CANNING HOUSE EDITION

latin american economy & business

July 2015 - EB-15-07

ISSN 0960-8702

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

Latin American Newsletters since 1967

Greece, seen from Latin America

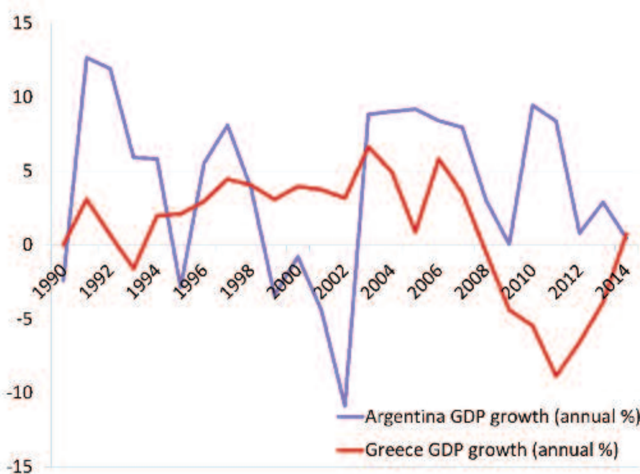
The Greek financial crisis has been closely watched across Latin America, as the South European country has zigged and zagged between austerity and heterodoxy, between the Euro on one side and a possible Grexit and emergency revival of the Drachma on the other. Latin American politicians have claimed Greece proves them right – in sometimes-contradictory ways. And economists have argued over whether Greece could or should "do an Argentina" – in other worlds default on its debts, force the creditors to take a "haircut", and enjoy a post-crisis surge in growth. Here, we try and pick our way through some of the arguments.

In July an Argentine tourist on a Mediterranean cruise was a little put out when he tried to withdraw cash from an ATM in Greece: the machine refused his request. He had fallen victim to the emergency 60 Euros-a-day bank cash withdrawal limits imposed in the middle of the Greek financial crisis. Assuming the story is true (it was reported among others by Mexico's financial newspaper *El Financiero* and the *Financial Times* of London), this was a particularly poignant moment because the tourist in question was Domingo Cavallo, the twice former Argentine economy minister, who in late 2001 had been the author of the infamous *Coralito*, which, amidst a crisis of similar magnitude, limited bank withdrawals to 250 Pesos a week (initially US$250 or around 227 Euros at today's exchange rate). Shortly after that, Cavallo was forced to resign, the Argentine government collapsed, and there was a maxi-devaluation and a default on Argentina's foreign debt. A question now being asked is whether it would be so bad if Greece followed the Argentine example?

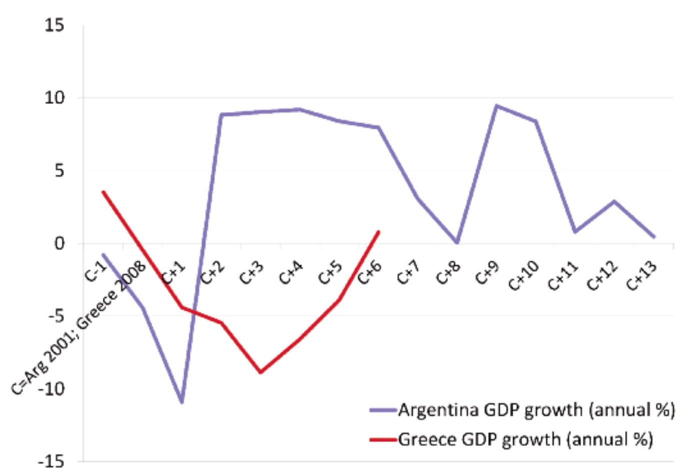
Cavallo thinks it would be. He believes that Greece should definitely stay in the Eurozone. His view is that undergoing more austerity now will be a lesser evil than the collapse in real wages that would accompany a Grexit. In the opposing camp on the austerity question are ranged a number (but not all) of Latin America's centre-left leaders. Many hailed the 62% "oxi" or "no" vote in the referendum on 12 July, when the Greek electorate rejected the austerity measures proposed by the EU leadership. For the Latin Americans, this was a rejection of the traditional, regressive IMF-backed austerity recipe. Argentina's President Cristina Fernández tweeted her "solidarity with the brave Greek people and their government." Venezuela's Nicolás Maduro spoke of "a victory against the financial terrorism carried out by the IMF". There were similar comments from the Ecuadorean government, and Bolivia's President Evo Morales spoke of "a defeat of European imperialism". Brazil's Dilma Rousseff was more cautious: she merely expressed her hope that Greece would resolve its problems "within the framework of the European Union".[1]

The economic case against conventional adjustment was made in a joint article in *The Huffington Post* by the US Nobel prize-winner Joseph Stiglitz and Martín Guzmán of Columbia University. Their key contention is that austerity is counter-productive, and when imposed in the context of an unsustainable debt burden, it can tip a country suffering from recession into something even worse: full-blown depression. "Defaults are difficult. But even more so is austerity" they wrote, adding "The good news for Greece is that, as Argentina showed, there may be life after debt and default".[2] Paul Krugman, another US Nobel prize-winning economist, has taken a similar line. Indeed, as our chart shows, GDP contracted drastically in the first two years of Argentina's crisis (2001 and 2002), but rebounded after that, and recovered strongly into the high single digits for all of 2003-2008. If we take the Greek 'crisis year' as 2008 and compare it to the Argentine growth curve after its 2001 'crisis year' onwards, it is evident that the recession in the European country has already dragged on for much longer than it did in Argentina. Argentina had two years of recession. Since austerity was first imposed, the Greek economy has contracted unremittingly for six consecutive years. Over that period, output fell by around one-quarter and unemployment rates rocketed. Positive growth was achieved only in year 7 (2014) and in view of the latest developments, the country can now be expected to crash back into recession in 2015.

GDP % ch year on year



GDP % ch year on year post crisis year



So does this prove that an Argentine-style default and debt write-down (the bulk of Argentina's creditors accepted a 70% 'haircut', or reduction in the value of their debt papers) is a better policy than the IMF's traditional recipe of grinding budget cuts and seemingly never-ending belt-tightening? Not at all, says another group of analysts led by Venezuelan Ricardo Hausman, a former IDB economist now at Harvard. Like many others, he stresses the differences between Argentina and Greece. He says Stiglitz is too focused on the US austerity debate, where the issue has been "whether a government that could borrow at record-low interest rates, in the middle of a recession, should do so." In sharp contrast, he says that Greece "piled up an enormous fiscal and external debt in boom times". Rather than being crippled by debt service, "until 2014 the country did not pay, in net terms, a single Euro in interest". On Hausman's reckoning, by 2007 Greece was spending more than 14% of GDP in excess of what it was producing. His point is that these funds – a reflection of EU generosity – were not used to upgrade the country's

[1]http://www.infolatam.com/2015/07/13/america-latina-y-la-crisis-griega/
[2]http://www.alternet.org/economy/argentina-shows-greece-there-may-be-life-after-default

productive capacity. Greek exports (fruits, olive oil, raw cotton, tobacco and some refined petroleum products) remain weak (while its main revenue earner – tourism – faces big competitive challenges). Hausman's bottom line is that "Greece needs to develop its productive capabilities if it wants to grow." Unless and until it does, that adjustment will necessarily be hard.[3]

Those who say direct comparisons between the Argentine and Greek experiences are just too simplistic cite a number of other factors. While Argentina was a highly dollarised economy, its "neo-currency board" exchange rate regime had important heterodox features, and cannot be compared directly to Greece's full Euro-zone membership. Crucially perhaps, because the Peso continued in circulation throughout, it was relatively easy and quick for a new government to break the peso-dollar peg at the start of 2002 and move forward with a devalued, export-encouraging currency. Greece, in contrast, is entirely reliant on the Euro and appears to have no rapidly-actionable contingency plans for re-launching the Drachma. There are two other major differences. One is that shortly after the 2001-2002 crisis, Argentina enjoyed the benefits of a decade-long "super cycle" of strong commodity prices, particularly in the case of its soya, grains, and oilseed exports. It therefore became feasible for the country to quickly "export its way out of trouble", in a way that just does not look possible for Greece in 2015. "The devaluation might have helped Argentina for a couple of years, but the key to its growth performance was the commodity boom, which Greece or Spain are not likely to encounter given their export base," Silvana Tenreyo of the London School of Economics (LSE) wrote in 2012. "This reduces the appeal of exit and increases its cost, as peripheral Europe might end up institutionally and economically worse off by losing its international partnerships with the core."[4]

"As a footnote to the debate, it is worth mentioning that in 2015, nearly 14 years after its default, Argentina still faces a legal dispute with its "holdout" creditors in New York courts, which in effect restricts its access to international capital markets."

