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Anger over the *gasolinazo*

Fuel prices at Mexico's service stations rose by between 14.2% and 20.1% on 1 January, triggering widespread anger across the country. There were protest marches, road and service station blockades, and significant outbreaks of looting. There is much to suggest that the current downstream phase of the government's landmark energy reform, launched in 2014, has been badly handled.

In theory, Mexico's transition to a free market in energy was supposed to be relatively smooth. The 2014 energy reform started with the upstream sector – with the end of the state monopoly in oil and gas exploration and production (E&P), as well as electricity generation. The reform was set to gradually work its way into the downstream sector, with official price controls at the petrol pump to be lifted during the course of 2017. That is still the game plan, but some of the benign assumptions made at the start of the process back in 2014 are proving to be either wrong, or at the very least overoptimistic.

One of the assumptions was about the speed of adjustment. The energy reform, it was argued, would lead to major new E&P investment by international oil majors, and in a matter of just a few years would reverse Mexico's decade-long decline in crude oil output. In that scenario, the liberalisation of the downstream sector would take place against a background of relatively plentiful supply. However, although new upstream investment is materialising, the production curve in Mexico is still trending down and liberalisation is coming amid a scarcity of supply.

The second major assumption that permeated most presidential and ministerial speeches back in 2014 was that prices would come down and, in fact, that the reform would virtually *guarantee* lower energy prices across the board. It is easy to understand why President Enrique Peña Nieto and his officials said what they said, but it was a rash promise.

The whole point of the reform was to attract new investment, remove monopolies and make the energy sector more competitive. The textbooks say that more competitive industries tend to have lower prices. This may be true in the long-run, but it overlooks a key problem. The international oil market has always been cyclical, with up-cycles as well as down-cycles. And the volatility of foreign currency exchange rates also plays a role. The upshot is that Mexico's energy sector can become relatively more or less competitive, but it cannot entirely buck international price and currency cycles.

Ministers also over-sold the idea that introducing a free market at service station level (the first private sector service stations in the country have begun to operate) would lead to smooth incremental adjustments, removing the need for the big centrally-controlled price increases of the past, known as *gasolinazos*.

One reason behind the ferocity of the early 2017 protests is that many Mexicans believed that politicians specifically had promised an end to the unpopular *gasolinazos* – only for the Peña Nieto government to turn around and announce a new one over Christmas.

Finally, the energy reform has become tainted by other problems facing the Peña Nieto government, including the problem of official corruption and major controversy over serious human rights violations by security forces. As such, public opinion in Mexico is not well disposed to hearing or believing what government officials have to say right now.

Furthermore, the way the petrol price increase was introduced created a perfect storm. Prices have been increased by government decree, at slightly different rates across 90 different geographical zones, and are then to be liberalised in a north-to-south process, starting in February.

The announcement came amid reports of petrol shortages and hoarding. In December, the state oil company Pemex had admitted that supplies were stretched. This was because of bad weather in some ports (Mexico has to import part some of its fuel needs) as well as the recurring problem of pipeline theft by criminal cartels, which disrupts the supply chain. Jorge Piñón, an energy specialist at Texas University, did not mince his words. "We are looking at the total collapse of Pemex's refinery system" he told the *Associated Press* (*AP*) news agency. The country's refinery output dropped below 1m barrels per day (bpd) for the first time in 2016, down from 1.06m bpd in 2015. Mexico now has to rely on imports to meet half its petrol consumption needs– at a time when the cost has increased sharply, mainly because of peso depreciation.

Other oil sector experts were equally scathing. "The entire system of refining and distribution is rotten", commented Miriam Grunstein, an energy analyst at Rice University in the US, as local newspapers reported supply deficiencies in 13 of the country's 31 states. Carlos Murriet, a Pemex executive, admitted that fuel stocks in early January were down to just six days' worth of demand, which Grunstein described as "ridiculously low", adding, "with Pemex, there is no planning …and simply fixing small holes ends up being more expensive". Piñón made the point that as long as the country's refinery and petrol distribution system is inadequate, Mexican consumers will face "internal overpricing" at their service stations. "I don't see a near-term solution" he added.

The Peña Nieto government has been trying making its case, but getting something of a hostile hearing. An official statement acknowledged that "there has not been enough investment in infrastructure for the storage and transportation of fuels", and promised that the government would seek to increase minimum storage capacity to 15 days' worth of consumption. Finance Minister José Antonio Meade has defended the transition to market pricing. He said that in peso terms, oil prices had increased 67% over the last year and that keeping them artificially low through increased subsidies would have "destroyed public finances". In an opinion piece published in the newspaper *Excelsior*, the environment and natural resources minister Rafael Pacchiano also said that fuel subsidies – which in 2012 had represented 3% of GDP – needed to be phased out as part of the country's transition to a lower-carbon footprint. Mexico, he noted, has become the fourth highest per capita fuel consumer in the world.

While many will sympathise with this argument, the reality is that Mexicans see the increase in prices as too abrupt, and as being more indicative of domestic inefficiency than of any genuine environmental concern. Gerardo Esquivel, an economist at Colegio de México, says that taxes represent 40% of the current price of petrol at the Mexican pump. "A 20% increase is not the most appropriate way to adjust prices, it could have been done more gradually" Esquivel suggests, adding: "The increase is now being associated to the liberalisation of the service stations sector, but it really relates to the depreciation of the peso. It also reflects years of neglect at Mexico's refineries and our growing import dependence".

Politicians have also piled in. Alejandra Barrales, leader of the left wing Partido de la Revolución Democrática (PRD), accused the Peña Nieto government of delivering a cocktail of measures perfectly designed to cause social instability. Ricardo Anaya, of the own right-wing Partido Acción Nacional (PAN), said that the current situation was caused by years of neglect at Pemex, which had created a creeping increase in import dependence. Perhaps the greatest political beneficiary of the *gasolinazo* could be Andrés Manuel López Obrador, leader of the left-wing Movimiento de Renovación Nacional (Morena) and a vehement opponent of the 2014 energy reform. In countless statements, López Obrador, who some early polls place in the leading position for the presidential race in 2018, had warned that the government's promises of lower prices on the back of the energy reform would not materialise.

Manuel Molano, deputy director of the Instituto Mexicano de la Competitividad (IMCO) and a supporter of the energy sector reform, has said that the government is inadvertently "doing everything possible to elect López Obrador in 2018". Yet, it seems that *all* politicians like to promise lower fuel prices, even if it is a risky promise to make. In what could be a foretaste of his election platform, López Obrador is now promising that if elected in 2018, he will build five new refineries – and lower the prices of both petrol and electricity.

REGIONAL ECONOMY REVIEW

ARGENTINA

Reshuffling the economic team

The end-of-year surprise in Argentina was that Alfonso Prat-Gay was replaced at the head of the country's economic team, with Nicolás Dujovne and Luis Caputo taking over respectively as the new treasury head and finance minister. There are bound to be changes under the new, more collegiate leadership, but in some respects the basic game plan, which seeks fiscal repositioning and economic recovery in 2017, remains in place.

When the leader of an economic team is removed, analysts usually try to determine the mix of personal, political and policy reasons behind the decision, and predict what changes the new leadership will make. Prat-Gay is widely seen as having done a very good job of beginning to turn around the Argentine economy. Of special importance was the removal of exchange controls (in December 2015) and the deft resolution of Argentina's long-standing dispute with the hold-out creditors (in April 2016). These and other decisions brought Argentina back in from the cold, reconnecting it with international capital markets.

On the debit side, however, Prat-Gay was said to hanker after super-minister status, clashing with other members of the economic team. He is reported to have disagreed with the central bank president, Federico Sturzenegger, over monetary policy, to have clashed with the cabinet chief Marcos Peña, and to have been at odds with the rest of the government over its handling of a dispute over payroll taxes (this concerned an increase in the threshold for the impuesto a las ganancias). "Alfonso is absolutely brilliant from a technical point of view, and has healthy political ambitions, but he just isn't a team player… Eventually the president decided he had to go," one unnamed member of the ministerial team told the *Financial Times*.

Observers also highlighted a key political problem. While Prat-Gay made a good job of phase one – beginning to turn the economy around – there were doubts about delays to phase two – completing that job and ensuring an economic recovery in 2017. This year, the stakes are very high. Mid-term congressional elections are due in October. President Mauricio Macri needs a convincing win. Whether he gets one or not may determine his chances of being a one- or two-term president. The results of the mid-terms will also open – or close – the doors to deeper structural economic reforms in Argentina.

The Macri government's main political problem is stagflation. In 2016, the economy contracted and inflation touched a 40% annual rate. A repeat performance in 2017 could be electoral suicide. The central dilemma for the government is how to balance the task of narrowing the fiscal deficit on the one hand, with other measures to stimulate economic recovery on the other. President Macri's approach has been to reduce the fiscal deficit gradually. The deficit for 2016 is estimated at 4.8% of GDP, and the target for 2017 is to narrow it further to 4.2%.

Third quarter GDP data, released in December, appeared to paint a depressing picture. In year-on-year terms, real GDP slumped for the second consecutive quarter, with a fall of 3.8%. There were sharp declines in manufacturing, construction and consumption. Private sector investment, which the government has been trying to encourage, also contracted. "This confirms that the recovery has been delayed by longer than we expected," said Alejo Costa of Buenos Aires-based brokers Puente. The result directly contradicted Prat-Gay's earlier promise that the economy would start growing by September. In the first nine months of 2016, GDP fell by 2.4% on the same year-earlier period.

