the end of January it announced a reorganisation of the central administration, with budget cuts across the existing 20 ministries. This included a freeze on the salaries of the president, ministers, secretaries, and under-secretaries. There are controversial plans for a labour reform, now likely to be discussed in congress in March. These include reducing minimum redundancy and overtime rates, greater use of temporary and sub-contracted labour, and streamlining the operation of industrial tribunals. Overall, the aim is to make the labour market more flexible and competitive. Despite relatively good relations between the government and the labour unions in Macri's first two years in office, tensions have increased and the labour reform could trigger new political battles.

Analysts remain concerned that the government may have miss-stepped in its attempt to reduce inflation. In an unexpected move at the end of December the Central Bank (Banco Central de la República Argentina – BCRA) increased its inflation targets, from 8%-12% to 15% this year, and from 5% to 10% for 2019. Some analysts attribute the change to a direct intervention by President Macri and cabinet chief Marcos Peña, seen as interfering with the bank's autonomy. Whatever the reason, it appears to signal a U-turn in the BCRA's policy stance: earlier in December it had been signalling that further interest rates increases were likely and that monetary policy would remain tight. Only weeks later BCRA president Federico Sturzenegger said "by making our inflation objective more gradual, this will allow for an easing of monetary policy". The BCRA cut its benchmark interest rate by 0.75 bps to 28% on 9 January. In the short term, this might help economic growth and ease some of the political pressures on the government. But there are also risks. Continuing high inflation could make the next round of wage negotiations with the unions more difficult. It could also prolong the relative over-valuation of the local currency (already buoyed up by significant foreign currency borrowing) and therefore reduce the competitiveness of exports.

COLOMBIA

Modestly positive outlook for 2018

After a difficult 2017, with the economy estimated to have grown by around 1.5%, the outlook for the Colombian economy in this election year is modestly positive.

Last year saw another year of below-par economic growth in Colombia. The country continued to suffer the tail end of the negative oil price shock of 2015-2016 and the knock-on effects of fiscal austerity, including an increase in the VAT rate at the beginning of the year. Fixed investment, which had contracted in 2016, managed only 0.3% growth in 2017. Consumer and business confidence was muted. While investor interest in Colombia continued, in December 2017 US ratings agency Standard & Poor's cut the country's rating to BBB-, down from BBB.

This year, with legislative (March) and first-round presidential elections (May) due, the outlook is for modest improvement. International oil prices are now expected to rise by around 5% which, coupled with increased domestic production, should boost export earnings. Better global growth prospects will also play a part. Fixed investment will pick up pace, as the 'fourth generation' highway projects continue and capacity is renovated in response to rising activity in mining and manufacturing. Regional governments are also expected to step up capital spend against budget. There will still be an element of public sector fiscal austerity, but less so than in earlier years. The fiscal deficit peaked at 4% of GDP in 2016 and fell to an estimated 3.6% in 2017. This year the aim is to reduce that to 3.1%, meaning the squeeze will be less intense and the public sector will be able to play a more positive role in stimulating growth.

Also supporting growth in private consumption in 2018 is the fact that inflation is due to come down (not least because the one-off VAT-related price increases of early 2017 are now beginning to drop out of the 12-month baseline of comparison). On 29 January the central bank cut its benchmark interest rate by 25bps to 4.5%, with some further reductions expected during the course of this year. Some analysts remain concerned about the construction sector, where signs of weakness in residential housing demand are continuing. But growth of 3%-plus is expected in agriculture, retail and wholesale trade, and in industry.

A range of growth forecasts for this year now put GDP expansion at somewhere between 2.0% and 3.0%. The Central Bank and the finance ministry are projecting 2.7% growth, although Adolfo Meisel, an outgoing central bank director, recently said he thought growth might be a little lower, at 2.5%.

Forecasts for the Colombian economy						
	2014	**2015**	**2016**	**2017e**	**2018f**	**2019f**
GDP % change	4.4	3.1	2	1.5	2	3
Inflation year-on-year eop	2.9	5	7.5	4.3	3	2.7
Exchange rate eop COP/US$	2392	3,149	3001	2984	3000	2953
Devaluation (% eop)	24.1	31.6	-4.7	-0.6	0.5	-1.6
Central Bank benchmark interest rate	4.5	5.75	7.5	4.75	4	4
Fiscal balance (% of GDP)	-2.4	-2	-4	-3.6	-3.1	-2.5
Current account balance (% of GDP)	-5.2	-6.5	-4.4	-3.6	-3.2	-3.4
Unemployment rate (%, eop)	9.3	9.8	9.8	10.6	11.2	11
Source: *BBVA Research*						

Meisel said the bank had made its contribution to recovery by cutting interest rates (down 325bps since December 2016). He suggested there would now be a period of relative interest rate stability. The outlook for this election year assumes that there will be no major political surprises to unsettle the markets. Currently the three front-runners in the presidential race are Gustavo Petro (a centre-left candidate from the Partido Progresista), former Vice-president Germán Vargas Lleras (a centre-right figure from Cambio Radical), and the former mayor of Medellín Sergio Fajardo, running as an independent. Petro has spoken of increasing government spending, Lleras of cutting taxes, and Fajardo of lowering interest rates. Whoever wins, the markets appear to be expecting a degree of policy continuity and macro-economic stability.

HONDURAS

The economy under Hernández (again)

On 27 January President Juan Orlando Hernández was sworn in for a second four-year term in office, promising to deliver further economic improvements. But the fact that he continues to be dogged by claims of electoral fraud reduces his political legitimacy and may have negative implications for the country's social and economic outlook.

Supporters say the first Hernández presidency delivered some real improvements. A three-year stand-by agreement with the IMF encouraged investors and helped stabilise inflation and growth. While Honduras continues to suffer one of the world's crime rates, homicides have been falling. Last year the public sector deficit was cut to 1.2% of GDP (below the 1.5% target), while foreign currency reserves rose, also above target, to US$3.36bn. The economy grew by an estimated 4.0% while inflation was 4.5% and unemployment stood at 5.9%. Admittedly, these numbers are not that sharply different from what Hernández inherited four years earlier. During his time in office GDP grew by an annual average of 3.57%, marginally below the 3.62% average achieved during the preceding four years. And total government debt has actually edged up to 44% of GDP, compared with 40.1% at the start of his term.