The second difference is simply to do with orders of magnitude. Even at its worst point (2001-2002), Argentina's foreign debt burden was much smaller than that accumulated by Greece. Although it is hard to find directly comparable figures, Greece's total debt is currently estimated at 177% of GDP.[5] According to the World Bank, meanwhile, Argentina's external debt, as a proportion of gross national income (GNI), was 47.1% in 2001, rising to a peak of 125.3% in 2002 (largely because of the effect of the maxi-devaluation of that year, which reduced the overall size of GNI in US dollar terms). Thereafter, aided by debt rescheduling and a creditor "haircut", it trended down. The latest data point in this series, for 2013, is very low: 22.7%.[6]

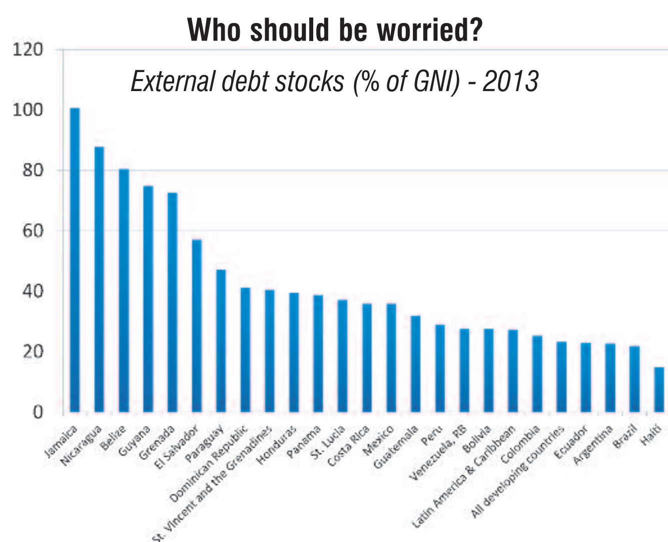
As a footnote to the debate, it is worth mentioning that in 2015, nearly 14 years after its default, Argentina still faces a legal dispute with its "holdout" creditors in New York courts, which in effect restricts its access to international capital markets. This is still a big pending issue, which the next Buenos Aires government (set to take office in December, after general elections on 25 October) will have to face. In the hypothetical case of a Greek default, the same legal difficulties are unlikely to be repeated, because collective action clauses in bond contacts have subsequently been modified. It is now easier for a majority of creditors to accept a binding rescheduling deal without being blocked by a minority. However, in other respects, any decision by Greece to drop the Euro as its currency would take it, and the rest of the EU, into uncharted legal waters.

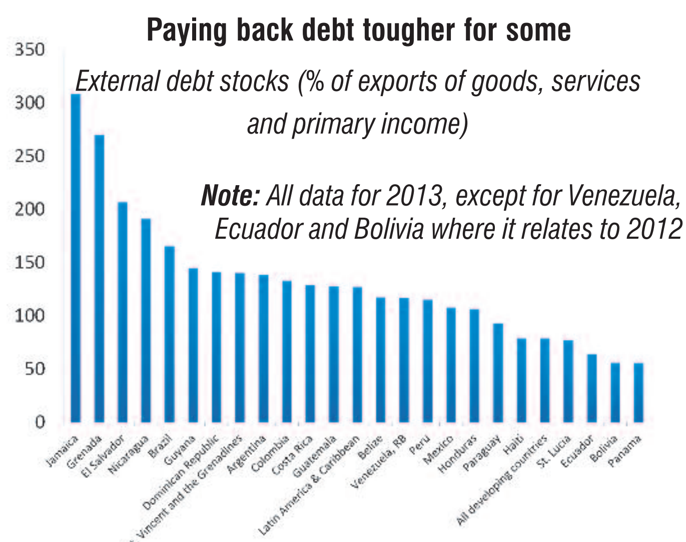
More widely, the Greek crisis prompts the question: to what extent are today's Latin American and Caribbean economies exposed to potentially similar difficulties? Interestingly, there are three countries – Ecuador, El

[3] http://www.project-syndicate.org/commentary/greece-export-problem-by-ricardo-hausmann-2015-03
[4] http://www.marketwatch.com/story/no-argentina-isnt-a-role-model-for-greece-2015-07-07
[5] http://blogs.ft.com/the-world/2015/01/is-greek-government-debt-really-177-of-gdp/?Authorised=false
[6] http://databank.worldbank.org/data/home.aspx

Salvador and Panama – and one 'free associated state' of the US, Puerto Rico, where the US dollar is the de-facto currency, and where the local economies can be said to share some 'Eurozone-like' operational features (but only some). Of the four, one – Puerto Rico – is also in the middle of a debt crisis, which we examine elsewhere in this report.

One way of assessing the level of debt sustainability in Latin American and Caribbean countries is to look at two indicators: first, total debt as a proportion of GNI, and second, total debt as a proportion of annual revenue from the exports of goods and services and other income (e.g. remittances).





Source: *World Bank*

What this shows is that regional economies are well below Greek-like danger levels. In terms of debt/GNI, the most-indebted countries are in Central America and the Caribbean (the list is led by Jamaica, with a debt to GNI ratio of 100.6%, followed by Nicaragua, Belize and Guyana). In terms of hard currency revenues, Jamaica is again top of the list, with debt equivalent to three year's worth of foreign currency earnings, followed by Grenada and El Salvador. On both criteria, the dollarised economies of Ecuador and Panama are way down at the bottom end of the ranking and not over-leveraged at all. Brazil, which is one of the least-indebted countries in terms of GNI (debt equivalent to only 21.9% of GNI), is the fifth most highly-leveraged country in terms of foreign earnings (debt equivalent to 165.6% of its annual earnings). This reflects the fact that Brazil's giant economy is less open to foreign trade than many of its regional peers. Also worthy of note is that the data suggests Venezuela is not particularly exposed (debt reported as only 27.5% of GNI, representing 117.1% of its foreign currency earnings). However, the accuracy of these statistics can be called into question, and throughout this year a number of analysts have suggested that a Venezuelan foreign debt default cannot be ruled out. Debt sustainability also relates to other indicators such as the size of fiscal and current account balances.

Relatively high debt levels in the Caribbean are a cause for concern. In July, Alicia Bárcena, executive secretary of the UN Economic Commission for Latin America (ECLAC, also known by its Spanish acronym, CEPAL) said it was proposing that multilateral lending institutions should initiate a debt write-down programme for the Caribbean. CEPAL said it favoured a gradual but ultimately 100% write-down of multilateral public sector debts, most of which had been incurred to boost recovery from a string of natural disasters suffered in 1990-2014.

In exchange for the write-down, CEPAL was suggesting that members of the Caribbean Community (Caricom, a regional common market), should make contributions to a new ‘resilience fund’ to protect against future disasters. According to CEPAL calculations, five Caribbean countries (Antigua and Barbuda, Barbados, Grenada, Jamaica, and St Kitts and Nevis) were among the 20 most-indebted countries in the world in 2013. This group of five Caribbean countries had total debts of US$46bn, representing 71% of sub-regional GDP. In an interesting parallel with the Greek crisis, CEPAL said that in the absence of a write-down, reducing Caribbean debt to sustainable levels would require austerity measures of such severity that they would trigger a major recession. To avoid that, a write-down was justifiable, it added, because the debt had not been incurred due to “policy errors or bad fiscal management” but as a result of “external shocks” aggravated by the structural problems of small island economies and a fall in foreign direct investment.