However, a careful reading of the data suggests that the beginning of a turn in the economic cycle may not be too far off. In quarter-on-quarter terms, the drop in GDP in June-September was a relatively shallow 0.2%, much better than the 1.9% q-on-q fall registered in the second quarter. The slower rate of contraction could be traced to an improved export performance and a small rise in government consumption. London-based consultancy Capital Economics now says it expects the economy to begin its recovery in the first half of 2017. It estimates that GDP will have fallen by 2.5% overall in 2016, and will recover with growth of 1.5% in 2017. (The consensus among other private forecasters for growth this year is more upbeat, at around 3.0%.)

There was also an 11th-hour piece of fiscal good news. In the last days of Prat-Gay's tenure, the authorities announced that its tax amnesty – allowing Argentines to register previously undeclared overseas and domestic assets upon payment of a one-off tax penalty fee – had been more successful than previously expected. The amnesty scheme was launched in May 2016. In the second phase, ending on 31 December, citizens could avoid prosecution for tax evasion by paying a one-off 10% fee. In the third phase (running to 31 March this year), the fee goes up to 15%. Prat-Gay announced that over US$90bn worth of assets had been declared, generating over US$5bn worth of windfall tax revenues.

That windfall figure is expected to rise further to over US$100bn by the end of the third phase (some estimates suggest that Argentines have between US$200bn and US$400bn worth of undeclared overseas assets, and that the amount declared under the amnesty could reach US$130bn). Prat-Gay pointed out that the newly-declared assets were 35 times greater than the US$2.6bn generated by a similar amnesty, offered by the previous government. Argentina's economic authorities may be benefiting from a global change in attitudes to tax evasion. Tax expert Alan Lips of Miami-based Gerson Preston observes: "The world has changed. It is dangerous if you have money out there and you think it is hidden. It may be for a while, but in the long term it is going to be discovered."

Whatever the reasons, the tax amnesty windfall has helped partially cover – at least in the short term – the big hole in the country's underlying fiscal accounts. Including the additional tax amnesty-receipts, total tax revenues in 2016 rose by 34.6% to ARS2,070bn (US$130.6bn). This was actually a fall in real terms, once the near 40% rate of inflation is taken into account.

What will Dujovne and Caputo do differently? So far, Dujovne has done most of the talking, and has been wary of making concrete promises. Nicholas Watson of Teneo Intelligence has summed up the transition by observing that "Prat-Gay's major failing was on fiscal consolidation, which in turn will be Dujovne's principal challenge". Dujovne, a former chief economist at Banco Galicia, has a reputation as something of a fiscal hawk. In an early January interview with the daily *La Nación*, the new minister said he would focus on tax reform, and take a few months to draw up proposals to submit to the rest of the government. He described Argentina's payroll taxes, which can average 40% of a salary, as "ridiculous", saying they pushed people into the informal sector, which he estimated accounts for around 35% of the Argentine economy. Dujovne said his aim would be to narrow the fiscal deficit below the 4.2% percentage points of GDP targeted for this year. He would re-instate mid-year deficit targets and establish "very clear fiscal goals for this year, 2018, and 2019". There have been suggestions that the new team will try and combine tough fiscal measures designed to widen the tax base with others to boost consumption. One suggestion is that some of the tax amnesty windfall could be spent on improving state pensions, which would be politically popular and could help get the economy moving again.

One of the first measures taken by the new team was to lift one of the last remaining capital control measures. In place for almost a decade, the regulation required inward foreign funds flowing to portfolio investments to remain in Argentina for a minimum of 120 days. This regulation originally had been introduced as a one-year lock-in measure, to limit volatile speculative flows of "hot money". Prat Gay reduced it to 120 days at the start of his term in the ministry. Removing it now in its entirety may add some volatility to the peso exchange rate, but on the other hand it could help Argentina gain emerging-market status in the MSCI stock price index, an upgrade from its current classification as a frontier market. Argentina's status in the MSCI index is currently under review, with a decision due to be announced in June. An upgrade would have the effect of attracting more portfolio investment into the country. The economic team has been seeking to boost private participation in an investment infrastructure programme. Widening and deepening the stock market would help achieve that.

BRAZIL

Trumping austerity

There will be an interesting comparison to make over the next few months between two brash businessmen and TV personalities who have recently entered the political fray. Both have presented local versions of the reality TV show *The Apprentice*. One – clearly – is Donald Trump, who takes office as President of the United States on 20 January. The other is less famous, but is still big in Brazil – João Doria, the millionaire businessman, was sworn in as the new major of São Paulo, Brazil's largest city, on 1 January.

Both Trump and Doria have their own versions of 'draining the swamp' – a pledge to cast out corrupt politicians and bringing in supposedly more efficient and business-like methods and people to run public affairs. Doria is now a member of the centre-right Partido da Social Democracia Brasileira (PSDB), but he still counts as a political newcomer. His experiment in government is starting 20 days earlier than Trump's, and it may be worth looking for any points of comparison between what the two men actually do once in office.

Doria's first measures have included symbolic moves such as cutting back on the use of official cars for city officials. Doria also said he was reducing the number of city secretariats from 27 to 22, while he would reduce the number of city political appointees and advisers by 30% and reduce the value of city contracts by 15%. The incoming São Paulo mayor has set as one of his targets an increase of 66,000 in the number of pre-school nursery places. If he achieves that target, he will exceed the 150,000 total of places added in the last four years by the previous left-wing administration led by Fernando Haddad, of the now somewhat discredited Partido dos Trabalhadores (PT).

While both Trump and Doria can be seen as high-ego business tycoons trying to teach politicians a trick or two, there are, of course, major differences between the jobs they have taken on. Strangely, the purely financial challenge of running the city of São Paulo could be seen as tougher than that of running the US – a superpower and the world's largest economy. This is because Doria will be under much greater immediate pressure than Trump to deliver a reduction in government spending (many analysts expect that US government spending under Trump is actually set to increase). Doria is one of 5,568 Brazilian mayors elected last October and who took office on 1 January under the cloud of a nationwide fiscal squeeze. In late 2016, Brazil's federal congress voted through a constitutional amendment freezing federal government spending (capping increases to the rate of the inflation in the preceding year). With federal spending capped, President Michel Temer and Finance Minister Henrique Meirelles are trying to keep State and municipal spending in line. Brazil's 27 states are trying to renegotiate US$127bn worth of debts. Three of them – Rio de Janeiro, Minas Gerais and Rio Grande do Sul, have officially declared themselves in a state of "financial calamity". The government has earmarked an extra BRL5bn (US$ 1.55bn) of revenue from a recent tax amnesty programme to help cities, but that won't be enough.

A congressional bill from last year offering the States favourable rescheduling terms in return for tough action to put their own houses in order (including a freeze on public sector hiring and wages) was watered down in negotiations, leading Temer to partially veto it. Now, it looks as if negotiations will be conducted on a State-by-State basis. With few options for outside help, mayors like Doria will have to take radical action to balance the books. In a move that may or may not be part of Trump's play-list, Mayor Doria is looking at privatisation: one high profile asset potentially up for sale is São Paulo's samba stadium (the Anhembi Sambadrome).

COLOMBIA

Tax job done?

Two days before Christmas, the government led by President Juan Manuel Santos finally got full congressional approval for its tax reform bill, which has now become law. The changes are designed to do three things: to make up for the steep loss in oil and gas revenues suffered since hydrocarbons prices slumped in 2014; to deter international ratings agencies from withdrawing Colombia's investment grade in 2017; and to lay the basis for increased social spending in the hoped-for 'post-conflict' era. It is not yet clear if the law will be able to deliver all of that.

The final version of the tax reform bill was approved in the lower house by 78 to 14 votes, and in the senate by 46-16 in favour, with opposition parties on both the Left and the Right voting against. Possibly the key measure from the business point of view is that Colombia's extremely high corporate income taxes are being reduced in phases, from a maximum of 43% down to 33% by 2019. The income tax burden is being shifted slightly away from corporates and toward wealthier individuals. In response to widespread tax evasion, the law introduces tougher penalties. Those who don't pay taxes now face possible prison sentences of four to nine years. For the population at large, the biggest piece of bad news is that the Value-Added Tax (VAT) rate increases from 16% to 19%, although a number of basic products such as food and medications will be exempt (also exempt are bicycles, to encourage a reduction in urban pollution). A government proposal to introduce a new 'health tax' on soft drinks was eventually dropped as part of the congressional negotiations on the bill, meaning that revenues will be lower than originally had been planned. On the other hand, proposals to increase the thresholds at which certain taxes begin to apply were also dropped, which will mean a small rise in expected revenue.

Overall, the finance ministry calculates that without the reform, 2017 tax revenues would have been COP126,900bn (US$42.3bn). With the reform, revenues are now projected to be higher by COP6,200bn (US$2.07bn), for a total of about US$44bn. This will help reduce the fiscal deficit, estimated at 3.9% in 2016, down to 3.3% in 2017. But it is clear that the reform falls short of making up for the loss of oil and gas revenues. Depending on assumptions about the GDP growth rate this year, it will boost revenues by less than 1% of GDP.

In comparison, oil and gas related tax revenues represented 3.3% of GDP in 2013 and have now dropped to virtually zero. It is expected that oil prices will recover moderately in 2017, so there may be some small revenue upside from that quarter. But from any perspective, Colombia will remain worse off than it was before the oil slump. The government's own growth projections are modest. After real annual GDP growth of 3.1% in 2015, officials now expect that economic growth cooled to around 2.0% in 2016, a rate that will pick up to 3% in 2016. Even that may be over-optimistic. Consultancy BDO Colombia says any stimulus derived from the lower corporate tax rate is likely to be cancelled out by the negative effect of the increase in VAT, which will boost inflation and constrain consumption.