The president was nevertheless enthusiastic about what he can offer in the next four years. In his inauguration speech he promised more economic development. Earlier, during a telephone call in January, Alejandro Werner, the IMF's director for the Western Hemisphere, congratulated Hernández on his second term. The president responded that his aim would be to maintain growth, create jobs, and reduce economic inequality. There may well be a second stand-by agreement. In the first appointments, Wilfredo

Cerrato has been moved from the finance ministry to take over as the new president of the Central Bank. Cerrato's former deputy, Rocio Tábora, succeeds him as the new finance minister.

Rather than 'more of the same', an alternate and more pessimistic scenario for Honduras is also a possibility. Since the November elections over 30 people were killed in clashes with police during anti-government protests. At one point the economic cost of the protests and associated disruption was put at over US$100m a week. The government had been expecting 2017 GDP growth of up to 4.8%, but this was cut back to 4% because of the end-of-year disruption. The protests have begun to wane. However, in the absence of meaningful dialogue with the opposition parties, they could conceivably flare up again, frightening investors and leading to lower growth this year. There is also a real danger that an increasingly authoritarian Honduran government will be seen as slipping back on earlier commitments made to fight crime and corruption and to enhance the rule of law.

There are already claims that the newly appointed head of police has links with drug traffickers. In January the new congress passed a law, which in effect prevents public servants accused of corruption from being brought to trial for three years after the event (it does this by establishing there can be no criminal prosecutions until after a full audit of the last three years of public accounts). Much may depend on talks between the government and the Organisation of American States (OAS). The OAS continues to say that the elections were flawed. As the sponsor of the locally-based Mission for Support Against Corruption and Impunity in Honduras (Maccih) the OAS also has an interest in ensuring higher standards of transparency. Although the re-elected Hernández has the support of the United States, the IMF, and other pillars of the international community, its underlying lack of legitimacy may yet prove to be a significant negative for the economy.

BRAZIL

Relax about now, worry about then

Perspectives on Brazil's long battle to emerge from recession and to reform its lopsided economy are changing. Amid signs of growing levels of activity, analysts are worrying a lot less about the economy for most of 2018 – particularly the period running up to the October elections – but, on the other hand, they are beginning to worry a lot more about what happens in, and after October.

Everything suggests that the outgoing and unloved government of President Michel Temer will preside over a reasonably good year for the Brazilian economy in 2018. The recovery is underway. After two disastrous years in 2015 and 2016 (when GDP dropped by 3.8% and 3.4% respectively) the economy is estimated to have grown by 1.1% in 2017; the government is forecasting 3.0% for 2018. While this may be on the optimistic side, most forecasts for Brazilian growth this year are hovering around the 2%-3% range.

Business and consumer confidence indicators are pointing upwards. Inflation has plunged to an annual rate of 2.9% in December, boosting domestic purchasing power and clearing the way for significant cuts in interest rates. The steep fall in investment is beginning to bottom out. Car sales grew by 9.2% last year, helping the wider industrial sector to grow by

2.5%, the first positive result after three consecutive years of contraction. Although much more needs to be done the government has had some success trying to bring the fiscal deficit under control. The primary public sector deficit (excluding interest payments) last year was BRL110.6bn (US$35.1bn) or 1.69% of GDP. This was a reduction of almost one third in dollar terms, relative to the 2016 deficit of US$49.5bn.

The Temer administration will probably struggle to deliver another big bit of fiscal restructuring – pension reform. Most analysts agree that without pension reform the fiscal accounts are unsustainable. The latest, watered down version of the reform is likely to be voted in congress in February. As it stands it will cut the large public pensions deficit by only around 25%, or maybe by even less. If it is approved, the next government will most probably have to come up with further, deeper changes. If it is not approved, the next government will have to start out again with a new and comprehensive approach to the problem. Either way, it is being seen as less of a short-term issue: many believe the Temer administration has pretty much done what it can as far as structural reforms are concerned.

Instead, most analysts are now focusing on the big uncertainty: who will win the October elections and what kind of economic policies will they follow? Predicting the election outcome remains highly difficult, given the volatility of the electorate and the uncertainty over whether former president Luis Inacio Lula da Silva will or will not be formally banned from standing because he has been sentenced on charges of corruption. Many fear the elections could be won by right-wing or left-wing populists who might turn away from reform. Sergio Rial, president of Spanish bank Santander's Brazilian operation, expressed the concern of many when he said at the end of January that he was worried that the next government might not be committed to what he called "an agenda of fiscal balance".

MEXICO

Nafta guessing game continues

The sixth round of Canada-Mexico-US talks on the future of the North American Free Trade Agreement (Nafta) were held in Montreal on 23-29 January, amid conflicting signals over the ultimate outcome.

Interpreting Nafta smoke signals remains an uncertain business. The head of the Mexican negotiating team, economy minister Idelfonso Guajardo, said that for the first time in the latest talks all three delegations felt progress had been made. Talks over a dozen chapters were very advanced and Canada had placed "creative ideas" on the table. Officials said the chapters on telecommunications and e-commerce were almost finalised. Guajardo's ministry later announced that a seventh round of negotiations would be held in Mexico City between 26 February and 6 March. US Trade Representative Robert Lighthizer was more guarded, saying there had been "some advances" but that difficulties remained: he specifically rejected Canada's proposals to resolve a deadlock over local content rules in the automobile sector.

Mexican Nafta watchers were tracking US Secretary of State Rex Tillerson's visit to Mexico City in early February. The visit came amid reports by *Reuters* news agency that Mexico is considering allowing US air marshals to travel on commercial cross-border flights. This led to speculation that Mexico might be seeking to make concessions on both border security and immigration issues in a bid to secure a successful Nafta renegotiation. While not directly confirming that interpretation, *Reuters* quoted a senior Mexican government official saying "all our efforts now are based around Nafta and making sure the pact doesn't collapse". During Tillerson's visit Mexican foreign minister Luis Videgaray suggested Mexico's relationship with the Trump administration was closer and "more fluid" than it had been with previous US governments.

MEXICO

Mexican economy bounces back firmly in Q4

Despite significant uncertainty about the future of Nafta, data released from Mexico's statistical institute, Inegi, revealed that the economy performed strongly in the fourth quarter of 2017. Real GDP growth rose by 1% compared with the third quarter, its strongest result of the year, which helped lift full-year growth to 2.3%.