REGIONAL BUSINESS REVIEW

MEXICO

Tough times for steel

The Mexican government has been applying import duties on steel and steel products, as a world steel glut and surge in cheap imports, mainly from China, erodes the position of domestic producers.

“Latin American steel producers are worried about what they see as unfair competition from China.”

In line with World Trade Organisation (WTO) rules, and following an anti-dumping investigation, in June the government imposed tariffs on cold-rolled steel imports from various Chinese suppliers. Similar tariffs were imposed on hot-rolled steel imports from Germany, China, and France. In July, after another investigation, tariffs were applied on imports of certain types of carbon steel pipes from the US, Spain, and India. Also in July, the economy ministry announced new restrictions against unfair competition, with steel importers required to submit a security deposit and accept regulation according to installed capacity and verifiable sales. A further 86 steel products have been added to the ‘sensitive merchandise’ list, which means they are subject to additional scrutiny. In mid July, the ministry said it had 31 anti-dumping quotas in place, nearly half on Chinese products.

Mexico imports around 7m tonnes of steel annually, normally on a duty-free basis. The domestic industry had unsuccessfully called for the imposition of a blanket 15% import tariff. The more selective approach, singling out specific products and suppliers, came after meetings between government officials and locally-based steel companies Ahmsa, ArcelorMittal Mexico, DeAcero, Ternium, Tubacero and iron ore producer Minera Autlan. Ahmsa said that domestic steel prices had plunged by 40% in the first five months of the year and the government had been slow to respond. In June the company laid off 4,000 workers and said another 4,000 would be dismissed by the end of July as it reduced its investment programme and restricted production. But after the extra selective tariffs were announced, Ahmsa spokesman Francisco Orduña welcomed them as “very positive” and said plans to lay off the second 4,000 employees would not necessarily go ahead. ArcelorMittal had also been planning staff reductions.

> “Mexico’s private sector is not unanimous over the need to restrict cheap steel imports. Car exports, particularly to the US, have been booming and Eduardo Solis, president of the Mexican Auto Industry Association (AMIA), has said that the sector is “enormously concerned” over lobbying by domestic steel producers.”

Latin American steel producers are worried about what they see as unfair competition from China. In July, eight national and regional steel associations, including Canacero, the Mexican iron and steel chamber, and industry bodies from Argentina, Brazil, Chile, Colombia and Peru published an open letter saying Chinese state companies were selling their products without regard to WTO rules, in a way that was impacting domestic producers and threatening thousands of jobs. The letter said Chinese state-owned enterprises (SOEs) have some 425m tonnes per year of overcapacity, and are exporting at knock-down prices simply to “maintain activity and employment”.

Mexico’s private sector is not unanimous over the need to restrict cheap steel imports. Car exports, particularly to the US, have been booming and Eduardo Solis, president of the Mexican Auto Industry Association (AMIA), has said that the sector is “enormously concerned” over lobbying by domestic steel producers. Steel parts were a “fundamental component” of vehicle sales and exports, he emphasised. The auto industry imports around 90% of the steel it uses. Economy Minister Idelfonso Guajardo told the *Wall Street Journal* that the government was seeking the right balance and had rejected blanket import tariffs. “We want a smart integration of Mexico in the global economy. Yes, we want to continue being a country that welcomes free trade, but active enough to battle unfair competition” he said.

REGION

Corporate Radar

Sierra Oil Wins Round 1 Licences: Mexico’s Sierra Oil and Gas led the only consortium to win licences in the first phase of the country’s Round 1 hydrocarbons licensing auction, announced on 15 July. Sierra, in partnership with Talos Energy of the US and Premier Oil of the UK, was declared the winner of the shallow water Blocks 2 and 7 in the Gulf of Mexico. Under the bidding rules, companies were required to offer a share of profits to the government and a minimum level of investment in developing the blocks. Mexico’s regulator, Comisión Nacional de Hidrocarburos (CNH), said that the consortium had offered the government 74%-86% of the profits from Block 2 (off the coast of Veracruz) and 83%-88% of the profits on Block 7 (facing the coast of Tabasco). The CNH estimated that investment in each block would be around US$1.3bn over the next five years. Each licence has a 30-year term. Contracts will be signed in August.

Falabella subsidiary boosts Colombia investment: Department store Sodimac Colombia, in which Chile’s Falabella has a 49% holding, says it is boosting its 2015 investment by 46.7% to US$81.8m. The chain, which is 51% controlled by Colombia’s Corona, said the money would be spent on opening new stores, refurbishing existing outlets and offering new online services. General Manager Miguel Pardo said the company had opened a new Homecentre-branded store early this year, and planned at least one more. First quarter sales in Colombia had grown by 10.7% year-on-year. Sodimac also operates retail chains in Peru, Argentina, Brazil and Uruguay.

Grupo Alfa fails in takeover bid for Pacific Rubiales: In early July Alfa SAB of Mexico and Habour Energy of the US dropped their US$1.7bn takeover bid for Pacific Rubiales, the Colombia and Canada-listed oil company. The

bid was seen as a key move to develop a multinational Latin American oil company but faced resistance from a Venezuelan-based group of minority shareholders, who with a 20% stake in the company were able to reject the combined offer of 6.50 Canadian dollars a share as insufficient. The O'Hara group that blocked the takeover is also known as 'Bolichicos' because of its claimed proximity to the Venezuelan government. According to press reports, the Bolichicos managed to postpone a special shareholders' meeting to consider the Alfa-Harbour offer to 28 July. In advance of the meeting, Alfa-Harbour improved the offer to C$7.00, but this was insufficient to meet the Bolichicos' demand for C$9.0. Analysts said that Pacific Rubiales, which has been impacted by low oil prices and the ending of its licence to operate a key production field in Colombia, will now have to reconsider its strategy. As far as Alfa is concerned, Andrés Bezamilla, an analyst at Mexican brokers Valmex, said, "There are two scenarios. In the first, the company will look for other partners to bid in Mexico's licensing rounds. In the second, it will give Pacific some time to think it over and then come back with a new offer. The positive thing is that it hasn't allowed itself to be pushed by O'Hara into increasing the offer price."

Profits down for the top 500: According to Chile-based *AmericaEconomía Intelligence*, profits at Latin America's top 500 private sector companies dropped for the second year running in 2014, falling by 41% to US$2.48bn. There hadn't been a two-year consecutive fall in earnings since 2001-2002. The fall was attributed to a number of factors, including the end of the commodities boom, the depreciation of local currencies against the US dollar and the fact that many of the companies are based in economies that experienced slow growth. Of the top 500, 203 companies are based in Brazil, 119 in Mexico, 65 in Chile, 44 in Argentina, 30 in Peru and 24 in Colombia. Brazil and Argentina – together home to about half the Latin American total – experienced economic stagnation last year. Andrés Almeida, head of the team that wrote the report, noted, "This is a new and less prosperous era. The commodities super-cycle is over. Profits and sales growth experienced from the 1990s to now cannot be maintained. Then, there was explosive growth in the commodities sector. Now prices have fallen and are stabilising."

"Profits at Latin America's top 500 private sector companies dropped for the second year running in 2014, falling by 41% to US$2.48bn..."

Carrefour does well in Brazil: Despite the slowdown in the Brazilian economy, sales by the French retailer Carrefour rose by 7.1% year-on-year in the second quarter, company executives said. Carrefour was doing better in the Brazilian recession than its also French-owned rival Casino, because a greater proportion of its sales were food or food-related, and spending on food items tends to be inelastic in a downturn, officials commented. Globally, Carrefour said that sales growth had slowed because of competition in France and a fall in consumer spending in China. Second quarter sales were EUR21.4bn (US$23.2bn). Excluding energy and forex fluctuations, sales grew by 2.6% in the period, down from 3.2% in the first quarter. Sales in Spain and Brazil were the bright spots. Brazil is the company's second largest market after the home market in France. Carrefour's Financial Director Pierre-Jaen Sivignon said that a global EBIT of EUR2.51bn-EUR2.53bn seemed a "reasonable" forecast for this year. Carrefour was considering listing its Brazilian subsidiary, but short-term capital market conditions in Brazil were not appropriate for an IPO. In any case, he noted, "we don't need an IPO to support our growth in Brazil".