It remains to be seen how the ratings agencies will react. Fitch Ratings and Standard & Poor's (S&P) both assigned Colombia a negative outlook in 2016. Fitch dropped Colombia's long-term rating to BBB, down from BBB+, just two notches short of non-investment grade. Finance Minister Mauricio Cárdenas told *Bloomberg*, "we're going to introduce all the decisions that are necessary to keep our BBB rating". But Sergio Clavijo, president of Colombia's Asociación Nacional de Instituciones Financieras (ANIF), has been more sceptical, arguing that the tax reform should have been implemented years ago, as far back as 2012. Speaking before the law was approved, he observed: "It's going to be vey hard to avoid at least the reduction of one of the two notches keeping us above investment grade". He suggested that by October next year (2018), "once markets realise that the expected additional tax revenue is coming in too late and too little, one notch will be gone".

It is also clear that the tax reform on its own will not generate the extra funds needed to meet all the government's commitments to higher social spending associated with the peace settlement. Nevertheless, President Santos tweeted congratulations to his finance minister and to congress for approving a law which, he said, "will allow more social programs to benefit more Colombians". In the government's defence, the process of funding the peace settlement with the country's left-wing guerrillas will stretch out over various years, and will depend on sustained fiscal and macro-economic management over that period, not on one single tax law. This does not alter the fact, however, that the tax reform itself will be politically unpopular. Finance Minister Cárdenas admitted as such. "I am the first to recognise that it is a difficult measure, which will require a large sacrifice from all Colombians – but it is necessary", he emphasised.

A highly uncertain outlook for 2017

For Cuba, 2016 hardly finished on an auspicious note, with the death of Fidel Castro, the looming inauguration of Donald Trump as US president and, in late December, the announcement that the economy had contracted sharply in the second half of the year. This raises significant uncertainty about the outlook for 2017. In President Raúl Castro's (pledged) last year as president, he may struggle to return the economy to growth and stabilise relations with the US, which could complicate the transition to a new leadership in early 2018.

Cuba's economic performance was disappointing in 2016. After growing by 4.4% in 2015, driven by a surge in fixed investment and private consumption, GDP slowed sharply. In July 2016, the authorities reported that GDP had risen by just 1% in the first half. In late December, President Castro said that full-year growth had shrunk by 0.9%, implying a contraction of around 2% in the second half. Detailed data are not yet available and Castro was vague about the factors explaining the slowdown, referring loosely to "cash restrictions" and "a reduction in fuel provision". Reading between the lines, this implies that oil deliveries from Venezuela fell sharply during 2016, on the back of severe economic problems in that economy. The Cuban government, therefore, is likely to have had to source fuel imports from elsewhere, at market prices, which will have hampered the amount of funds available for other government spending.

Given that public consumption accounts for a hefty one-third of GDP – extremely high by international comparison – this knock-on effect highlights the extent to which the national accounts remain vulnerable to external developments. The government has not yet released fiscal data, but it is likely that the deficit topped the 5.8% of GDP shortfall recorded in 2015.

Venezuela and US outlook will be crucial

The economic outlook for 2017 will depend to a large extent on developments in Venezuela, as well as the evolution of US policy towards Cuba. In terms of Venezuela, it is difficult to envisage oil shipments to Cuba returning to previous levels. Not only does the Caracas government have to abide by a new production quota cut, agreed in November 2016 by the Organisation of Petroleum-Exporting Countries (OPEC), but continuing severe domestic foreign currency shortages mean that the Venezuelan government will more urgently need to secure market prices for its dwindling oil exports, rather than subsidising other countries' consumption. The terms of the 'oil-for-doctors' swap between Venezuela and Cuba are extremely hazy, with no data available on the exact amount of oil being sent to Cuba, but nonetheless it is highly likely that shipment levels will continue to slip in 2017. This will constrain Cuban government and also private consumption growth this year, in turn making it difficult for the authorities to meet their GDP growth target of 2%.

Cuba's economic performance will also be influenced by developments in the US. In late November, president-elect Donald Trump tweeted that "if Cuba is unwilling to make a better deal for the Cuban people, the Cuban/American people and the US as a whole, I will terminate deal". This has raised speculation that Trump might look to roll back the measures introduced by President Barack Obama, which have essentially eased (although not removed) trade, investment and travel restrictions. Trump has not given any further details of his intended Cuba stance and the fact that most policy hints come via Twitter – which does not give scope for detail – means that much remains up in the air.

Risk of roll-back

If the recent détente is rolled back, the short-term impact on the Cuban economy would probably be relatively mild. This is because the measures introduced by Obama have had more symbolic importance than economic, chipping away at the raft of trade and investment restrictions. However, with sanctions still technically in place, many US businesses have remained wary of doing business in Cuba, and bilateral trade has actually fallen over the past two years.

If the measures are rolled back, the number of US tourists would fall, but given that US arrivals still account for only a very small percentage of the island's overall tourist market, the impact would be minor. It is possible, however, that tourism could be affected indirectly. For example, in the event that Trump tightened up US travel restrictions again, the recent surge in non-US tourists keen to visit Cuba before it opens up entirely to the US market might wane a little. With services accounting for a growing share of the Cuban economy, this would hamper GDP growth and increase the current-account deficit, albeit not dramatically.

The medium- to long-term impact of a roll back of the Obama measures would be greater. Prior to the November US election, there was a growing consensus that the US economic embargo on Cuba would be lifted entirely, reflecting growing pressure from US businesses and a shift in broad US public sentiment. Estimates suggested that this could boost Cuba's GDP growth significantly, possibly to 5-6% per year, amid a stimulus to external trade, fixed investment and private consumption. However, on the assumption that this possibility is all but discounted with Trump's election, Cuba's potential GDP growth outlook in the medium term may be lower.

Much will depend on the foreign-policy team appointed by the Trump administration. In early January, the US State Department confirmed that Trump had asked all politically-appointed US ambassadors to leave their posts before his 20 January inauguration. This is contrary to usual practice, which typically allows these a grace period to wrap up their affairs.

Obama's pick for US ambassador to Cuba, Jeffrey DeLaurentis, currently chief of mission at the newly re-opened embassy (he was appointed chargé d'affaires at the-then US interests section in August 2014), is one of those diplomats likely to have to vacate their posts in the next two weeks. There is no sign of who might replace him as chief of mission, but on the assumption that Trump does not rescind the embassy of its status, the process of nominating and securing congressional support for Trump's preferred choice for ambassador to Cuba is likely to take several months, with a diplomatic vacuum remaining in the interim. If a hardliner is appointed in DeLarentis' place, almost inevitably that would bode poorly for Cuban-US relations.

In reality, not only would it be logistically difficult for Trump to reverse the Obama policy changes, given that many US businesses have already adjusted their investment positions with regard to Cuba (for example, airlines have already increased commercial flights to the island), but it is also unclear whether Trump would have the backing of his own Republican Party for a full reversal of the recent opening to Cuba.

As such, rather than completely drawing a red pen through the Obama measures, another scenario is that new Trump administration, under pressure from US business interests, simply leaves things as they are now, making no effort to improve bilateral relations, or to further ease any restrictions.

Treading water

President Raúl Castro has little more than a year left in office, having pledged to step down when his term ends in 2018. In theory, a handover should happen in the first quarter of 2018, with the president selected by a new National Assembly when it first meets after the scheduled February 2018 parliamentary elections. In this context, the challenges facing President Castro during his remaining months in power are diverse. In an ideal world, he would have liked to have boosted the island's economic performance, setting a firm foundation for the first non-Castro president in Cuba in nearly sixty years. However, this does not seem likely. Instead, GDP growth is likely to remain subdued, dragged down by lower oil shipments from Venezuela, with little impetus from investment, trade or consumption. This will complicate the transition to a new Cuban leader, which in turn could raise political uncertainty.

VENEZUELA

Maduro government issues new bond

The details surrounding a new sovereign bond issuance of US$5bn in late December are murky. However, the development will ease concerns of an imminent debt default, ahead of a large scheduled repayment in April.

Even though last October's debt swap eased the government's repayment schedule in 2017, a large repayment of just under US$3bn falls due in April, following repayments of around US$1bn in the first quarter of the year. Securing the funds to meet these payments may be tricky: the stock of international reserves stood at US$10.9bn in early January (down US$5.2bn from a year earlier), but much of this is held in gold, which is difficult to liquidate in large quantities at short notice. Against this backdrop, the government led by President Nicolás Maduro issued US$5bn in sovereign bonds on 29 December, helping to alleviate immediate concerns about a debt default.

The sovereign issuance was the first since October 2011 and came as somewhat of a surprise to markets, as there had been little indication that the government was considering issuing bonds. Existing debt trades with extremely high yields, which would have made a new issuance prohibitively expensive, even assuming that there was demand for Venezuelan sovereign bonds. The government side-stepped these problems by reserving the issuance for the state-owned Banco de Venezuela, with the instruments not available on the open market. As a result, the government was free to set the coupon rate at a low level (6.5%) and fix a long-term maturity date (2036).

However, the deal was very opaque. The government did not consult the National Assembly (which is controlled by the political opposition), or publish details in the Official Gazette, as is constitutionally required, with central bank officials also reportedly kept in the dark over the new bond. The deal appears to have been underwritten by a Chinese firm, Haitong Securities, raising questions about whether the deal was actually designed to provide the Venezuelan government with a new Chinese loan, with China requiring a bond issuance to underpin the new finance, given concerns about repayment capacity. This would seem to be a reasonable explanation, as it is relatively unlikely that a state-owned bank would have US$5bn lying around in spare cash.