The firm fourth-quarter result partly reflected a cyclical bounce-back after a particularly weak third quarter, which was blighted by the impact of two earthquakes. Nevertheless, the fact that economic activity did indeed stage a solid recovery in the fourth quarter is positive, as many forecasters had expected the economy to continue to struggle for the remainder of the year and had downgraded their projections for both the third and the fourth quarters. At the time of writing, Inegi has only released the headline GDP growth figure, with a full sectoral breakdown of the results as yet unavailable, so it is difficult to pin down the precise industries that contributed to the recovery, but it is likely that construction played a major role in the bounce-back, reflecting considerable reconstruction efforts.

The outlook for 2018 is highly uncertain and will depend to a large extent on the results of the Nafta renegotiation talks that are currently underway, as well as on the outcome of the July presidential election. However, the solid 2017 result has engendered a larger dose of optimism about prospects for the current year, with the government announcing that it expects GDP growth of between 2% and 3%. In late January, the IMF revealed that it had raised its growth projection from 1.9% to 2.3%. If the US economy remains solid, there is even potential for growth to accelerate in 2018, with strong consumer demand in the US feeding through to firmer manufacturing exports from Mexico.

Inflation still high, the peso still weak

With the Mexican authorities facing a relatively benign growth outlook, their main concern will be inflation. Full-year data show that inflation averaged just over 6% year-on-year in 2017, up from 2.8% in 2016. Price growth was particularly marked in the second half of the year, with inflation ending 2017 at 6.8% – a near-17 year high. This places the central bank in a quandary, since policy-makers had hoped to put interest rates on hold after a prolonged period of monetary tightening, which has seen the policy rate rise to 7.25%. Yet another rate hike is more likely than not when the central bank's monetary policy committee meets on 8 February.

The problem is that rate hikes have clearly not had a significant impact on reining in inflation, which has been fuelled in large part by the depreciation of the peso, which has fed through to inflation via higher import costs, which have been passed onto the consumer. The peso has undergone moderate appreciation since late December, strengthening from just under Ps20:$ to around Ps18.7:$ at the end of January, but the local currency remains extremely weak by historical comparison. The peso has been volatile, swinging rapidly in response to developments in Nafta talks. The danger is that investor caution during the remainder of the negotiation process – which is now expected to drag well past the end-March anticipated conclusion – will keep the peso weak for much of 2018. This will keep inflation high, posing ongoing difficulties to policy-makers.

ECUADOR

Ecuador returns to international capital markets

The government tapped capital markets on 9 January, raising US$3bn, in the fourth bond issuance in under a year. Given a still-large fiscal deficit and relatively high external financing needs, the authorities remain reliant on debt issuance to close its financing gap. The fact that this most recent issuance was at better terms than previous bond sales augurs well, while President Lenín Moreno's subsequent win in a referendum on constitutional reform is another indication of a shift to the centre, both in terms of political and economic policy-making.

Investor interest in Ecuador remains firm, with the issuance proving around three-times oversubscribed. The 10-year bond was the tenth issuance since Ecuador returned to international capital markets in 2014, following its external debt default in 2008. This most recent issuance yielded 7.875%, lower than the 8.875% 10-year bond issued last October, despite continued monetary policy tightening in several developed economies (which tends to push up yields in emerging markets, as governments are forced to increase investor returns in order to attract interest).

Higher oil prices have boosted investor interest

The fact that yields have fallen is likely to reflect a number of factors. Firstly, oil price trends are more favourable. Brent crude was trading at around US$57/b when Ecuador tapped international capital markets last October; at the time of the January issuance, prices were approaching US$70/b, with futures prices also elevated, indicating that many market participants expecting oil prices to remain reasonably firm in the short term. Given Ecuador's commodity-dependent economy, this points to a likely improvement over the course of the year, with higher oil income helping to reduce both the current-account and fiscal deficits.

There is also a political dimension to increased investor interest in Ecuadorean debt. In recent months, President Moreno has moved steadily further away from his populist left-wing predecessor, Rafael Correa, which has boosted confidence that some form of fiscal consolidation is likely during the remainder of the current predecessor's tenure. A subsequent landslide victory for Moreno in the 4 February referendum on constitutional reform, with the electorate approving all seven propositions, will bolster the president's standing. Given that one of the proposals was a ban on presidential re-election (even non-consecutive), this also eliminates the possibility that Correa may again bid for the presidency at a later date. Although it is possible that another candidate may assume power in the next election and loosen the fiscal purse strings, markets will be relieved that the charismatic Correa will not be able to engineer a revival.

Structural weaknesses remain in place

That said, despite the investor interest in Ecuador amid a revival in oil prices, the economy remains fragile. Despite an improvement, the current-account and fiscal deficits will still be large and repeated bond issuance will lift public-sector debt. The debt burden, at over 40% of GDP, is fairly heavy for an economy that has only relatively recently exited default and average maturities are fairly low. GDP growth remains positive, but is fairly suppressed, while a still-strong US dollar continues to pose competitiveness problems to Ecuador's dollarised economy.

VENEZUELA

Venezuela announces maxi-devaluation

After holding the official exchange rate known as 'Dipro' steady at BsF10:$ for nearly two years, President Nicolás Maduro announced the elimination of this official rate on 31 January. The rate had been essentially reserved for public-sector imports, but the government now plans to use a much weaker rate, the so-called 'Dicom', for all foreign-currency transactions. The move is likely to fan the flames of already-rampant inflation and, coupled with an ongoing slide in oil production, will do little to address the critical problems facing the economy this year.

The 'Dicom' foreign-exchange system has been dormant since last August, so the government has announced that with the elimination of 'Dipro', 'Dicom' will be reactivated. Dicom was designed as an auction system, with the government supposedly making US dollars available on a weekly basis to the private sector, with participants placing bids for required amounts of foreign currency. The government allocated US dollars on a discretionary basis and at its own preferred exchange rate. However, shortages of US dollars led the authorities to suspend these sales, with the last auction taking place on 31 August 2017.

Dicom auctions restart

The first Dicom auction following the elimination of the Dipro rate took place straight away, on 1 February. The government had indicated that foreign currency sales would probably use a rate of BsF3,345:$ - the rate used at the last auction in August 2017 – but following the auction, the authorities announced that it had sold foreign currency at a rate of BsF25,000:$. The total amount of foreign currency sold has not been revealed, but given shortages of US dollars, as a result of low levels of foreign reserves and falling oil production (*see below*), the auction is unlikely to have satiated market demand.