URUGUAY

The pros and cons of gradualism

When looking at Uruguay's recent macroeconomic performance, 'gradualism' is the word that most comes to mind. It has both positive and negative implications.

On the upside, gradualism means that despite neighbouring Argentina and Brazil's plunge into recession, Uruguayan GDP growth is still in positive territory, even if there is something of a slowdown going on. On the downside, it is clear that some of the problem areas of the economy – such as a high fiscal deficit and above-target inflation rate – are going to take some years to resolve.

Uruguay's GDP grew by 3.5% in 2014. Most analysts expect the pace to slow this year, but to remain positive. Data for the first quarter of 2015 showed year-on-year growth picking up to 4.0%, led by utilities, foreign trade and tourism. This appears to confirm the view that Uruguay has decoupled itself from neighbouring giant Brazil, where GDP fell by 0.2% y-o-y in the first quarter. Brazil and Uruguay's other large neighbour, Argentina, still matter, of course, but diversification of exports has been important (Uruguay's largest single beef export market in H115 was China, taking 41% of the total). Nevertheless, during the first quarter household demand growth slowed to 3.0% year-on-year, down from 4.6% in Q114. In July, Economy Minister Danilo Astori reiterated the government's view that this year's growth prospects were "reasonably good", with GDP expansion likely to be in a 2.5%-2.8% range. Astori said that growth would trend around 3% in subsequent years.

In a recent report, BBVA Research says it expected Uruguay's real annual growth to slow to 2.6% this year, rising to 3.0% in 2016. "Although domestic demand is still the main force behind this growth, private consumption will slow down in harmony with the less buoyant labour market, while investment will also experience a loss of momentum as no major private sector initiatives on the scale of the Montes de Plata project are foreseen… and public investment will have been put on hold given the need to make fiscal savings" the report says. The investment phase in the large-scale Montes de Plata cellulose plant, controlled by Arauco of Chile and Stora Enso of Sweden-Finland has now concluded. It will produce 1.3m tonnes of paper pulp a year.

"BBVA Research attributes growth to Uruguay's reputation for legal stability, its good business climate, and the government's "shrewd administration of public debt", among other things. But it also makes it clear that progress in two problem areas, the fiscal deficit and inflation, will be slow."

BBVA Research attributes growth to Uruguay's reputation for legal stability, its good business climate, and the government's "shrewd administration of public debt", among other things. But it also makes it clear that progress in two problem areas, the fiscal deficit and inflation, will be slow. To tackle the fiscal deficit, which was 3.3% of GDP in 2014, the government is working on a five-year budget plan. This year BBVA expects the deficit to narrow only marginally to 3.1% of GDP. Most of that will in any case reflect the impact of lower international oil prices. Inflation is expected to stay above the centre-point of the target range, and is predicted at 8.0%-8.4% this year, which will reflect wage inertia and an inflationary pass-through from the expected peso deprecation against the US dollar.

There is an active policy debate going on within the ruling left-wing Frente Amplio coalition of President Tabaré Vázquez. For example, in July it was reported that Vice President Raúl Sendic was supporting proposals to use some US$2.5bn of the country's US$18.19bn foreign currency reserves to boost infrastructure investment, an idea also backed by the trade union confederation, Plenario Intersindical de Trabajadores-Convención Nacional de Trabajadores (Pit-Cnt) union. But Economy Minister Astori said that such a plan was not under consideration. He described the foreign currency reserves as "an asset for the country that we have to manage very carefully". There is also a significant debate over salaries and the cost of living, which the government is eager to hold within the framework of its 5-year budget plans. Astori has stressed that real wages have increased and poverty has been reduced, social gains which must be defended; but he has also suggested that going forward the government will seek a policy on salary levels that "defends employment" – seen as a reference to the need for moderation.

REGION

Mercosur (sort of) reacts

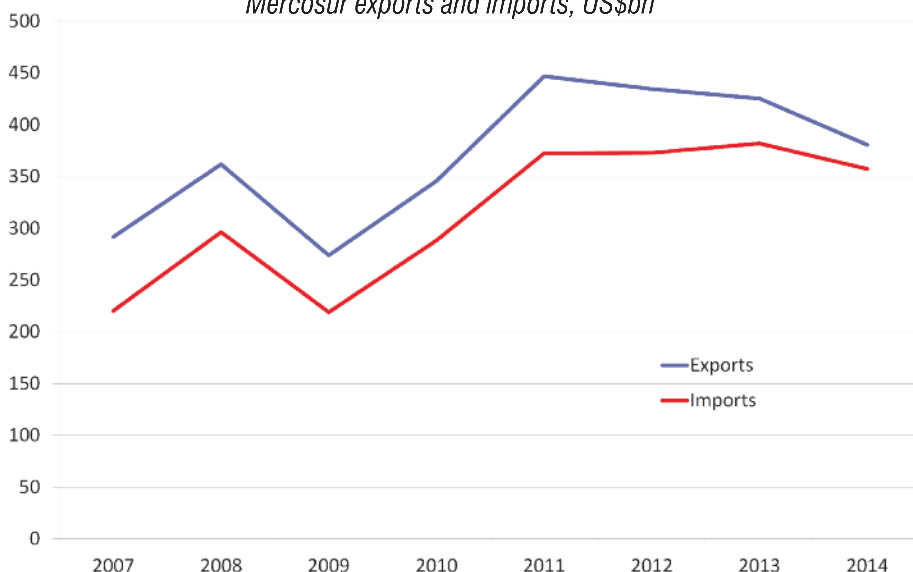
"It is hard to see any action being taken until the next full Mercosur summit, due in December in Asunción, by which time a new government will be in the process of taking office in Argentina."

Mercosur, Latin America's Southern Common Market, is in crisis, arguably. Both internal and external trade is on a downward trend. Its three largest economies are in recession. There is a history of internal disagreements over protectionism, and after 15 years of intermittent negotiations the trading bloc has still been unable to reach a free trade agreement (FTA) with the European Union. Yet at the summit of Mercosur heads of state held in Brasília in July, it was pretty much business as usual.

The one-day presidential summit on 17 July dealt with five main issues. First, a decision in principle was taken to admit Bolivia as the sixth full member, joining Argentina, Brazil, Paraguay, Uruguay and Venezuela. Bolivian accession has been a complicated process, lasting almost three years. Nevertheless, it was enthusiastically welcomed by Venezuela's President Nicolás Maduro, who proclaimed: "Mercosur is our north, our road map, and we will be bet everything on its transformation, strengthening and enlargement". Yet there are fears that Bolivia's accession – which still needs to be approved by the Paraguayan and Brazilian legislatures – will increase Mercosur's economic asymmetries and further complicate the internal decision-making process. Bolivia does not support the proposed FTA with the EU, for example.

A second big issue is the need to revive trade within the block, which has fallen because of the macroeconomic difficulties in the bloc's key members, Argentina, Brazil and Venezuela (all of which are predicted to experience GDP contraction this year) and the spread of internal tariff and non-tariff obstacles to trade, such as Argentina's requirement for sworn import statements, which must be approved individually by the authorities and are used to protect local industries. Uruguay and Paraguay, with support from Brazil, secured an agreement that tariff and non-tariff barriers to intra-Mercosur trade will be analysed in a technical meeting due to be held in Paraguay in August. But it is hard to see any action being taken until the next full Mercosur summit, due in December in Asunción, by which time a new government will be in the process of taking office in Argentina.