Notwithstanding the murkiness of the deal, the short-term impact on Venezuela will be positive. Even if the Chinese required a new bond to underwrite fresh financing (or the rolling over of an existing loan), the fact that China is showing signs of some flexibility will reduce the immediate risk of a default. Repayments falling due in the medium- to long-term will undoubtedly increase, but with the economy in such deep crisis, the government is unlikely to be overly concerned about this time-frame, focusing its efforts on 2017.

VENEZUELA

Large minimum wage hike will fuel inflation

The government has defended its decision to increase the minimum wage by 50% on the basis that such a large hike was necessary to respond to soaring inflation. Yet by printing money to fund the increase, the authorities are trapped in a vicious circle of monetary creation and ever-increasing domestic prices.

On 8 January, President Nicolás Maduro announced that the minimum wage would be increased by a massive 50%, to BsF40,638 per month. Including food vouchers, known as 'Cestaticket', the so-called "integral" minimum wage now stands at BsF104,358. At the weakest official exchange rate known as Dicom, the monthly minimum wage amounts to US$60 (US$154 including food vouchers), but at the black-market exchange rate these figures amount to just US$12 and US$31 respectively.

Hikes to the minimum wage are becoming more rapid and larger, fuelling concerns that hyperinflation might be taking hold. The latest increase marked the fifth in the past year, with the minimum wage standing at just BsF9,648 per month at the beginning of 2016, less than a quarter of the current rate.

The "integral" monthly minimum wage has increased even more rapidly, by over six times, over the course of the past year. This is likely to reflect worsening food shortages, with the government seeking to compensate by providing more food vouchers, although in reality this is unlikely to tackle the underlying lack of availability.

The difficulty is that the wage hikes are likely to be funded through printing money. Monetary aggregates were already rising at a rate of nearly 160% year on year at the end of December. The Central Bank (BCV) will step up the creation of money in early 2017 to pay for higher public-sector wages, in addition to the introduction of new, larger-denomination bank notes.

Inflation data is difficult to come by, as the authorities stopped publishing these statistics some time ago, making forecasting even more complicated. The Troubled Currencies Project, run by the Johns-Hopkins and Cato Institute, estimates that inflation ended 2016 at 290%. With monetary growth accelerating even more quickly in 2017, that figure is likely to rise further, sustaining the risk that hyperinflation might take hold.

REGIONAL BUSINESS REVIEW

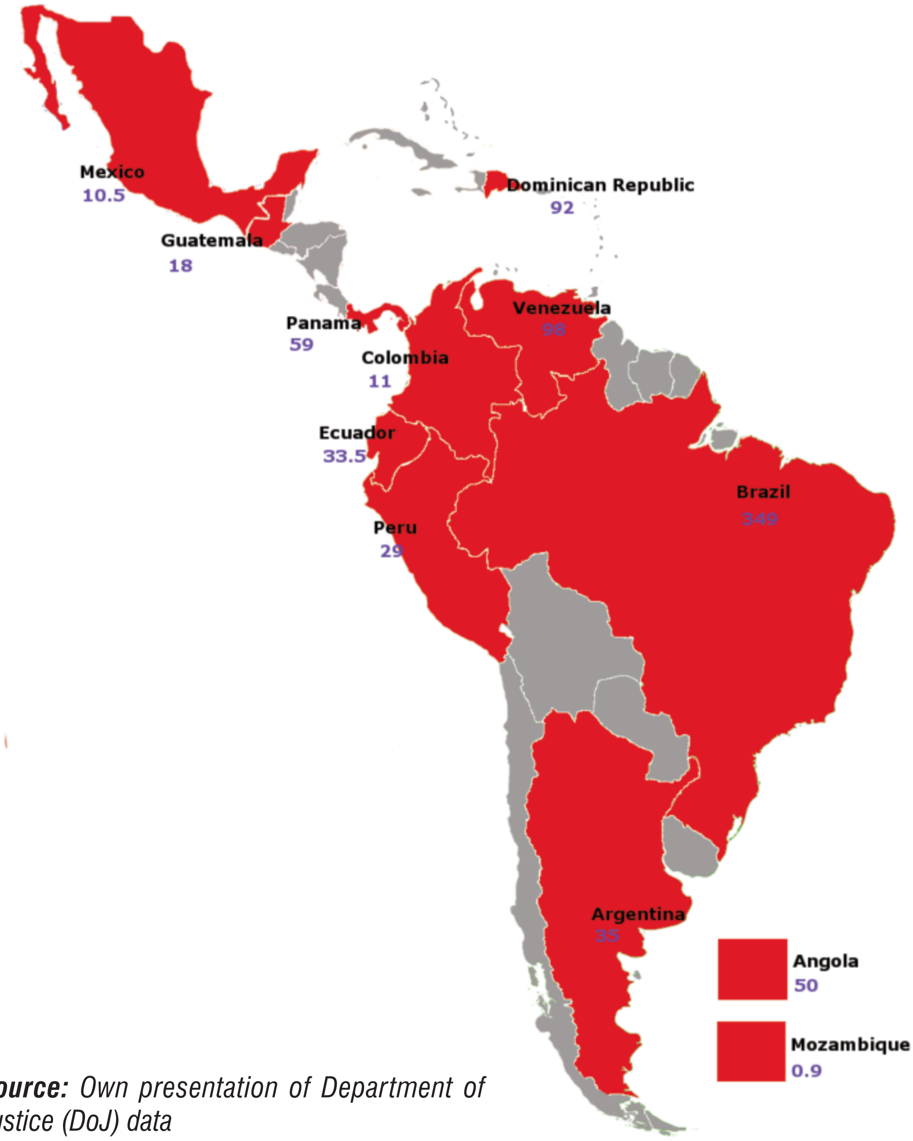
REGION

Odebrecht scandal ripples through the region

Odebrecht's record plea deal with the US Department of Justice (DOJ) closed one chapter for the Brazilian company, but the book is not yet closed on its "unparalleled" bid rigging and bribery scheme on three continents.

On 21 December, the US Department of Justice (DOJ) announced that the Brazilian construction conglomerate Odebrecht and its petrochemicals unit Braskem had pleaded guilty in a federal district court in Brooklyn to violating US anti-bribery laws, under the US Foreign Corrupt Practices Act of 1977. Starting from around 2001, according to the DOJ, Odebrecht funnelled illicit payments worth US$788m to corrupt officials in 12 counties (including Brazil) to win and retain business.

Approximate bribes paid by Odebrecht (in US$m)



Source: *Own presentation of Department of Justice (DoJ) data*

As part of a plea deal, US authorities levied a historic US$4.5bn penalty on the company, the biggest to date anywhere in the world. Odebrecht is contesting the amount on the basis of its 'ability to pay', with the final amount to be decided on 17 April next. Lawyers for the Brazilian company, however, agreed to an initial 'disgorgement' payment of US$3.5bn, US$2.6bn from Odebrecht and US$957m from Braskem. Of this amount, 80% (US$2.8bn) will be paid to Brazil, with the other 20% split equally between the US and Switzerland (which provided banking account information as part of the investigations).

Odebrecht was founded in the 1940s and employs roughly 250,000 people. The Odebrecht scandal emerged as part of the unprecedented Brazilian federal investigation, starting in March 2014, into a massive corruption network centred on Brazil's state controlled oil giant, Petrobras. This investigation, known as 'Operation CarWash' lifted the lid on a cartel of companies, politicians and business executives engaged in a massive bribery ring, effectively paying kickbacks for exclusive (and very lucrative) contracts from Petrobras, for which Petrobras would be routinely overcharged and the proceeds used to curry favour with politicians, political parties and other 'influencers'.

Odebrecht, it emerged, was one of the biggest players in this scheme, triggering separate investigations into Odebrecht itself, along with several other of Brazil's best known companies like Andrade Gutierrez, Camargo Correa and Queiroz Galvão. In all, according to the DOJ, Odebecht paid bribes of US$349m in Brazil. But it had a similar 'modus operandi' to expand its activities abroad. Using a specially-created and top secret 'structured business division', the company doled out US$439m in 11 other countries to secure

Odebrecht payments in Latin America and Africa, US$m		
	Bribery payments (est).	**Benefits from payments (est).**
Latin America		
Brazil	349	1900
Venezuela	98	n/a
Dominican Republic	92	163
Panama	59	175
Argentina	35	278
Ecuador	33.5	116
Peru	29	143
Guatemala	18	34
Colombia	11	50
Mexico	11	39
Africa		
Angola	50	261
Mozambique	0.9	n/a
TOTAL	**786**	

Source: *US Department of Justice (DoJ).*

work, including Angola, Argentina, Colombia, Mexico, Venezuela and Mozambique. The DOJ described this top secret 'structured business' division, which was run from the very top of the company, as a "standalone bribery department", funnelling payments to recipients (including government officials) via off-shore entities. Odebrecht even bought itself a bank in Antigua to serve its structured business division. In March 2016, Marcelo Odebrecht, the (now former) company CEO, was handed down a 19-year jail sentence in Brazil for corruption and money laundering.

In all, according to DOJ estimates, Odebrecht benefitted to the tune of US$1.4bn from this "massive and unparalleled bribery and bid-rigging scheme", which operated on three continents.