There are several explanations for the elimination of the Dipro exchange rate and the restart of Dicom foreign-currency auctions. The first is that the government is seeking to address deep currency distortions and return the heavily-managed exchange rate to something like market equilibrium. The Dipro rate was hugely overvalued and the restricted nature of the foreign-currency system generated a large black market, where US dollars routinely changed hands at up to BsF266,000 as of late January. This huge gap between the official Dipro exchange rate and the black-market rate was a major contributing factor to an increase in corruption in recent years, as individuals with access to US dollars at the BsF10:$ rate could make huge sums of money by selling these dollars on the black market. Following the 1 February Dicom auction, the black-market rate appreciated somewhat, to BsF225,000:$ on 5 February.

The second reason for eliminating the Dipro rate is that the resulting maxi-devaluation artificially boosts the fiscal position. This is because Venezuela's oil export earnings are denominated in US dollars, so by devaluing the official exchange rate, the government is increasing its local-currency revenue from oil. This improves the income side of the budget and, given that much fiscal expenditure is also denominated in local currency, it has the effect of narrowing the budget deficit.

Hyperinflation is set to rise further

However, the sharp devaluation will have a number of negative effects on the economy. The government is monetising the fiscal deficit, which will require an even more significant ramping-up of money-printing by the central bank. Broad money (defined as the amount of cash in circulation plus instant-access bank deposits) is already over thirteen times higher than it was a year ago. The devaluation will drive this figure even higher. With vastly more local currency in circulation, prices will increase ever-more rapidly, particularly given that shortages of basic consumer goods continue. Any firms that import goods will face much higher costs as a result of the devaluation, which will also contribute to lifting inflation.

A lack of official data makes it difficult to assess the current level of inflation with any accuracy, but the IMF stated in late January that it had revised its inflation forecast for Venezuela upwards by more than five-fold; it is now projecting inflation of 13,000% this year. Moreover, this announcement pre-dated the elimination of Dipro by several days, so it is possible that the Fund may again revise its projections upwards as a result of the devaluation.

Oil production slides

Meanwhile, oil production has continued to slide. The latest data from the International Energy Agency (IEA) showed that oil production fell to 1.61m b/d in December, representing a fall of 490,000 b/d from December 2016. Oil production is now only half the level it was when Maduro's predecessor, Hugo Chávez, took office in 1999. The average decline registered during 2017 was around 8%, marking a much more rapid slide than in previous years (production fell by 2% in 2016 and 1% in 2015). The IEA expressed significant concern in its Monthly Oil Market Report, describing the decline as "precipitous" and highlighting the likelihood of another, even deeper fall in output in 2018. It stated that there were only 50 rigs drilling for oil in December, with industry sources indicating that at least 100 are necessary to arrest the decline in production.

In the context of this fall, as well as the devaluation (which is likely to fuel hyperinflation), the government is probably envisaging an even more marked economic deterioration as 2018 progresses. It is also likely that bond-holders, who have not received interest and capital payments on bonds that have fallen due in recent months, will take more legal action against the Venezuelan authorities to recoup their losses. These factors are likely to explain the decision of the constituent assembly (dominated by the ruling PSUV) to call an early presidential election, which is expected at some point before the end of April. With the opposition in disarray, Maduro is clearly hoping to secure another six-year term in office before the economy goes from bad to worse. Yet even if he does win re-election, there are major questions about his ability to remain in power in the context of six-digit inflation, another steep fall in GDP (the IMF is forecasting a 15% contraction), and ongoing shortages of consumer goods.

SPECIAL FOCUS

NICARAGUA

An oasis of stability in a turbulent region

Nicaragua remains an outlier in Central America. Governed by a radical left-wing socialist government, the country stands out for its stability, security and steady economic growth. Thanks to its safe environment, diverse landscape, architecture and rich cultural heritage, it now has a thriving tourism industry, with Nicaragua a 'must see' on top destination lists for 2018. US tourists, including legions of surfers and big-spending retirees, are heading to the country in increasing numbers every year. It also has one of most attractive – and transparent – investment environments in the region, with strong inflows of FDI from the US, China and elsewhere driving growth in recent years. With both the US congress and the administration led by President Donald Trump taking an increasingly dim view of the left-wing government, however, there is some concern about prospects moving forward.

While President Daniel Ortega of the left-wing Frente Sandinista de Liberación Nacional (FSLN) has earned himself a rather dubious political reputation, he is considered a pragmatic business man. Unlike his left-wing counterparts in Venezuela and Ecuador, Ortega has implemented a business-friendly administrative, legal and regulatory framework in the country, and the government works very proactively to encourage international investment. While China and Venezuela have been key economic partners, the government by and large has crafted working relations with a variety of external investors – including in the US and Europe – without political or ideological strings attached.

The result has been real average annual GDP growth of almost 5% since 2013, with annual FDI inflows of between US$800m and US$900m in that period.

Safe and secure

According to the Nicaraguan government, there were 431 homicides in the country in 2017 – compared with 4,410 in Guatemala – meaning that it had by far Central America's lowest homicide rate, at an estimated seven per 100,000. This is lower than Costa Rica's rate of 12.1 and Panama's 10.2. In the region, Nicaragua had the fourth-lowest murder rate behind Chile (3.3), Ecuador (5.8) and Argentina (6).

According to the United Nations World Tourism Organization (UNWTO), Nicaragua was the eighth-fastest growing global tourism destination in 2017, with arrivals up over 28% to September. Total annual arrivals have yet to break the 2m mark, meaning the industry has very strong growth potential.

In early February, the IMF published a statement following a staff visit to Nicaragua in which it concluded that the country's economic performance in 2017 was above expectations, with a favourable outlook for 2018.

To minimise downside risks to the economy moving forward, the Fund encouraged Nicaragua to further fortify its policy framework. To this end, it urged the Ortega government to move ahead with implementation of an international taxation law, as well as reducing tax expenditures, rationalising