Source:
International Trade Commisison
Note:
Mercosur defined as 4 original members, Argentina, Brazil, Paraguay and Uruguay
Link:
http://www.trademap.org/tradestat/Product_SelCountry_TS.aspx



Uruguay, meanwhile, has pushed ahead with an initiative to rescue its bilateral trade with Venezuela from a range of payment problems. Both governments have agreed that Uruguay will export US$300m worth of foodstuffs to Venezuela during the rest of this year. This will include 120,000 tonnes of rice, 44,000t of powdered milk, and 80,000t of soya, among other items. Given Venezuela's poor payments record, the money will go into a collateralised fiduciary account in Bandes Uruguay bank in Montevideo. As part of the deal, Uruguay's state oil company, Ancap, will pay US$262m for recently received oil imports from Venezuela. Earlier long-term concessionary finance terms offered on these oil shipments are being converted according to a formula based on spot prices plus a discount. The net effect is to clear a backlog of debts on both sides. Venezuela gets some desperately needed food imports, while Uruguay's dairy farmers, who had been severely impacted by payment delays on their exports to Venezuela, get some relief. Uruguay's President Tabaré Vázquez says Caracas has responded positively to a suggestion that similar mechanisms be used to triple bilateral trade to US$1bn in subsequent years.

In fourth place, the summit agreed to make yet another effort to revive the EU FTA negotiations. This long running saga has for the most part been an internal discussion within Mercosur over how to establish a common bargaining position in relation to Europe. With Argentina and Venezuela being the slowest to move, Uruguay, Paraguay and Brazil had suggested a "two-speed" approach to negotiations. There have even been suggestions that each member could negotiate its own separate FTA (a move which would call into question the whole point of Mercosur). The summit agreed to kick the issue forward once again, with a single-speed approach and with each member country requested to submit its list of proposed zero-rated products in bilateral trade with EU by the fourth quarter of this year.

Uruguay has already said it will propose zero-rating for some 92% of the products it trades with the EU.

Finally, in fifth place the summit agreed to “deepen” negotiations with other trade blocs, an in particular with the Pacific Alliance (Chile, Colombia, Mexico and Peru), which has established a reputation for being more dynamic and free-trade friendly. Brazil – Mercosur's dominant member – has been shifting gradually towards a more flexible trade position as it considers the need to try and export its way out of trouble. Armando Monteiro, Brazil's minister for industry, foreign trade and development, has said that Brazil needs to “integrate” with foreign trade movements that are “more dynamic than Mercosur”. Brazil's powerful leading industry lobby, Confederação Nacional da Indústria (CNI), said in a statement that “in practice, Mercosur has not been able to consolidate as a free trade area, and recent summits have not dealt with subjects that are important and urgent issues for industry”.

VENEZUELA

Peering into the black box

The Venezuelan economy is not doing well – some would call that a massive understatement. A key problem is the dearth of credible data on GDP, inflation, trade and external payments. Juan Cristóbal Nagel (editor of the *Caracas Chronicles* blog and economics professor at Universidad de los Andes in Chile) has said that trying to analyse the current state of economy is like “looking into a black box”.

Without credible and continuous data series, it is difficult to get a sense of the country's macroeconomic dynamics. Writing for the US-based *Foreign Policy*, Nagel quotes the view of Asdrúbal Oliveros, of the Caracas consultancy Ecoanalítica, who calculated that 12-month inflation in May-June 2015 was running at 128%, with a public sector deficit of 20% of GDP and a balance of payments deficit of US$17bn. Oliveros says that a forecast by *The Economist* that Venezuelan GDP will drop by 4.2% this year is “conservative”. No official inflation data has been published since February, when the central bank reported inflation of 68.5% in 2014.

The view of Western multilateral financial institutions, many shunned by the Left-wing ‘Bolivarian’ government of President Nicolás Maduro, is also sombre. In its April World Economic Outlook, the IMF said that it expected the Venezuelan economy to contract by 7% in 2015, due to the collapse in oil prices, policy distortions and government controls that had intensified shortages of basic goods and driven inflation to over 60%. In July the IMF updated that view, putting potential inflation at 100% in 2015 and warning that the government's macroeconomic policies were unsustainable.

> “Francisco Toro...compared the Venezuelan economy to a patient being brought into the emergency ward suffering from hypertension, diabetes, drug addiction and HIV. The challenge for the doctor is to come up with a list of treatment priorities. But first, he must focus on another more urgent issue: the two gaping gunshot wounds in the patient's chest.”

One very graphic attempt to animate Venezuela's economic dynamic has come from Francisco Toro, another blogger. Criticising a recent speech on the economy by opposition leader Henrique Capriles as “disjointed”, Toro attempted his own diagnosis. He compared the Venezuelan economy to a patient being brought into the emergency ward suffering from hypertension, diabetes, drug addiction and HIV. The challenge for the doctor is to come up with a list of treatment priorities. But first, he must focus on another more urgent issue: the two gaping gunshot wounds in the patient's chest. Toro describes these two wounds in economic terms as the multiple exchange rate system and the country's massive energy subsidies. The

exchange rate system prices the US dollar at between VEB6.30 (the main official fixed rate) and VEB200-plus (the official Simadi free market rate). As Toro explains it, the government refuses to sell scarce dollars on the free market at a high price, but insists on selling them to state companies and others at the lowest price. The mechanism encourages corruption. A business selling its most valuable commodity exclusively to customers who will only pay the lowest price would quickly go bankrupt, but the government keeps things going by constantly printing more money through the central bank, fuelling inflation.

The second bullet hole is described as massive petrol and electricity subsidies, which lead to an equally massive misallocation of resources, also funded by printing money. Toro criticised Capriles for not talking of the need to eliminate these subsidies – in his view a necessary but politically unpopular measure. After these two "life threatening" gunshot wounds, Toro says the other afflictions lower down the treatment priority list include the fiscal deficit, expropriations of private companies, price controls, labour legislation that discourages productivity, a collapsed welfare system, and long term dependence on oil exports.

The (illegal) 'parallel' (or black market) exchange rate continues to soar, trading at VEB683.3/US$ on 27 July, according to Miami-based websites that publish it daily based on trade at the Venezuela-Colombia border. The Maduro government says this published rate is "a lie" and part of the 'economic war' being waged against the country by international opponents of the Bolivarian Revolution.

Whatever the diagnosis, the absence of hard data makes it difficult to forecast what will happen over the rest of 2015, in the period running up to congressional elections in early December. Analysts do not exclude some kind of a crunch point, such as a collapse into hyperinflation or a debt default or some combination of both; on the other hand Venezuela has shown a perhaps surprising degree of resilience. Steve Hanke of Johns Hopkins University has calculated the latest price increases as representing an annual 772% cost of living growth rate. "They're very close to hyperinflation" he says. Regis Chatellier of Societé Generale says "It's a collapsing economy with a massive shortage of dollars and these guys are printing as much money as they can to survive… The risk of a default is increasing substantially". The pricing of Venezuela-linked derivatives in mid-July put the probability of a default within one year at 63%, up from 33% two months earlier.

Consultancy Capital Economics says that the Caracas government has taken some steps to try and stabilise the situation. In a recent report it notes a recent US$5bn loan from China "should help the economy to muddle through the next couple of months". It too believes inflation is now in triple digits, and states that in a two-month period (May and June) the black market Bolívar plunged by 40% against the US dollars, while foreign currency reserves dropped by US$2bn. In June Venezuela withdrew US$1.5bn from its SDR deposits with the IMF, to use the money to boost its foreign currency reserves. According to the Banco Central de Venezuela (BCV) reserves dropped from US$22bn at the beginning of this year to US$16bn in June.

CHILE

Central bank on hold … for now

The central bank kept its key policy rate unchanged at 3.00% at its meeting in mid-July. It will have scope to ease further in coming months if actual and expected inflation slips.

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The general softness in the global economy, and minerals prices in particular, has had a parlous impact on Chile. On 6 July, Finance Minister Rodrigo Valdés announced that the government had cut its forecast for real annual GDP growth this year to 2.5%, down from 3.6% previously. Annual growth in 2014 was just 1.9%.