For instance, in Angola, Odebrecht paid over US$50m in bribes, which delivered benefits of US$261.7m, according to the DOJ. In Mozambique, it paid over US$900,000 in bribes – the DOJ did not estimate the benefits accrued. But Latin America was Odebrecht's main theatre of operations. In Brazil alone, the firm's US$349m in bribery payments benefitted the company to the tune of US$1.9bn, on DOJ estimates.

While the multi-country plea bargain with the DOJ ends one major chapter for the company – which in a statement said it was looking forward to "turning over a new page and moving forward" – Odebrecht's legal woes are by no means over. It now faces investigations in several of the other 11 countries in which it paid bribes, which may also result in expensive plea bargain agreements.

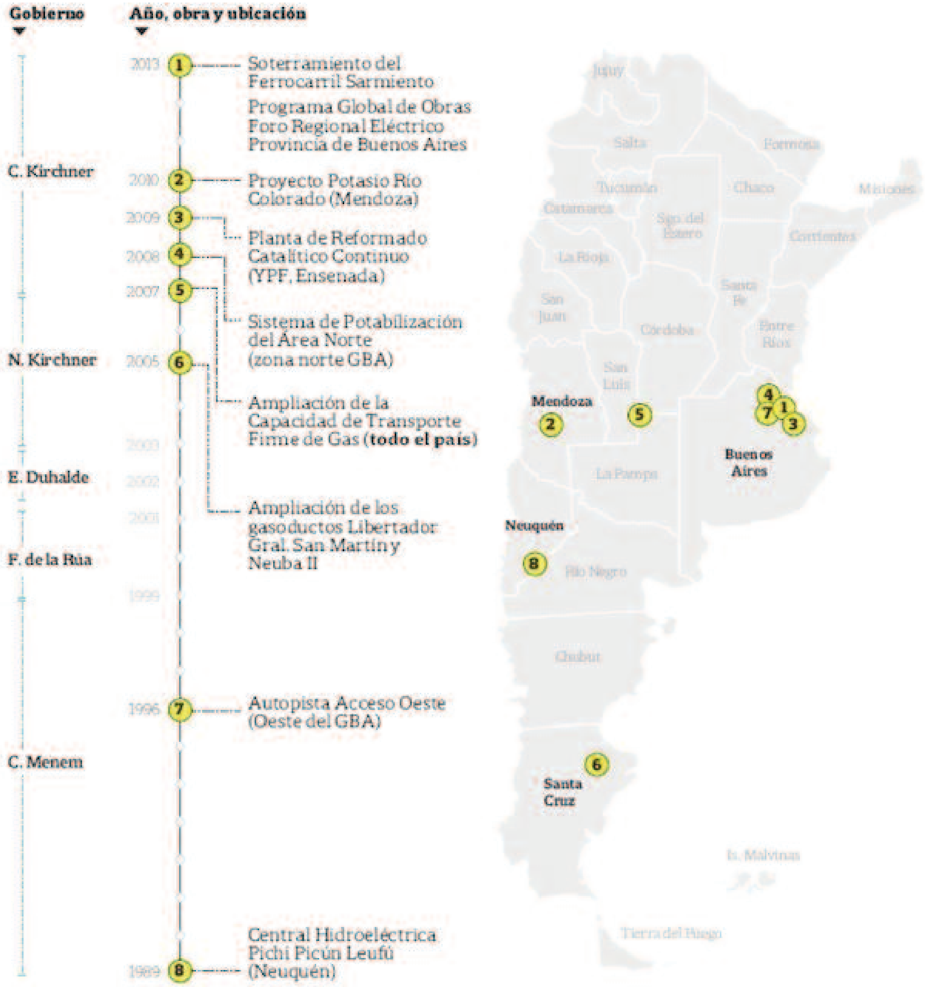
Taking the DOJ's report, the company's illicit activities in Latin America are outlined below. Notably, Odebrecht's bribery continued to run up to 2015-2016 in countries like Ecuador and Venezuela (when the Petrobras investigations were already underway and Odebrecht was already implicated), posing awkward questions for the sitting governments in Quito and Caracas. The crucial question now for regionals prosecutors is how far up the government hierarchy the Odebrecht payments went over the years.

Argentina

Bribes paid: US$35m+
Dates: 2007-2014
Presidents in office: Cristina Fernández (2007-2015)
Recipients: Undisclosed Argentine government officials and intermediaries
Projects cited: At least three infrastructure projects

Benefits: US$278m
Official response to date: According to the Argentine prosecutor leading the preliminary Odebrecht investigations, Sergio Rodríguez, his team is seeking information from the US and Brazilian authorities with regard to four Odebrecht projects in the country. Argentine media have alleged that Odebrecht paid millions in bribes to the former planning and public investment minister Julio de Vido (2003-2015). He has denied that.

Odebrecht has been operating in Argentina since 1989 (*see map below*).


Gobierno
Año, obra y ubicación
C. Kirchner
N. Kirchner
E. Duhalde
F. de la Rúa
C. Menem
2013
2010
2009
2008
2007
2005
2003
2002
2001
1999
1996
1989
1 Soterramiento del Ferrocarril Sarmiento
Programa Global de Obras Foro Regional Eléctrico Provincia de Buenos Aires
2 Proyecto Potasio Río Colorado (Mendoza)
3 Planta de Reformado Catalítico Continuo (YPF, Ensenada)
4 Sistema de Potabilización del Área Norte (zona norte GBA)
5 Ampliación de la Capacidad de Transporte Firme de Gas (todo el país)
6 Ampliación de los gasoductos Libertador Gral. San Martín y Neuba II
7 Autopista Acceso Oeste (Oeste del GBA)
8 Central Hidroeléctrica Pichi Picún Leufú (Neuquén)
Jujuy
Salta
Formosa
Tucumán
Chaco
Misiones
Catamarca
Sgo. del Estero
Corrientes
La Rioja
Santa Fe
San Juan
Córdoba
Entre Ríos
San Luis
Mendoza
Buenos Aires
La Pampa
Neuquén
Río Negro
Chubut
Santa Cruz
Is. Malvinas
Tierra del Fuego

Source: *La Nacion*

Colombia

Bribes paid: US$11m+
Dates: 2009-2014
Presidents in office: Alvaro Uribe (2002-2010), Juan Manuel Santos (2010-current)
Recipients: Undisclosed Colombian government official and others
Projects cited: Infrastructure works including one government construction project
Benefits: US$50m
Official response to date: Camilo Enciso, the presidential secretary for transparency, is leading the response to the DOJ allegations, but has stressed that the specific allegations raised appear to date to the previous government and do not implicate the current administration. Former president Alvaro Uribe (2002-2010) has denied knowledge of any wrongdoing. Separately, Enciso called for a review of arbitration cases in the country in which Odebrecht secured sizeable payouts from the State.

Dominican Republic

Bribes paid: US$92m+
Dates: 2001-2014
Presidents in office: Leonel Fernández (2004-2012), Danilo Medina (2012-current)

Recipients: Undisclosed government officials and intermediaries
Projects cited: Public works contracts
Benefits: US$163m+
Official response to date: State bodies were ordered to supply documentation by end December on all or any contracts inked with Odebrecht since 2001 to the office of the attorney general, Jean Alain Rodríguez, who is investigating the DOJ-alleged Odebrecht bribery of US$92m in the country. These include the Instituto Nacional de Aguas Potables (INAPA) and the Corporación Dominicana de Empresas Eléctricas Estatales (CDEEE). Odebrecht was part of a consortium (along with Italy's Tecnimont and local company Ingeniería Estrella) awarded the contract for a coal-fired electric plant at Punta Catalina, while it also participated in the construction of the Pinalito and Palomino hydro plants via the Empresa de Generación Hidroeléctrica Dominicana (EGEHID). The national office of public works also submitted documentation relating to 11 contracts involving Odebrecht between 2007 and 2012. Alain Rodríguez noted that there would be "no limits" to the investigation or judicial actions.

Ecuador

Bribes paid: US$33.5m+
Dates: 2007-2016
Presidents in office: Rafael Correa (2007-2017)
Recipients: Undisclosed government officials and intermediaries
Projects cited: Public works, construction contracts
Benefits: US$116m+
Official response to date: Ecuador's attorney general, Galo Chiriboga, has requested information from the US and Brazil about the bribery allegations and President Rafael Correa has demanded that the names of those implicated be revealed. Coming on top of another corruption scandal at the state oil company Petroecuador, the case is particularly sensitive for the Correa government ahead of a general election on 19 February; and could further weigh on support for the left-wing ruling Alianza Pais (AP).

Correa expelled Odebrecht from Ecuador in September 2008 and rescinded all its contracts, after major structural failures were detected at the San Francisco hydroelectric plant. In July 2010, the company returned to Ecuador after agreeing to fix the plant (at an estimated cost of US$55m) and pay compensation of US$20m. In a statement issued on 26 December, the Correa government set out details of some six public sector contracts with Odebrecht since 2010, worth US$1.6bn. It noted that all contracts had been subject to scrupulous control and audit and that the government had never done anything to damage the country. The statement added that Ecuador would not accept allegations of wrong-doing without specific details, including names and inventories.

The opposition mayor of Quito, Mauricio Rodas, is under particular scrutiny because he awarded a new metro expansion project to a consortium comprising Odebrecht and Spain's Acciona. Last year, Odebrecht quit the project, with its share assumed by Acciona. Rodas denies any problems with the US$1.5bn contract, whose pricing was questioned.