Merchandise trade, selected partners, US$m									
	EXPORTS FOB			IMPORTS CIF			BALANCE		
	Jan-Nov 16	Jan - Nov17	% change	Jan-Nov 16	Jan - Nov17	% change	Jan-Nov 16	Jan - Nov17	% change
TOTAL	**2056.67**	**2231.55**	**8.50**	**5384.69**	**5581.05**	**3.65**	**-3328.02**	**-3349.50**	**0.65**
US	866.10	927.97	7.14	1052.29	1224.90	16.40	-186.19	-296.93	59.47
MEXICO	64.06	55.34	-13.61	533.84	567.26	6.26	-469.78	-511.91	8.97
CANADA	34.15	42.38	24.10	29.68	37.28	25.63	4.47	5.10	13.96
CENTRAL AMERICA	500.82	388.85	-22.36	1295.69	1319.67	1.85	-794.87	-930.82	17.10
COSTA RICA	124.78	129.28	3.61	444.74	444.24	-0.11	-319.96	-314.96	-1.56
EL SALVADOR	230.46	149.18	-35.27	301.98	317.57	5.16	-71.52	-168.38	135.42
GUATEMALA	82.57	57.15	-30.78	387.88	399.53	3.00	-305.32	-342.38	12.14
HONDURAS	63.02	53.23	-15.52	161.08	158.33	-1.71	-98.07	-105.10	7.17
REST OF LATIN AMERICA & CARIBBEAN	231.87	245.74	5.99	644.63	656.58	1.85	-412.76	-410.84	-0.47
PANAMA	36.48	34.17	-6.33	36.98	17.79	-51.89	-0.50	16.38	-3379.40
PUERTO RICO	35.14	43.24	23.05	2.04	2.07	1.24	33.10	41.18	24.40
DOMINICAN REPUBLIC	12.87	5.44	-57.76	8.03	9.89	23.21	4.84	-4.46	-192.00
VENEZUELA	104.36	116.81	11.93	187.85	139.25	-25.87	-83.49	-22.45	-73.11
OTHERS	43.01	46.08	7.14	409.73	487.58	19.00	-366.71	-441.49	20.39
EUROPE	208.59	296.86	42.32	392.11	437.25	11.51	-183.52	-140.39	-23.50
GERMANY	25.81	50.87	97.07	80.13	94.08	17.40	-54.32	-43.21	-20.45
BELGIUM	27.54	46.73	69.70	11.02	10.41	-5.50	16.52	36.31	119.88
SPAIN	11.66	10.93	-6.21	61.87	71.75	15.95	-50.21	-60.81	21.10
UK	44.98	68.22	51.65	15.27	14.28	-6.50	29.71	53.94	81.53
OTHERS	98.60	120.11	21.82	223.81	246.73	10.24	-125.22	-126.62	1.12
ASIA	109.41	184.46	68.59	1420.95	1320.69	-7.06	-1311.54	-1136.23	-13.37
SOUTH KOREA	5.35	8.61	60.82	80.44	79.05	-1.73	-75.09	-70.44	-6.19
CHINA	51.74	81.10	56.75	28.07	29.99	6.86	23.67	51.11	115.88
JAPAN	19.49	25.15	29.04	118.85	129.19	8.70	-99.36	-104.04	4.71
OTHES	32.83	69.60	112.01	1193.60	1082.46	-9.31	-1160.77	-1012.86	-12.74
REST OF WORLD	41.68	89.95	115.83	15.50	17.42	12.38	26.18	72.53	177.06

Source: *DGA, MEM-Hidrocarburos, CNDC/ENATREL* subsidies, and implementing a comprehensive social security reform. It also recommended that the country build up its financial buffers, including by increasing international reserves. Finally, it also suggested that Nicaragua reinforce its supervisory and AML/CFT frameworks.

According to IMF calculations, real GDP growth was about 4.9% in 2017, up a little from 4.7% in 2016, supported by a strong recovery in agro-exports (from previous disease and drought), as well as tourism and remittances. Headline inflation, meanwhile, increased to 5.7%, reflecting raising oil and food prices, while core inflation stood at 4.1%.

The combination of buoyant of agricultural exports, tourism, and remittances helped offset the impact of higher oil prices, allowing the the country's structural current account deficit to decline sharply to 6.1% (from 8.6% in 2016). That same combination of agro-exports, tourism, and remittances also underpinned a rise in international reserves to US$2.59bn, or about 4.2 months' import coverage.

Private-sector credit growth, financed in part by a substantial increase in external obligations, decelerated slightly to 17%, the Fund reported. Within the financial sector, the non-performing loan ratio was a low 1.2% percent, while the capital adequacy ratio rose to 13.8% and profitability was stable at 20.9% (ROE).

The consolidated public-sector balance was largely unchanged at 2.5% of GDP in 2017, on preliminary IMF estimates, based on Nicaraguan government figures. A continuing deterioration in the financial position of the Social Security Institute (INSS) was partially mitigated by slightly lower budget deficit results for the central government and the municipality of the country's administrative capital and largest city, Managua (ALMA, in the Spanish acronym).

Looking ahead, the IMFs expect Nicaragua to post real annual GDP growth of 4.7% in 2018. According to the Fund, domestic demand should strengthen, supported by a surge in public infrastructure investment projects. Similarly, exports are expected to continue to grow in response to US demand, partially cushioning the impact of higher oil prices. Reflecting higher global oil prices, inflation is projected at 6.3%.

A higher oil import bill will also push up the current account deficit to a projected 7.7% of GDP. Continued inflows of FDI – along with concessional loans from multilaterals – will continue to finance the external deficit. The Fund projects international reserves of US$2.67bn in 2018, with coverage easing to about four months of imports (as higher oil prices make imports pricier).

Finally, the Fund expects the consolidated public-sector deficit to rise to 3.3% of GDP this year. The Fund notes that, absent a fiscal reform, a modest reduction in current spending by the central government would be offset by an increase in capital expenditure by Managua's municipal government, along with several state-owned enterprises. It also emphasises that the INSS deficit "will continue to increase until a reform is put in place".

Despite this deteriorating budget position, however, the overall public debt position is projected to remain stable in terms of nominal GDP, largely thanks

Nicaragua: Selected Social and Economic Indicators, 2014–2019					
I. Social and Demographic Indicators					
Main export products: beef, coffee, and gold.					
GDP per capita (current US$, 2016)		2,151	Income share held by the richest 10 percent (2014)		37.9
GNI per capita (Atlas method, current US$, 2015)		1,960	Unemployment (percent of labor force, 2016)		6.2
GINI Index (2014)		47.1	Poverty rate (national pov. line, in percent, 2014)		29.6
Population (millions, 2016)		6.1	Adult literacy rate (percent, 2015)		82.5
Life expectancy at birth in years (2014)		74.8	Infant mortality rate (per 1,000 live births, 2015)		18.8