The Banco Central de Chile's monetary policy board was similarly downbeat eight days later when it released a statement following a regular monetary policy meeting. "Output and demand have been weaker than assumed in the Monetary Policy Report's baseline scenario, and private growth expectations have dropped for this and next year. Confidence indicators have not recovered. In the labour market, job creation remains [curtailed] and nominal wages have decelerated", it noted. The central bank's monthly index of economic activity (IMACEC), was unchanged (in seasonally-adjusted terms) in May and rose by just 1.3% over the previous 12 months. Growth in services was just enough to offset a contraction in activity in the manufacturing, mining and wholesale trading sectors.

> "Developments – and official commentary – since the central bank's policy meeting in mid-June indicate that the economy is decelerating, not accelerating. Moreover, the main constraints on a further easing in policy are likely to disappear."

The key policy interest rate was reduced to its current 3.00% in October 2014. At the June 11 meeting, the Board had suggested that the general weakness of the economy would require the maintenance of easy monetary policy settings at least until the end of 2015.

However, "the option of further cuts to the rate had to be overruled again, in a context where inflation had been in the upper boundary or above the tolerance range for over a year; and where it was believed that it did not seem wise to heighten the already significant monetary impulse. This, especially considering that, as confidence grew, the economy should also grow more strongly towards the end of this year". The central bank runs monetary policy in order to maintain projected inflation at 3% over the policy horizon.

Consumer price inflation in Chile was 4.4% over the year to June. In the month of June alone, inflation was 0.48%, above than the consensus (of 0.3%). The rise was due to higher prices in three areas. Increased transport costs contributed 19 basis points to the rise in consumer prices in June. Higher accommodation and basic services costs added another 14 basis points; and increased power tariffs, nine basis points.

Analysts at Spanish bank BBVA argue that these factors are largely 'one timers', which will not be repeated in July. Transport costs, in particular, were driven up by the weakness of the Chilean peso (which has slipped from CLP600US$ in mid-May to CLP660/US$ in mid July), and by increased transport demand on the part of tourists in the country for the Copa América regional soccer tournament. BBVA is looking for consumer price inflation of 0.1%-0.2% (or less than consensus) in the month of July.

BBVA argues that the likely reduction in inflationary pressures in the coming months will enable the central bank to cut rates further prior to the end of 2015. We agree. Developments – and official commentary – since the central bank's policy meeting in mid-June indicate that the economy is decelerating, not accelerating. Moreover, the main constraints on a further easing in policy are likely to disappear.

Gourde and growth down; inflation and interest rates up

The weakness in the currency, and higher food prices, contributed to a surge in annual inflation in Haiti to 8.0% in June, from 6.6% in May. In spite of a stabilisation of industrial production and commercial activity in the second quarter, the central bank believes that overall real annual GDP growth could be below the 2.5% anticipated in the government's budget for the September 2015 fiscal year.

The Banque de la République d'Haïti (BRH, the central bank) has allowed the gourde to depreciate from US$1:HTG46 to nearly US$1:HTG57 since late June. The BRH had previously held the currency broadly constant since November 2014.

In a speech on 17 July 2015, BRH Governor Charles Castel identified a number of factors that had influenced the various players in the currency market. One [1] is the continuing deterioration in the current account. Although exports of goods and services rose by around 60% between 2009 and 2014, imports have consistently been larger, and have grown by more, increasing from just over US$2.8bn to a little under US$4.6bn in the same period. Thanks to slippage in the international price of oil, fuel imports in the eight months to the end of May this year were US$451m, down by nearly a third relative to the previous corresponding period. But the drop in the cost of oil imports, while good news, is not sufficient to make much difference to the overall balance of trade. Official aid transfers soared in 2010 as a result of the earthquake on 12 January that year. However, they have since been trending downwards. Thanks to the general growth of the US economy, remittances from Haitians living and working in that country have grown, but again not by enough to offset the fall in transfers.

"In the recent past, purchases of the Haitian currency by international organisations operating in the country have fallen – from US$113m in the nine months to the end of June 2014 to US$71m in the nine months to the end of June 2015."

In the recent past, purchases of the Haitian currency by international organisations operating in the country have fallen – from US$113m in the nine months to the end of June 2014 to US$71m in the nine months to the end of June 2015. This is substantially the result of the winding down of the UN MINUSTAH mission. Further, liquidity within Haiti's banking system has been boosted by seasonal falls in government revenues and increases in spending. An additional factor influencing the currency market has been heightened risk perceptions, in advance of the elections due to take place on 9 August.

All this is in the context of a very weak structural/ institutional environment. According to the budget, the economy was expected to grow in real terms by around 2.5% in the current fiscal year. This represents a deceleration relative to growth in the September 2013 (4.2%) and September 2014 (2.7%) Fiscal Years and relative to the average over the three years to September 2014 (3.9%). The slow growth is in spite of investment having amounted to 35%-38% of GDP each year since the end of 2006. By way of contrast, the corresponding figures for the Dominican Republic and the UN's list of 48 Least Developed Countries (LDCs) have been 16%-17% and 23-25%. As Castel notes, the near stagnation in Haiti's economy has been due signifi-

cantly to the poor quality of public spending. Further, the weakness of Haiti's tax administration, and the large percentage of people working informally, has meant that tax revenues have fallen from 12.9% of GDP in the September 2011 Fiscal Year to 11.9% in the year to September 2014. In the Dominican Republic, by contrast, the corresponding figures have risen from 12.6% to 15.0%. In Jamaica, the rise has been even greater, from 22.2% to 25.9%.

The weakness of the currency has contributed to a sharp uptick in inflation. Consumer prices rose by 1.9% month-on-month and 8.0% year-on-year in June. In May, the corresponding figures were 0.8% and 6.6%. The increase in annual inflation, of 134 basis points, was the strongest recorded since February 2011. In part because of the drought, there has been a fairly pronounced rise in food prices, which increased by 2.3% in June and by 8.1% over the preceding year. Clothing and footwear prices grew by 2.8% and 14.3%. These two categories account for about 57% of the basket of goods and services on which Haiti's consumer price index is based.

The BRH has been actively removing liquidity and supporting the currency. Over recent months, it has increased the reserve requirement ratio (RRR, the percentage of deposits with commercial banks that must be deposited with the central bank) from 40% to 48% for US$ deposits and from 38% to 44% for gourde deposits. (As of the end of April this year, US$ deposits accounted for about 57% of the total). The RRR that is applied to deposits of public sector entities is 100%. The BRH has also reduced liquidity by sales of US dollars to buy gourdes and through the sale of bonds. Collectively, these measures have taken HTG12bn out of the banking system since the beginning of October last year. The central bank has also imposed a ban on new US dollar lending, with effect from the beginning of July, and has sharply increased official interest rates. The BRH's seven, 28 and 91-day rates now stand at 10%, 12% and 16%, having been 3%, 4% and 5% at the end of September 2014.

According to Castel, the BRH will continue to remove liquidity from the system if necessary. The gross foreign exchange reserves available to the central bank amount to US$1.8bn, which is equivalent to around five months of imports. Net reserves amount to around US$860m (the main reason for the difference is Haiti's allocation of special drawing rights (SDRs) with the International Monetary Fund (IMF): these are regarded by the IMF as both an asset and a liability. Gross reserves were just over US$1.9bn at the end of September 2014.

In its early July monetary policy report, the BRH noted that economic growth in the current Fiscal Year could come in below the 2.5% anticipated in the government's annual 2015 budget. This outcome is the result of the drought and the lack of business confidence in the run-up to the elections in August. Mainly because of lower output of food and textiles/ clothing/ footwear, the index of industrial production compiled by the Institut Haïtien de Statistique et d'Informatique (IHS, the national statistics agency) was down 7.5% year on year in the second quarter. More recently though, there are indications that industrial production and commercial activity have stabilised.