Curiously, Miami press reported on 10 January that the conservative US Republican congresswoman Ileana Ros-Lehtinen (Florida) had sent a letter to the US Attorney General, Loretta Lynch, asking her to reveal the names of any officials bribed by Odebrecht in Ecuador between 2007 and 2016. Ros-Lehtinen argued that Ecuador legally does not have to reveal any names, and so she was requesting the US to make them known directly. "Correa's political pressure, in addition to corruption and lack of judicial independence under his government, makes it highly unlikely that Ecuadorian prosecutors will disclose the names of officials involved in the Odebrecht case or take them to court", she was quoted as stating in her letter.

Guatemala

Bribes paid: US$18m+
Dates: 2013-2015
Presidents in office: Otto Pérez Molina (2012-2015)
Recipients: Undisclosed government officials and intermediaries
Projects cited: Public works, infrastructure contracts
Benefits: US$34m+
Official response to date: As part of newly-launched investigations, the Guatemalan government on 9 January said that it had suspended payments under a US$399m highways contract with Odebrecht, amid suspected pricing irregularities. The contract was signed under the former government led by the disgraced president Otto Pérez Molina, who was stripped of his immunity and arrested for corruption in September 2015.

Mexico

Bribes paid: US$10.5m+
Dates: 2010-2014
Presidents in office: Felipe Calderon (2006-2012), Enrique Peña Nieto (2012-current)
Recipients: Undisclosed government officials and intermediaries
Projects cited: Public works contracts
Benefits: US$39m+
Official response to date: The Mexican government and the state oil firm Pemex have said the allegations made by the DOJ are "under review". Odebrecht and consortium partners have been awarded tenders for Pemex including (in 2014) the expansion of the Los Ramones II-Norte gas pipeline, from Nuevo León to San Luis Potosí (some 450kms). Estimated investment is US$1.2bn. Odebrecht was also involved in the Etileno XXI petrochemicals plant in Veracruz and the Tula refinery in Hidalgo, both completed by 2015.

Panama

Bribes paid: US$59m+
Dates: 2009-2014
Presidents in office: Ricardo Martinelli (2009-2014)
Recipients: Undisclosed government officials and intermediaries
Projects cited: Public works, infrastructure contracts
Benefits: US$175m+
Official response to date: On 2 January the minister of the presidency, Álvaro Alemán, said that Panama would demand compensation from Odebrecht for "the damage that the country has suffered". The government led by President Juan Carlos Varela has ordered that no more contracts be awarded to Odebrecht until the company collaborates with Panama's investigations into the bribery activities, and has requested information from the US. Speaking at the opening of the latest national assembly session, Alemán stated that "four million Panamanians have the right to know who were the beneficiaries of the alleged bribes paid by this company…The company has cooperated in the United States and Brazil, it must cooperate in Panama". The housing minister, Mario Etchelecu, also requested greater speed in the investigations and reiterated that he had opposed a US$569m urban renewal contract awarded to Odebrecht in June 2015 for the city of Colón. This project, slated to create 1,500 jobs, includes the refurbishment of Colón's Historic District, considered a World Heritage Site, as well as the construction of 5,000 homes and modernisation of the city's sanitation system. Odebrecht has been active in Panama since 2006, when it won the contract for the Remigio Rojas irrigation system in Chiriquí province. It has since completed 15 other projects in the country, according to its website.

Peru

Bribes paid: US$29m+
Dates: 2005-2014
Presidents in office: Alejandro Toledo (2001-2006), Alan García (2006-2011), Ollanta Humala (2011-2016)

Recipients: Undisclosed government officials and intermediaries
Projects cited: Public works, infrastructure, transport
Benefits: US$143m+
Official response to date: On 2 January, the attorney general's office said that Peru had demanded "a significant sum" by way of a 'pre-payment' from Odebrecht before starting talks on a plea deal, which would be the second for Odebrecht following the late-December deal with the US/Brazil/Switzerland. It later emerged that this sum amounted to US$8.9m. Hamilton Castro, the lead Peruvian prosecutor investigating the case, noted that Odebrecht would have to pay a much larger amount in any final agreement, and only once it provides thorough details on its illicit activities in Peru, including the identities of government officials bribed over the course of almost a decade. "The illegal earnings the company obtained must be returned to the Peruvian state, that's why we're negotiating a significant sum of cash that must be deposited in public coffers as prepayment…this amount should in no way be understood to be the final amount, Castro stated in reference to the US8.9m.

Odebrecht first went into Peru four decades ago, and some of its largest projects are in the country, including hydro schemes, an irrigation tunnel through the Andes mountains and a highway slicing through Amazon jungle regions. Odebrecht also had a 55% stake in the massive US$5bn Southern Gas (natural gas) pipeline project, which last year it said it would divest. If the consortium awarded the pipeline contract cannot replace Odebrecht's 55% stake by a 17 January financing deadline, the contract will be annulled. A Canadian company, Brookfield, and the China National Petroleum Corporation (CNPC) reportedly are interested. As we went to press, the government led by President Pedro Pablo Kuczynski said that whatever Odebrecht gets for the sale of its share of the contract would be passed to the Peruvian authorities by way of a "guarantee", as the local corruption investigations continue. The fall-out from Odebrecht scandal threatens to damage investor confidence in Peru at a time when the government is seeking new foreign investment – with a particular focus on modernising the country's infrastructure.

Castro first launched the Peruvian investigations in November 2016, based on Swiss intelligence reports, and he has already taken a team to Switzerland, but Odebrecht's direct cooperation would significantly expedite the process, he noted. Odebrecht has pledged to cooperate with the Peruvian authorities. The Kuczynski government in early January put a ban on Odebrecht from bidding on any public contracts and signalled that it might even sue the company for damages. In a TV interview on 6 January, Kuczynski suggested that the company should pay back Peru the full amount of the bribes, plus damages. "It should at least be 90 million soles [about US$27m], supposedly the amount of the bribes, plus penalties and fines", he stated.

Notably, Brazilian federal police in 2016 said that they had evidence of bribes paid by Odebrecht to former president Ollanta Humala. And according to local media, other documents linked to the Panama Papers (leaked in mid 2016), suggest that an associate of former president Alejandro Toledo may also have received payments from Odebrecht. Kuczynski himself, who took office pledging to rout entrenched corruption in the country, has also been forced to deny any links to Odebrecht – he served under Toledo as prime minister.

Venezuela

Bribes paid: US98m+
Dates: 2006-2015
Presidents in office: Hugo Chávez (1999-2013), Nicolás Maduro (2013-current)
Recipients: Undisclosed government officials and intermediaries
Projects cited: Public works contracts
Benefits: n/a

Official response to date: Venezuela's opposition-controlled national assembly has called for official investigations, to little response from the government led by President Nicolás Maduro. A local NGO, Transparencia Venezuela, also called on the Maduro government and ministries to account for all public sector contracts signed with Brazilian companies in the past 12 years; it got no response from the executive or ministries and so has taken a petition to the (government-controlled) supreme court, which is unlikely to be sympathetic.

According to reports by the main opposition coalition, Mesa de la Unidad Democrática (MUD), Brazilian companies including Odebrecht, Camargo Correa, Andrade Gutierrez and Queiroz Galvão, all implicated in the Petrobras scandal, secured 42 projects worth over US$50m in Venezuela, starting from 2000. Of those 42, 14 are still less than 30% executed, according to the Registro Nacional de Contratistas (three of which are Odebrecht projects).

In all, Odebrecht won 32 of the 42 projects tendered to Brazilian companies in the period from 2000, worth an estimated US$41m. The MUD-controlled legislature's audit commission is investigating potential irregularities estimated at US$16.6m relating to six of these Odebrecht projects, including extensions to the Caracas and Los Teques metro systems, bridges on Maracaibo lake and the Orinoco river and a contract for the sale of frozen beef. The suspected irregularities include overcharging, commissions, bribes, embezzlement and a lack of due planning for works.

Critics allege that the political and personal affinities between Venezuela's President Hugo Chávez and his Brazilian peer Lula da Silva (2003-2010) resulted in many contracts for Brazilian companies in Venezuela, led by Odebrecht and often backed by Brazil's National Development Bank (Bndes), which is not also the subject of scrutiny for its generous funding of Brazil's 'national champions' (*see below*).

According to the Venezuela's opposition daily *El Nacional*, Lula and Chávez met at least 55 times between 1998 and 2013, with 22 of those meetings in Brazil, 14 in Venezuela, and the rest in various other countries. From 2004, after Lula had become president, the two governments inked 37 accords, 27 of those benefitting Odebrecht, according to the daily. And even after he left office, handing over to his elected successor Dilma Rousseff on 1 January 2011, Lula continued to act as roving ambassador for Brazilian interests. Reportedly, following a 2 June 2011 meeting with Lula, Chávez three days later announced a US$4bn contract with Odebrecht. And between 2012 and 2013, Brazilian companies started 16 projects in Venezuela, 12 of which went to Odebrecht, according to *El Nacional*.

The Bndes question

According to Contas Abertas, Brazil's transparency watchdog, between 2007 and early 2015 over 70% of the financing that Bndes provided to Brazilian companies for infrastructure projects overseas went to Odebrecht, amounting to some BRL8.2bn (about US$2.5bn at current exchange rates). Bndes also gave Odebrecht an estimated US$6bn in supplier credit for exports between 2009 and 2015, as part of a scheme whereby companies like Odebrecht setting up projects abroad would also promote the export of Brazilian goods for each project. (These export supply credits would then be effectively repaid by foreign governments).