II. Economic Indicators						
	2014	**2015**	**2016**	**2017 (Est.)**	**2018 (Proj.)**	**2019 (Proj.)**
Output (Annual percentage change)						
GDP growth	4.8	4.9	4.7	4.9	4.7	4.5
GDP (nominal, US$ million)	11,880	12,748	13,230	13,727	14,532	15,499
Prices						
GDP deflator	8.4	7.5	4.1	3.8	6.2	7.2
Consumer price inflation (period average)	6	4	3.5	3.9	6.2	7.2
Consumer price inflation (end of period)	6.5	3.1	3.1	5.7	6.3	7.4
Exchange rate						
Period average (Cordobas per US$)	26	27.3	28.6	…	…	…
End of period (Cordobas per US$)	26.6	27.9	29.3	…	…	…
Fiscal sector (Percent of GDP)						
Consolidated public sector						
Revenue (excl. grants)	25.5	26.3	27.9	28.2	27.9	27.8
Expenditure	28.6	29.6	31.2	31.8	31.9	32.1
Current	22.6	23	24.2	24.7	24.2	24
of which: wages & salaries	7.4	7.4	7.6	7.6	7.4	7.4
Capital	6	6.7	7	7.1	7.8	8.1
Overall balance, before grants	-3.1	-3.3	-3.3	-3.5	-4.1	-4.3
Overall balance, after grants	-2	-2.2	-2.4	-2.5	-3.3	-3.5
Money and credit (Annual percentage change)						
Broad money	15.4	19	11	14.4	13.8	16.7
Credit to the private sector	20.5	23.5	17.5	16.6	15.9	16.5
Net domestic assets of the banking system	5.1	18.7	13	15.3	15.6	15.5
External sector (Percent of GDP, unless otherwise indicated)						
Current account	-7.1	-9	-8.6	-6.1	-7.7	-7.6
of which: oil imports	9.6	6.1	5.2	6.4	7.9	7.2
Capital and financial account	9.3	11.1	5.7	8.5	8.3	8.3
of which: FDI	6.7	7.1	6.5	6	5.6	5.7
Gross international reserves (US$ million)1/	2,147	2,353	2,296	2,593	2,667	2,772
In months of imports excl. maquila	4.2	4.6	4	4.2	4	4
Net international reserves1/	2,024	2,262	2,236	2,554	2,647	2,766
Public sector debt2/	40.2	40.7	41.9	42.6	42.6	41.9
Private sector external debt	44.7	44.9	44.8	43.3	40.9	38.5

Sources: Country authorities World Bank and Fund staff calculations and estimates.

1/ Excludes the Deposit Guarantee Fund for Financial Institutions (FOGADE).

2/ Assumes that HIPC-equivalent terms were applied to the outstanding debt to non-Paris Club bilaterals. Does not include SDR allocations. From 2016 onwards includes preliminary data on the domestic debt of SOEs and municipalities. Prior to 2016, the stock of domestic debt of SOEs and municipalities is calculated based on the capitalization of flows.

[1] On February 1, 2018, the authorities submitted to the National Assembly a proposal to replace general electricity subsidies with targeted subsidies according to consumption brackets, increasing gradually the VAT rate, adjusting the electricity tariff paid by retirees, and updating the tariff schedule.

Source: IMF

to the more dynamic economic growth, which will lift nominal GDP. The Fund also makes the point that the public-sector deficit should improve marginally in the medium term, as capital spending gradually returns to historical levels.

But nevertheless, it recommends that any substantial improvement in the deficit would require a fiscal reform and a comprehensive INSS reform, "in line with the 2017 Article IV Staff Report recommendations".

Main Policy Challenges

According to the IMF, the risks to Nicaragua's growth are broadly balanced in the near term, but remain skewed to the downside over the medium term. On the upside, the firming global recovery is expected to increase external demand. Rising US economic activity "is highly correlated with Nicaraguan GDP growth", it notes.

On the downside, spillovers from US migration, trade, and monetary policies continue to pose substantial risks. The latter coincides with the potential approval of the NICA Act by the US senate, while Venezuela's oil cooperation no longer plays a substantial role. Therefore, the Fund says, the government ought to increase its fiscal space and maintain a stronger international reserves position. Furthermore, financial institutions should continue to build financial buffers.

NICA Act

If approved by the US congress, the Nicaragua Investment Conditionality Act of 2017 (the NICA Act 2017), a response to the 2017 Nicaraguan election, would oblige an embargo on new multilateral lending to Nicaragua, upon which the country is heavily dependent.

In terms of building up fiscal buffers to cushion the country against negative external shocks, the Fund said it had once again encouraged the Nicaraguan authorities to take advantage of the strong economic performance "to complete the design and implementation of a tax reform aimed at creating additional fiscal space, as discussed in 2017 Article IV Staff Report".

The Fund said it welcomed recent measures to better target electricity subsidies and eliminate some VAT exemptions, and encouraged the authorities to include the remaining recommendations of the IMF's Fiscal Affairs Department (FAD) within their fiscal reform plan. "The FAD's proposals on subsidy rationalisation, elimination of VAT exemptions, international tax law implementation, and further strengthening of tax administration will help eliminate inequalities and increase fiscal resilience," it emphasised.

The Fund also welcomed the INSS reform plan, which aims to correct some inequities within the social security system and secure its long-term viability. It noted authorities' efforts to alleviate INSS' financing needs through payments of outstanding arrears and resumption of full government contributions in 2018. In addition to these measures seeking to address the imminent cash balance constraint, it also urged the local authorities to implement the FAD's proposed measures aimed at restoring the long-term sustainability of INSS finance. The fund did not elaborate on these suggested longer-term measures, but it is quite likely that these might be more structurally difficult and/or politically sensitive, such as formalising the (largely informal) labour force, increasing taxes, lowering the retirement age, and reforming other benefits, for example.

Financial sector buffers

The Fund notes the authorities' measures to enhance the resilience of the banking sector to shocks, noting the gradual adoption of prudential regulations in line with Basel III including the liquidity coverage ratio, the conservation capital buffer, and countercyclical provisions.

It reiterates the importance of expanding the supervisory perimeter but notes that while there is consensus to expand the financial supervisory perimeter to savings and loans cooperatives, "a decision on the allocation of institutional regulatory and supervisory responsibilities is still needed". The Fund thus encouraged the Ortega government to take advantage of the upcoming Financial Sector Stability Review mission from the IMF's Monetary and Capital Markets Department to discuss the best institutional arrangement.

Relatedly, the Fund acknowledged the efforts to implement the recommendations of the 2017 Financial Action Task Force (FATF) Mutual Evaluation Report. In support of this, the Nicaraguan congress has approved laws to enforce record keeping, due diligence, and notification of suspicious operations. Additional legal initiatives to address the remaining FTAF recommendations are under consideration by the (FSLN-controlled) national assembly.