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Looking forward, the prospects for Haiti's economy appear unexciting. The weakness of the currency will likely pressure inflation upwards for some time to come. The economy is growing, but not rapidly enough to have an

“Port Lafito was officially opened on 2 July 2015. Located 20km north of Port au Prince, it is the country’s first modern international port and terminal, with capacity to accommodate Panamax-sized ships. It currently occupies 400 hectares of oceanfront land, although this will be extended to 900 hectares in due course.”

impact on entrenched poverty. It is difficult to envisage a significant improvement in the overall business environment. Positive wildcards include: a possible further substantial fall in the international price of oil; higher-than-expected remittances from Haitians working in the US, thanks to the general strength of that economy; and growth in employment, trade and investment thanks to the opening of Port Lafito.

The opening of Port Lafito

Port Lafito was officially opened on 2 July 2015. Located 20km north of Port au Prince, it is the country’s first modern international port and terminal, with capacity to accommodate Panamax-sized ships. It currently occupies 400 hectares of oceanfront land, although this will be extended to 900 hectares in due course. Port Lafito was developed by a local conglomerate, GB Group. The port development was funded by private sector and international development banks including the State Commercial Bank – Banque Nationale de Crédit SA, The Industrial Development Fund, The International Finance Corporation (IFC – the private sector arm of the World Bank), the Nederlandse Maatschappij voor Financierings-Ontwikkelingslanden NV (FMO – the Dutch development bank) and National Insurance SA. Total investment in the port prior to the end of 2015 will amount to US$145m.

The operation of the port (and the associated ferry terminal) will be managed by SSA Marine, the largest independent private operator of passenger terminals in the world. The port is equipped with two Liebherr LHM 420 mobile cranes, the first of their kind in the Caribbean. Port Lafito can handle containerised and loose-bulk cargo. An agreement has been reached with PortMiami to exchange information and ideas about the promotion of trade and freight between the two ports. Agreements have also been reached with Evergreen Marine and King Ocean Services to include Port Lafito as a port of call.

According to GB Group, Port Lafito is a key element in the development of Lafito Global, an economic zone that will also include an industrial free zone, a business park and a residential precinct. The company thinks that the overall project will generate 25,000 new jobs by 2020.

Haiti's current account (US$mn), 2009-2014

	2009	2010	2011	2012	2013	2014
Exports of goods and services	1,034	1,016	1,312	1,324	1,567	1,655
Imports of goods and services	2,804	4,287	4,433	4,195	4,419	4,559
Balance of trade	-1,770	-3,271	-3,121	-2,871	-2,852	-2,904
Inwards transfers:						
Official aid	395	1,840	1,446	988	750	563
Remittances	1,376	1,473	1,551	1,612	1,781	1,977
Total transfers	1,771	3,313	2,997	2,600	2,531	2,540
Outwards transfers	-135	-167	-240	-232	-248	-249
Other items	12	22	38	55	32	12
Current account balance	-122	-102	-327	-449	-537	-600
As percentage of GDP	-3.45	-1.54	-4.35	-5.69	-6.36	-6.89

Source: *BRH*

Debt negotiations get under way

On 29 June 2015, the governor of Puerto Rico, Alejandro García Padilla, announced the formation of a Working Group that will seek a final and sustainable solution to the territory's well-publicised financial problems by the end of August. Discussions between the government and bondholders of in coming weeks will focus on four issues: government revenues, government expenses, structural reforms and a major debt restructuring. Among much else, the government will be seeking changes to the US Bankruptcy Code that will allow it to seek Chapter 9 protection – like municipalities in the US.

Towards the end of June 2015, Governor García Padilla openly recognised that the government of Puerto Rico, and its various agencies, will not be able to repay its outstanding debt. The debt amounts to around US$72bn, or roughly 100% of GDP: one third of the total corresponds to borrowings by public corporations such as the Puerto Rico Electric Power Authority (PREPA). In a state address on 29 June, the governor discussed how a lasting solution to the well-documented economic and financial problems of Puerto Rico might be achieved.

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Part of that solution, in the governor's view, should be provided by lawmakers in Washington DC. "Puerto Rico today is in a situation which is no different to that of New York City and Detroit some years ago. The success of New York City and Detroit came from an alignment of wills. All sectors – the unions, the governments, the banks, the bondholders and the men and women in the street – shared in the sacrifices, and now they share in the prosperity. The alternative – which is unacceptable in Puerto Rico – is that we continue to share in the crisis."

The governor also announced the formation of a 'Working Group for the Economic Recovery of Puerto Rico', which is charged with reporting to the government by the end of August. The Working Group comprises the governor's chief of staff, Victor Suárez Meléndez, the treasury secretary (and president of the Government Development Bank of Puerto Rico [GDB]), Melba Acosta Febo, the justice secretary, César Miranda Rodríguez, the senate president, Eduardo Bhatia Gautier, and the speaker of the house of representatives, Jaime Perelló Borrás. Separately, the GDB's chairman, David H. Chafey Jr., announced his resignation, just six months into a two-year term, and Governor García Padilla announced the appointment of three new directors to that institution. The new directors replace three others, whose terms had been due to expire in September this year.

The government and the Working Group have sought help from external advisers. Citigroup will act as the lead broker-dealer in relation to potential liability management transactions. Millstein & Co. will act as restructuring adviser. Cleary Gottlieb Steen & Hamilton LLP will act as legal counsel. On 6 July, the GDP appointed Public Financial Management Inc. (PFM) as Independent Registered Municipal Adviser. PFM has a wide-ranging mandate, which is valid to the end of June 2016, to advise the GDB on capital financing transactions.

The Working Group's mission includes several objectives:

- Design of a plan that will ensure the balancing of government-wide budgets over the next five years;

- Making of additional proposals to diversify Puerto Rico's economy and to improve competitiveness;

- Promotion of private-public partnerships that build on the success of the Teodoro Moscoso bridge, the Luis Muñoz Marín international airport and Highway PR-22;

- Promotion of fiscal and economic reforms that promote economic development (including changes to labour and welfare laws);

- Tax reforms, including changes to Puerto Rico's corporate and property tax regimes, and;

- Implementation of additional expenditure cuts.

The Working Group's plan will also seek to ensure that "the aggregate debt burden of the Commonwealth is adjusted so it can be repaid on sustainable terms while ensuring pension obligations are honoured over the long term and essential services for the people of Puerto Rico are maintained". Finally, the Working Group is charged with creating an apolitical Fiscal Oversight Board, which will guarantee the government's meeting of its commitments through the adjustment process.

"The Working Group is charged with creating an apolitical Fiscal Oversight Board, which will guarantee the government's meeting of its commitments through the adjustment process."

A clear indication of what the Working Group's plan will include was provided in a presentation in New York City on 13 July of a report by Dr Anne Krueger, a former First Deputy Managing Director of the International Monetary Fund (IMF), Dr Ranjit Teja, a Deputy Director with the IMF, and American University Professor Andrew Wolfe.[7] The overall challenge is to extract Puerto Rico from a vicious cycle of debt and stagnation (*see below*).

The report argues that a reduction of the fiscal deficit must go hand in hand with the removal of structural obstacles to growth. Reduction of the fiscal deficit involves both changes to revenues and expenses. The authors believe that, if accompanied by structural reforms, their proposed measures could produce fiscal balance for Puerto Rico by 2020. In relation to revenues, the authors suggest: a revamping of property taxes, which are based on 1954 valuations, an end to tax amnesties and exemptions and higher sales tax.

In relation to expenses, the authors think that there is scope for the government to cut outgoings by up to US$2bn annually by Fiscal Year (FY) June 2020, with further savings by FY June 2025 year. Freezing spending in real terms and renewing the Government Fiscal & Operational Sustainability Act (No. 66 of 2014) alone would save an estimated US$1bn annually. However, there is a possibility that the Act, which enables the government to change contracts and to restrict legal judgements against it, will be challenged in US courts as being unconstitutional. The authors also argue for a reduction in the teacher-student ratio in Puerto Rico's schools and a saving of around US$500m annually from a reduction of the subsidy to the University of Puerto Rico. A reduction in Medicaid benefits could also save an estimated US$150m each year.