Under Brazil's left-wing government led by the Partido dos Trabalhadores (PT, 2003-2016), Bndes lending went up fivefold to rival the World Bank for the size of its loan portfolio and disbursements. Since the Petrobras scandal, which implicated many of the 'national champions' that it had backed in bribery, Bndes has halted disbursements to projects abroad, meaning that work on major infrastructure schemes like the Caracas metro, the Dominican Republic's Punta Catalina power plant and Angola's Lauca hydroelectric dam have all but stalled. In fact, according to a *Bloomberg* report, of the

US$7bn that Bndes has committed to 25 construction projects abroad since 2009, only US$2.3bn has actually been disbursed.

The president of Bndes, Maria Silvia Bastos, told *Bloomberg* that the bank will continue to support Brazil's "engineering exports", but will no longer finance the majority of any undertaking. New compliance regulations are being implemented to require companies like Odebrecht and Andrade Gutierrez to sign compliance agreements that impose sanctions for impropriety.

Furthermore, no new funding for engineering projects overseas will be approved before revised rules are issued, which is not expected until late 2017. In the meantime, Bndes will resume payouts for only some of the 25 projects abroad already underway, according to Leonardo Pereira, the bank's foreign trade superintendent. Faced with this scenario, foreign countries have had no option but to seek alternative means of financing. In October, the Dominican Republic said it would look to issue up to US$600m in bonds to complete the Punta Catalina plant.

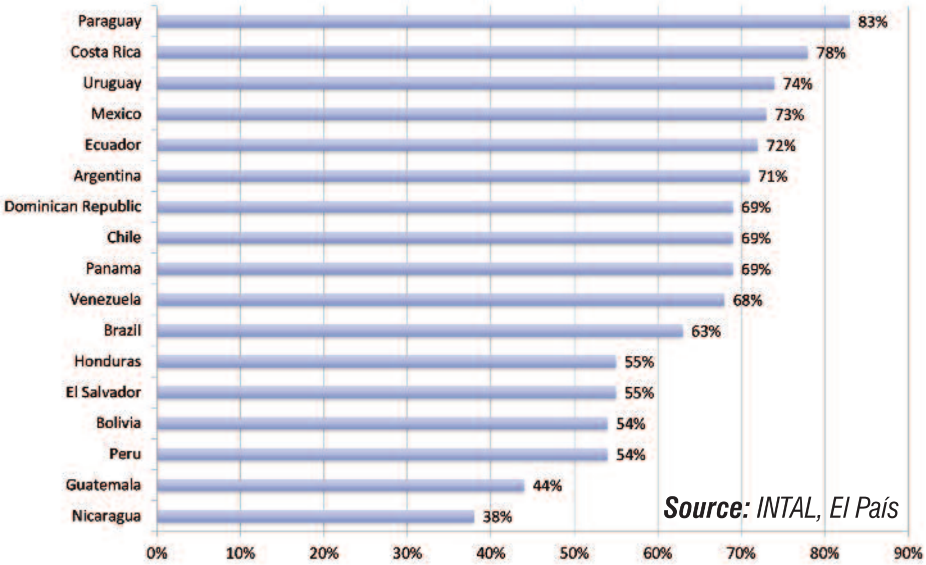
REGION

Social media reaches the poor

The spread of social media throughout Latin America has been so extensive that it has penetrated significantly into previously socially and economically excluded sectors of the population. This is one of the main conclusions of a new study carried out for Spanish newspaper *El País* by the Institute for the Integration of Latin America and the Caribbean (INTAL).

One of the surprising findings of the study was that 57% of Latin American social media users did not have enough to eat "occasionally or often" in the preceding year. Just over half – 51% – of people using platforms such as *Facebook*, *WhatsApp* and *YouTube* did not have running water at home. Although the region has seen rising living standards and the expansion of the middle class in recent years, significant pockets of poverty remain, and it seems that social media is reaching at least part of them. According to the UN Economic Commission for Latin America and the Caribbean (ECLAC), 28% of the regional population is still living below the poverty line. Meanwhile, in the ten years to 2015, the proportion of the population with internet connectivity tripled, going from 17% to 53%. This is still below average connectivity in the Organisation of Economic Cooperation and Economic Development (OECD), which stands at 82%.

Use of social meda in Latin America (% of total population)



Source: *INTAL, El País*

The study says that around 65% of the regional population is currently using social media. As in the rest of the world, the typical user is likely to be young. Amongst the population aged 24 years and under, 81% are social media users. Among those over 65, only 10% are on social media. The most popular applications are *Facebook* (54% of users), *WhatsApp* (52%), *YouTube* (30%), *Instagram* (14%) and *Twitter* (13%).

Another surprise result of the survey, which covered 20,000 respondents in 18 countries, was that Paraguayans seem to be the most intensive social media users. A total of 83% of Paraguayans are reported to be social media users, followed by Costa Rica (78%) and Uruguay (74%). Paraguay has experienced strong economic growth in recent years, but its per-capita income is still relatively low in comparative terms. Nevertheless, it has more social media usage than wealthier countries such as Chile (69%), Colombia (68%) and Brazil (63%).

There is also a suggestion that social media users may be more liberal on issues such as social and economic integration. Eighty-one per cent of social media users favour economic integration, compared to 70% of non-users. As might be expected, users tend to be optimistic about technology. A total of 48% expect new technology to help improve their health, and 45% believe it will help reduce climate change and create new jobs.

REGION

Why the MILA needs a political boost

Not all good ideas take off immediately. One idea – the creation of a single integrated capital market across the four Pacific Alliance countries (Chile, Peru, Colombia and Mexico), and known as the Mercado Integrado Latino Americano (MILA), ticks a lot of important boxes. It may be exactly what is needed as the region tries to get the best out of its limited investment resources at a time of global uncertainty. But it has made a slow start. A new report by the Inter-American Development Bank (IDB) and the US-based Wilson Center says that governments must now get the technical details right and give MILA a political boost.

Although the benefits of globalisation and free trade are being questioned in many quarters, the Pacific Alliance (PA) and MILA still attract enthusiasm. The case for the PA is strong. Its four founder members are committed to "open regionalism" and seek to achieve the free circulation of goods, services, capital and people. They pursue closer trading relations with Asia and have attracted the interest of other countries in the region (including the Mercosur bloc, formed by Argentina, Brazil, Paraguay and Uruguay). They achieved average annual GDP growth of 2.6% in 2014-2016, a relatively modest number in itself, but more impressive if we consider that it came after the end of the commodities boom, amid global headwinds, and was nevertheless double the rate achieved by the rest of Latin America. The PA countries represent 40% of regional GDP and 55% of the region's total trade. They have eliminated 98% of intra-regional trade tariffs.

The more specific case for MILA is also strong. Since the global crisis of 2008-2009, capital inflows into Latin America have slowed down and become more volatile. Global investors are likely to remain nervous and somewhat risk averse. The UK's Brexit vote (to leave the European Union), the advent of the Donald Trump administration in the US and the prospect of a US Federal Reserve monetary tightening cycle, along with tighter Basel 3 bank regulations and the 'de-risking' phenomenon, all point to a tendency to pull funds back into safe havens and away from emerging economies. In this environment, Latin American countries will need to invest as efficiently as possible to improve their productivity and competitiveness. The so-called *multilatinas* – regionally based international companies – need to raise equity and other capital to compete more effectively. A major priority, through public private partnerships (PPPs) and other mechanisms, is to improve the region's rather obsolete infrastructure – everything from large transport and logistics projects through to education, telecommunications, and broadband connectivity.

Pacific Alliance/MILA: Comparative data (2014/15)

	Brazil	Chile	Colombia	Peru	Mexico	Pacific Alliance (PA)	Latin America & Caribbean (LAC)	PA as % of LAC
Stock market capitalisation (US$bn)	843.9	236.6	153.2	121.2	831.8	1342.8	-	-
Value of domesticd debt securities (US$bn)	1977.2	131.6	84.7	25.4	596.8	838.5	-	-
Avge daily traded volume	2937	116	100	15	681	912	-	-
Listed domestic companies	356	230	70	208	139	647	1254	51.60%
GDP market prices (US$bn)	1774.7	240.2	292.1	192.1	1144.3	1868.7	5148	36.30%
GDP per capita (US$)	8539	13384	6056	6122	9009	8133	-	-
Population (m)	207.8	17.9	48.2	31.4	127	224.6	633	35.50%
Inflation rate	9	4.3	5	3.6	2.7	3.4	2.9	-
Unemployment rate	6.8	6.4	10.1	4.2	4.9	5.8	6.6	-
Imports, goods & services (US$bn)	254.2	72.8	70.8	45.3	428.7	617.6	1320.9	46.80%
Credit rating, sovereign risk, foreign currency: S&P	BB	AA-	BBB	BBB+	BBB+	-	-	-
Number of exchanges	1	3	1	1	1	6	-	-

Source: *Wilson Centre/IDB*

The priority, therefore, will be to maximise investment flows – both domestic and extra-regional – and to allocate them as efficiently as possible to the projects and activities that offer the best returns. MILA can claim to be a major step in the right direction to achieve this. Over a few years it has managed to create a partially integrated platform linking the stock exchanges of its four member countries. Through MILA, companies can now list in all four exchanges. Securities approved in one exchange can be traded across all of them, with standardised prospectus information. Brokers in one exchange can gain access to the other three. The Colombian, Chilean and Peruvian exchanges (but not yet Mexico) offer access to a single trading screen. And MILA is not small. By market capitalisation, it is the world's second largest emerging market stock exchange after China. By annual turnover, it is the fifth largest, after China, South Korea, Brazil and Singapore.

Yet Guillermo Perry and Diego Auvert, authors of the report, entitled '*Financial integration in the Pacific Alliance*', point out that MILA hasn't yet lived up to its promise. To date there have been no MILA-wide initial public offers (IPOs). There has only been secondary trading on the MILA platform, representing less than 1% of the total turnover of the flour bourses. The report warns that "the initial enthusiasm seems to be fading away". Perry and Auvert list a series of technical- and awareness-building steps that would help get MILA back on track.