In conclusion, the Fund acknowledges recent progress and encourages the government to continue improving data quality and availability. "Financial management of public accounts, and proper debt sustainability analysis, requires regular compilation and dissemination of domestic debt statistics for SOE and municipalities," it notes, adding that "compliance with the 2001 Government Finance Statistics Manual would go a long way towards improving macro-fiscal management". And finally, it suggests that external sector data should further improve after completing the ongoing review of FDI base statistics and compilation methodology.

REGIONAL BUSINESS REVIEW

MEXICO

Mexican wrestling gets ready to compete

Mexico has a unique wrestling culture, known as Lucha Libre, involving acrobatic masked fighters; it can trace its history back to the 1930s and earlier. As an entertainment business, the US-based World Wrestling Entertainment Inc (WWE) dwarfs it. But efforts are underway to proactively market the Mexican version of the sport internationally.

The key organisation in the Mexican sport is the Consejo Mundial de Lucha Libre (CMLL). Since the 1950s CMLL has operated a purpose-built wrestling stadium in Mexico City known as Arena Mexico. More than half a million people attend CMLL shows every year, around 20% of whom are thought to be tourists. Friday night matches can attract up to 10,000 ticket-paying visitors.

Lucha Libre has a rich and distinctive tradition. Fighters are never supposed to remove their colourful masks. The use of masks is said to have been pioneered by a Mexico City-based Irish wrestler, known as Ciclón McKey, who started using one in the 1930s. They rapidly became popular. The company that made the mask, Martínez Deportes, is still in business today, producing around 450 a week. The fighting is highly choreographed. Combatants are usually divided into two groups, the *rudos* (evil characters who often break the rules) and the *técnicos* (who represent good and play by the book). Women fighters were banned until the 1980s but now attract big crowds. The idea of a masked avenger has captured the popular imagination: in the 1980s a 'real life super-hero' known as Superbarrio campaigned over housing and urban issues in Mexico City.

A big challenge for the sport is to go international. In January CMLL took part in a series of major fights in six Japanese cities, organised together with New Japan Pro-Wrestling Co (NJPW). Dorian Roldán, business development manager for entertainment company Triple A, produced a promotional film, *Lucha Underground*, to develop new markets and merchandising spin-offs. While television and film rights are important, Triple A still makes most of its money from live events. Roldán claims *lucha libre* is the second most popular sport in Mexico after football, ranked by attendance at live events. He argues that, just as US media companies have revived comic-book characters of the 1950s – Marvel and DC Comics – so Mexico has the opportunity to repackage its lucha heroes of the 1950s and 1960s (among them legendary characters such as Santo and Blue Demon).

As a business, Mexican wrestling has often been in the shadow of the US. North of the border, top WWE fighters can earn over US$2m a year, while the big-name Mexican wrestlers earn only a small fraction of that. The Mexican wrestlers regularly complain that organisers and promoters always take a lion's share of the profits. There is, however, a lot of crossover either side of the border. WWE usually holds some fights in Mexico, and the CMLL tries to build up support in the US, particularly among the Mexican immigrant community there.

MEXICO

Getting ready for carbon trading

Mexican government officials have confirmed that in the second half of this year a pilot national carbon emissions trading system will be put in place, involving around 500 companies transacting certificates representing some 400m tonnes of CO2.

Mexico has been gradually preparing for carbon trading in a context where government policies are designed to encourage a reduction in harmful emissions. In 2013 the government introduced a tax on fossil fuels. In 2013 and 2014 Mexico signed climate change cooperation agreements with the state of California, with Ontario and Quebec in Canada, and with a number of countries including Germany, Chile, and France. At the Paris Climate Change Conference in late 2015 Mexico undertook to cut greenhouse gases by 30% by 2020, and to cut overall emissions by 30% below 1990 levels, by 2050. This was followed by an energy transition law that required clean energy sources to reach 25% of all electricity generation by 2018, rising in stages to 35% by 2024.

In November last year there was a further step forward with the launch of a platform on the stock exchange to trade in carbon credits on a voluntary basis. The platform, called MEXICO2, allows polluters to offset their emissions with tradable certificates. At the time, Luis Tellez, chief executive of the exchange (Bolsa de Valores de México – BVM), commented, "Increasingly investors are asking that companies do their part to reduce carbon emissions." The head of MEXICO2, Eduardo Piquero, said he expected a million carbon credits to be traded in the first year of operation, rising to two million in the second year; however, he said the price of each credit had yet to be determined and would vary according to the type of project involved.

The overall idea is to create a cap-and-trade system. Rodolfo Lacy, the deputy environment minister, has explained that the government will set limits on the amount of carbon pollution companies can release into the atmosphere. Some companies will be comfortably within the limit, while others, using older technologies, will exceed it. Low or even negative emitters will include renewable energy producers and companies planting trees. High emitters will include coal- and oil-burning thermal power plants and iron and steel producers. The high emitters can purchase clean energy certificates to offset their pollution. By controlling overall permitted emission levels, the government can ensure they are gradually reduced, allowing the market to mediate between the high and low emitters and to set prices that enable the change to happen.

According to current government plans, in August this year an obligatory national carbon trading system will be introduced, requiring an up-to-date national registry of emissions (Registro Nacional de Emisiones). It will have a three-year pilot phase, with the full system coming into force after that, in August 2021. In January Lacy told website *Dialogochino.net* that 100 Mexican companies were already participating in a California-based carbon trading system so as to understand how pricing works. He added that the plan in Mexico is to offer local companies that emit more than 25,000 tonnes of carbon a year the chance to either take direct mitigation measures that would bring them back under that upper limit, or to buy offsetting clean energy credits on sale by other low emission companies. Lacy added "We believe that there may be 500 or more participants in the carbon market in our country emitting more than 400m tonnes, and the price is established by the balance of supply and demand." Once the market was fully established in Mexico, the government would seek to link it to California- and Quebec-based carbon markets: this would require agreements on trading standards and processes.

MEXICO

Successful deepwater auction

The results of the latest auction of oil and gas blocks (known as Phase 4, Round 2) were announced on 31 January and quickly hailed by officials as one of the most successful to date. Earlier, the authorities had said that awarding seven or more blocks out of the 29 on offer would qualify as a success. In the event 19 blocks, representing total investment commitments of up to US$93bn, were allocated to bidders.

Deputy minister for hydrocarbons Aldo Flores Quiroga said that if oil and gas was found in all the awarded blocks, they could represent 1.5m barrels per day worth of oil production by 2032, and 4bn cubic feet a day of gas.