- First, they suggest that the four exchanges should create a 'VIP' or 'signature' market within MILA, listing corporates with high governance standards, so as to attract the attention of international investors.
- Secondly, there should be a passport system (rather like the one operating in the European Union) allowing fund managers to create and trade investment products simultaneously across all four exchanges.
- Thirdly, to reduce transaction costs, brokers and traders should be able to access markets remotely (reducing the costly need for correspondent broker relationships).

- For the same reason, there should be further harmonisation of issuance, clearing, settlement and operational procedures.
- Importantly, the report calls for PA pension funds (and at a later date for insurance companies) to be given "local status" within each jurisdiction. The move implies that pensions would become fully "portable" within the PA, which would be consistent with the principle of freedom of movement.
- Perhaps the most challenging recommendation is that the four countries should harmonise the tax treatment of financial products, including investment portfolios, pensions, and pension funds. Differing tax treatment of MILA investments across the four countries is seen as a major disincentive to use of the platform.

Perry and Auvert say that ultimately, there should be full harmonisation and the creation of a single stock exchange, which would deliver significant economies of scale in terms of liquidity and opportunities for risk diversification. Achieving that would require political will and agreement "on a broad and ambitious vision for regional financial regulation".

ECUADOR

Ecuador piles in with fresh debt issue ahead of general election

On 10 January Ecuador returned to market with its second bond issue in a month (and its fourth in less than a year), raising US$1bn through a fresh tap of its 2026 bond. Like Brazil – whose state-controlled oil giant Petrobras successfully issued US$4bn the previous day – the cash-strapped Andean country took advantage of an upturn in capital markets ahead of the inauguration of the business-friendly administration led by US president-elect Donald Trump.

This latest issue, which came barely a month after a US$750m ten-year issue on 8 December, means that the left-wing government led by President Rafael Correa has now raised US$3.75bn via dollar bond sales in the last six months alone.

As in December, the latest issue was oversubscribed at US$2.2bn, allowing the sovereign to offer a slightly lower yield of 9.125%, in from an initial price of 9.25% (+/- 1.8%). Despite Ecuador's high risk profile (based on its record as a serial defaulter), the strong investor appetite likely reflects the rise in oil prices on the back of the new global output agreement between the Organisation of Oil Exporting Countries (OPEC) and other leading producers including Russia; and possibly also some expectations of a shift toward a more investor-friendly policy stance after the mid-February general election, even if the ruling Alianza Pais (AP) retains power for another four years.

The AP's candidate to replace Correa, his former vice president Lenín Moreno (2007-2013), is considered a little more pragmatic than Correa, who has taken a very antagonistic stance towards the private sector. The right-wing opposition is also expected to make legislative gains, which could push the AP towards the centre (albeit a fractured legislature also risks paralysis).

Nonetheless, the case remains that no matter who wins the election, the new government due to take office in May will inherit a sizeable fiscal deficit (stuck at over 5% of GDP for the past three years) and a deteriorating debt profile.

Technically, the Correa government is correct when it insists that Ecuador's debt stock is not high. In September last year, the treasury put it at just under the constitutional cap of 40% of GDP (albeit this does not include mounting accumulated arrears to suppliers, or off-balance sheet oil-backed financing deals with China). In October, President Correa moved to decree a change in the public debt methodology to exclude from the headline calculation the government debt burden owing to state entities, thereby reducing the overall public debt ratio to 26% of GDP. While this has clearly allowed for additional borrowing ahead of the 2017 election, the move was criticised by opposition economists.

Debt obligations are set to increase sharply from 2017, at a time when the budget position remains weak. With recent new issues carrying average maturities of 5-6 years, the next government may therefore have to do some deft renegotiation/reprofiling once it takes office, in order to reduce and spread these near-term commitments.

All of last year's debt issues were put towards the 2016 budget, including a sizeable reconstruction bill for a severe earthquake in April (estimated at US$3bn). At the outset of 2016, the-then finance minister, Fausto Herrero, put budget financing needs at US$6.6bn. Over the course of the year, that doubled to some US$13bn.

GDP

There was a small rise of 0.5% in quarterly growth in June-September, following a rise of 0.7% in the preceding three months. The government is confident that the economy has hit bottom and is now on the upturn. On the 12-month comparison however, real GDP contracted by 1.6% year on year in the third quarter, with continued sharp falls in investment (-6.9%), government consumption (-4.4%) and imports (-3.2%).

Ahead of the February election, the treasury has been coy about 2017 financing needs. There will not be a 2017 budget until the newly-elected government takes office (ahead of a general election, the previous year's budget is rolled over), but in late October, the-then minister for economic policy, Patricio Rivera (who subsequently took over Herrero's role in a cabinet reshuffle), put financing needs for public spending and debt payments in 2017 at US$5.3bn, about 5.5% of GDP. On paper, this would be down by over 50% on previous years. In part, this owes to the fact that a lengthy period of public investment (including in cost-saving hydro-electricity plants built with Chinese support) is complete. It is also the case that the government expects oil earnings to rise in 2017, as the new reserves come on-stream and global oil prices recover. The 2016 budget was based on an oil price forecast of US$35/barrel (/b). West Texas Intermediate (WTI) oil was trading at about US$51/barrel in mid-January. (Ecuador's Napo and Oriente crude trades a discount of about US$5-7 to the WTI barrel).

Despite the oil price recovery, the government's fiscal position remains uncomfortable and with that in mind private economists still put this year's gross financing needs at around US$10bn – and suggest that up to half of that would have to be raised externally, adding to the growing debt pile.

Talking up the economy

Announcing the latest debt issue, Finance Minister Rivera also talked up the real economy, stating that investors, perceiving the "palpable signs of economic recovery in the country" had "ratified their support for our economy".

President Correa and the new economic policy minister Diego Martínez (formerly the central bank president) have likewise been loudly touting "a strong recovery" in late 2016. While admitting to a contraction in 2016, Correa in early January insisted that the full-year 2016 result would be no more than -1.7%. He called out the IMF, which having previously amended its initial 2016 forecast from a stark -4.5% to -2.5%, was still way off, he noted. The central bank now projects real annual GDP growth of 1.4% in 2017. Private economists are more cautious, expecting only a mild recovery, amid continued fiscal constraints, doubts about the oil price recovery and investor uncertainty around the direction of economic policy under a new administration.

REGION

Corporate Radar

Garza family trouble in Mexico: Uncertainty over US President-elect Donald Trump's policies toward Mexico have had a big negative impact on Grupo Xignux, the Mexican industrial and agro-processing company controlled by two wings of the Garza family, considered one of the country's most powerful business clans. Sales in the first nine months of 2016 were down by 7.1% to US$1.39bn. Over the same period, Ebitda slumped by nearly 26% to US$110.8m. According to analysts Signum Research, Xignux could be impacted by any renegotiation of the North American Free Trade Agreement (NAFTA). It is also carrying significant US dollar debt, and its margins are being squeezed as the Mexican peso depreciates against the US dollar. To some extent, this can be managed with currency hedges. “Dollar debt is an important issue now. Some companies have begun to change their sources of finance” says Luis Garinian of Grupo Bursátil Mexicano.

Ford drops San Luis Potosí plant: In a move widely linked to the influence of incoming US President Donald Trump, Ford in early January announced that it was cancelling a plan to build a US$1.6bn automobile plant in San Luis Potosí, Mexico, and would instead invest US$700m in its facilities in Flat Rock, Michigan, to produce more electric and self-driving cars.: “We didn’t cut a deal with Trump. We did it for our business”, Chief Executive Mark Fields stressed. Officially, Ford says that its main business reason for the U-turn was that small car sales in the US have fallen recently (as low fuel prices and a recovering economy encourage US consumers switch back to their preferred larger vehicles).

However, many analysts argued that the decision (Ford had been planning to transfer all production of the Ford Focus from Michigan to Mexico to save costs) had been at the very least influenced by Trump’s criticisms of the company (and its competitors in the sector) for transferring employment outside the US, as well as his threats to apply a 35% import tariff on cars and components made in Mexico (albeit the US president cannot directly levy taxes, in fact). US automotive workers earn an average of US$28 an hour, compared to the US$5.50 an hour earned by their Mexican counterparts. During the US presidential campaign, Ford disputed Trump’s claims that jobs had been lost to Mexico, pointing out that it currently employs 85,000 US workers, up by nearly 50% on 2011. In Mexico it employs 8,800.

The news caused concern in Mexico, especially for the authorities in San Luis Potosí, a northern state where GDP has been growing at roughly double the national average and unemployment has fallen to 3%. It also caused concern further south in Honduras, where the local components industry had been hoping to benefit from Ford Escort-related orders for electrical wiring harnesses.

The Mexican government also was worried that Trump’s renewed criticism of the Japanese car maker Toyota was intended to force a rethink of *its* plans to expand its facilities in Baja California, and to build a new US$1bn plant in Guanajuato to make components for the Corolla model sold in the US. Toyota is the third largest car seller in the US, after General Motors and Ford. Toyota, however, has reiterated its commitment to Mexico.

Some industry specialists, while conceding the importance of the Trump factor, also argue that for manufacturers like Ford, their labour needs are changing, with an emerging emphasis on the skilled engineers and technologists needed for the next generation of self-driving and electric cars. These skilled workers, the argument goes, are more likely to be found in the US than in Mexico.

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