These deepwater blocks will take time to come on-stream – covering the Área Perdido, Cordilleras Mexicanas and Cuenca Salina basins, the first oil is not likely to be produced until 2028.

Five companies applied for blocks on their own, while a total of 14 did so grouped together in consortia. The results were seen as a big success for Royal Dutch Shell, which acquired an interest in a total of nine blocks. Other successful companies included Malaysia-based PC Casrigali with six blocks, and Spanish-owned Repsol Exploración México, with stakes in three blocks. Pemex, the state-owned Mexican oil company won four blocks, two outright and two as part of consortia.

As part of the 35-to-50 year exploration and production (E&P) contracts that have been awarded in Phase 4, the Mexican government will receive US$525m in up-front payments. Officials estimate that if successful, drilling the new wells and providing the associated infrastructure and maintenance services could generate 230,000 jobs in the first 15 years. Finance ministry officials said that the E&P contracts signed meant that 64.7% of production profits would go to the state, rising to 67.2% in the event of higher-than-expected production or international prices. This was greater than the 59% achieved in the only other deepwater auction in Mexico, held as part of Round 1.

These auction results were significant in various ways. They suggest that the decade-long decline in Mexican oil production may be reversed – this was one of the aims of the oil and gas reforms introduced by the current government, which ended the state oil monopoly and again opened the industry up to foreign investment. Just after the reform in 2014, and during the worst of the international oil price slump in 2015 and 2016, there were fears that international oil companies would be unwilling to commit to the high investment costs required to develop deepwater deposits. However, against a background of moderate price recovery, these worries now seem to have been dispelled. Nor have companies been deterred by the chances that Andrés Manuel López Obrador, a nationalist on oil policy, will win this year's presidential election (López Obrador remains the front runner). Shortly after the auction results were revealed, López Obrador repeated an earlier pledge to review the contracts if he is elected.

URUGUAY

Unhappy farmers take action

With unexpected speed, a series of protest meetings and 'tractorcades' have swept across different parts of the country, as Uruguayan farmers vent their anger against the centre-left government of President Tabaré Vázquez. An initial set of government concessions may not be enough.

Farmers and cattle ranchers say they are facing major economic difficulties and that the government has been insensitive to their needs. Protests have been led not just by the traditional farming lobbies – such as the Asociación Rural del Uruguay (ARU) and the Federación Rural (FR) – but also by independent farmers known as the *autoconvocados* (the 'self-convened'). One of the high points of the protest movement came on 23 January with a mass meeting in the central department of Durazno, attended by up to 10,000 farmers and billed as the largest farmers' protest in more than a decade. By 30 January President Vázquez was offering an initial package of concessions. Farmers will be exempt from paying VAT on diesel fuel for a year; milk producers are to get help with their debts; rice farmers will get a 15% reduction in electricity tariffs for the next three months. These measures were quickly rejected as "insufficient" by the protestors, as both sides prepared for further negotiations. Senator Jorge Larrañaga of the opposition Partido Nacional (traditionally strong in the countryside) accused the administration of "once again turning its back on producers…they give everything to obtain foreign investment but never do enough for the Uruguayan producer".

Consultancy Blasina y Asociados has sought to sketch out the economic background to the farming crisis. It points out that the index of consumer prices, set at 100 in December 2010, reached 172.86 in December 2017. In other words, over a seven-year period inflation – including the operating costs that famers must pay – has totalled 72.86%. But in the same period the value of the US dollar – a key component of the export price they receive for their produce – has increased much more slowly, by 43%. In other words, because of an overvalued currency all farmers are being squeezed by production costs that are rising faster than the dollar-linked prices at which they sell their produce. By Blasina y Asociados calculations, the squeeze became particularly intense after February 2016. Movements in relative prices have also been unkind to farmers. Fuel oil prices rose by 59% over the last seven years, while petrol prices, linked to Brent crude, rose by only 2%. The farming lobbies are focusing their protests on three main issues: the exchange rate, the price of diesel, and the price of electricity.

PERU

Potato troubles

Protests and clashes spread out across parts of central Peru in early February, as farmers reacted to a fall in potato prices. As a result of demonstrations, roadblocks and ensuing clashes between farmers, police, and truck drivers, two people were killed. By 5 February potato growers from Junín, Pasco, Huancavelica, Ayacucho, and Apurimac had ended their strike following the announcement of government concessions. But farmers from Huánuco were still holding out, saying that they were not party to the deal.

On 1 February the agriculture ministry, in a bid to end the protests, said it would buy stocks of unsold potatoes at a price of one Sol (US$0.31) each potato, and up to a maximum of 7,000kg per farm. Agriculture minister José Arista said this concession would cost the government around PEN50m (US$15.6m) and was being made on the understanding that all roadblocks would be lifted. Arista said political issues were inter-twined with the farmers' economic protest, as many farmers' leaders were also candidates in upcoming local elections. The ministry said it was looking in to the feasibility of other measures to help the farmers. These included a reduction in administrative charges on potato sales in the Lima wholesale market; easier access to credit; and a review of import tariffs on frying potatoes.

Corporate Radar

SQM settles in Chile: SQM, Chile's leading lithium and fertiliser producer, said at the end of January that it had reached an out-of-court settlement with state prosecutors investigating its involvement in making alleged illicit campaign contributions in 2008-2015. The investigation lasted three years. SQM has not admitted guilt, but did agree to pay CLP900m (US$150m) to the authorities and to make CLP1,650 (US$275m) worth of donations to various charities.

Embraer shares on the up: Shares in Embraer, the Brazilian aviation and defence company, jumped by over 4% on the Bovespa on 2 February following a report by newspaper *O Globo* that it would create a joint venture with Boeing of the United States. Boeing has expressed interest in acquiring Embraer, but the government, which holds a 'golden share' giving it the right of veto, has opposed a direct sale on national security grounds. The creation of a joint venture might be a way to resolve the impasse. The *O Globo* report said the new company would focus on commercial aircraft production, leaving the defence side of the business unaffected by the takeover. However, Embraer issued a press statement saying no deal had been reached and that negotiations with the US company were continuing.

Chinese on their bikes: Two China-based bicycle-sharing companies are planning to launch their service in Mexico City and other urban centres, according to press reports. Beijing-based Ofo is looking at Mexico City, Guadalajara, and Monterrey, while its rival Mobike is planning to launch a service in February in Miguel Hidalgo, a wealthy suburb of Mexico City. In the capital both companies would compete with the state-run Ecobici service, which currently offers around 6,000 bicycles available from 450 stations.

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