[7] Krueger, Anne O., Teja, Ranjit and Wolfe, Andrew, Puerto Rico – A Way Forward, June 2015.

Structural reform includes changes on many fronts. In particular, the report suggests that the government should try to reduce disincentives to the hiring of workers by securing a relaxation in the Federal minimum wage. It should also seek a downwards revision to federal welfare payments – which are more generous relative to the (low) incomes in Puerto Rico than they are in the rest of the US. A Federal law which places Puerto Rico at a disadvantage relative to other island nations in the Caribbean is the Jones Act (the Merchant Marine Act of 1920, as amended), which requires that all seaborne trade with the territory be carried out by US flagged and crewed vessels. The government could also seek an exemption from this. Finally, it could cut red tape, widely considered as challenging for businesses operating locally.

Crucially, Krueger, Teja and Wolfe argue for debt relief for the Puerto Rican government and its agencies. This could involve an extension of debt maturities and/or lower interest payments. "To achieve this, bondholders would need to be convinced that relief would support reforms that would result in a larger return than continuing on the present path," they note. They also note that discussions would need to be coordinated with holders of the government's General Obligations and holders of government agencies' bonds.

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Like the governor, the authors note that it would be helpful if Puerto Rico were covered by Chapter 9 of the US Bankruptcy Code, which covers municipal governments. This would require a change to the law by the US Congress. Whether or not such a change would be supported by powerful stakeholders remains to be seen. To the extent that creditors have greater protection under the Bankruptcy Code than they do in the current, rather uncertain situation, they should support the extension of Chapter 9 to the government of Puerto Rico and its agencies. In early July 2015, legal action by Franklin Templeton Investments, OppenheimerFunds and Blue Mountain Capital Management – which collectively own around US$2bn in bonds issued by PREPA,[8] resulted in a ruling that Puerto Rico's own Recovery Act was unconstitutional. The Recovery Act had been passed in 2014 in order to facilitate restructuring by financially distressed municipalities in the territory. The three investment firms had been concerned that they would be disadvantaged if they ever had to engage in debt restructuring negotiations with PREPA. Under Chapter 9, they would have been in a stronger position.

Over the coming weeks, it is likely that all parties – the government and its agencies, Federal politicians and the bondholders – will raise additional proposals and counter-proposals. ***At this stage, it seems reasonable to expect that legislative change in Washington DC will extend Chapter 9 to the government of Puerto Rico and its agencies.*** This would strengthen the positions of the creditor and would make it easier for the Working Group to execute a plan along the lines proposed by Krueger, Teja and Wolfe. It would also reduce the risk of a disruptive default, an exacerbation of the vicious cycle; and a further wave of emigration from Puerto Rico to mainland US.

The vicious cycle of debt and stagnation

The recent report published by Krueger, Teja and Wolfe explains how Puerto Rico has long been in a vicious cycle of mounting debt and economic stagnation.

The Commonwealth of Puerto Rico is an unincorporated territory of the US. Its people are U.S. citizens, and have the right to live and work in the rest of

[8] Blue Mountain Capital Management LLC v García Padilla *et al.*, case 3:14-cv-01569 and Franklin California Tax-Free Trust *et al*. v Commonwealth of Puerto Rico et al., case 3:14-cv-01518. Both cases were heard in the U.S. District Court for the District of Puerto Rico.

the country. However, they are not liable to pay US federal taxes unless they work for the federal government. Income from bonds issued by the government of Puerto Rico, the GDB (its fiscal agent) or its agencies are not subject to federal or Puerto Rican income taxes. They have therefore long appealed to investors in the estimated US$3.7trn US municipal bond market .

In recent years, the mounting financial problems in Puerto Rico have been reflected in mounting yields on the bonds. Yields on the benchmark government General Obligations (GO) and the power utility PREPA stood at about 5% in mid-2013. At that time, yields on bonds of the GDB were around 6%. By April this year, the yields on the GOs were about 10%, while the yields on PREPA and GDB bonds stood at about 14% and 15% respectively. The major ratings agencies downgraded the government of Puerto Rico to below Investment Grade in early 2014.

As the report notes, it is very unusual for any government to establish fiscal sustainability when economic growth is low. This is because low growth restricts revenues and increased debt ratios. Puerto Rico's economy has actually been contracting for nearly a decade, which, as the authors note, 'is remarkable for an economy suffering neither civil strife nor overt financial crisis.'

The fall in activity has been due to both structural and cyclical problems. Falling house prices have been a major reason for a drop in investment of 10 percentage points of GDP over the decade to June 2014. The deterioration of the economy and the local housing market has been accentuated by the problems in the banking sector, and vice versa. Bank assets have been reduced by around one third since 2005. The doubling of the oil price over the seven years to 2012 represented a sharp deterioration in the terms of trade given that the territory is dependent on imports for almost all power generation.

The failure of Puerto Rico's economy to participate in the solid recovery of the US economy since 2010 suggests that the territory suffers from a serious competitiveness problem. The World Economic Forum's *Global Competitiveness Report for 2014-15* rates Puerto Rico as being the 32nd most competitive economy, out of 144. This is a respectable outcome by the standards of Latin America and the Caribbean (with Chile in 33rd position) but a challenge given that the rest of the US is in third position. The businesses surveyed by the World Economic Forum reported that inefficient government bureaucracy; restrictive labour regulations, tax regulations and tax rates are the biggest difficulties that they face in Puerto Rico.

Other data validates these concerns. Krueger, Teja and Wolfe note that only 40% of adults in Puerto Rico are in the workforce (versus 63% in the US). This is partly because the Federal minimum wage is high (77% of per capita income versus 28% in the US) and applies to a greater number of workers (28% of hourly workers versus 3%). It is also because the local regulations that govern overtime, paid vacations and dismissal are more onerous than they are in the US.

In addition, generosity of the welfare system is a disincentive to find work. According to one estimate cited by the authors, a family of three who are eligible for food stamps, Aid to Families with Dependent Children, Medicaid and utilities subsidies could receive US$1,743 per month: a worker on the minimum wage would take home monthly pay of US$1,149.

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The combination of diminished opportunities at home and freedom of movement to the rest of the US have contributed to large-scale emigration. The total population of Puerto Rico fell for the first time in 2006, and has since dropped from over 3.8m to around 3.5m now.

Other challenges include expensive energy costs, because of the inefficiency of PREPA and high transportation costs. Again, the transport costs are due partly to the aforementioned Jones Act.

These problems are reflected in the industrial structure of Puerto Rico. The relatively high cost of unskilled labour has constrained the development of tourism – a sector where the territory should have a competitive advantage – the number of hotel beds is about the same as in the 1970s. High transport costs have forced players in the manufacturing sector to focus on high-value and capital-intensive areas such as software and pharmaceuticals.

“It is reasonable to ask whether the crisis in Greece offers pointers for the situation in Puerto Rico. In both cases, the governments of relatively small entities of very large (and rich) polities have found themselves in financial problems as a result of structural and cyclical problems. In neither case do the governments have control of monetary policy.”

The weakness of the economy has hit the government’s revenues, even as it has offered tax breaks to attract businesses to Puerto Rico. Krueger, Teja and Wolfe note that tax revenues have fallen from 15% of GNP prior to 2006 to around 12% now. Revenue projections have tended to be optimistic, while the Office of Budget Management has had little power to enforce spending cuts.

Persistent deficits have caused public sector debt to rise from 62.2% of GNP in the (June) 2000 fiscal year to 71.2% in the 2005 fiscal year to 90.9% in the 2010 fiscal year to just over 100% now. In the meantime, deficits are also being posted by PREPA, the Puerto Rico Aqueduct and Sewer Authority (PRASA), the Highway & Transportation Authority (HTA), as well as the pension schemes for government workers (ERS) and teachers and judicial workers (TRS). The combined deficits were around 5% of GNP in the fiscal year to June 2014.

In addition, the authors highlight a long history of non-transparency and statistics that are dated or otherwise unreliable.

Why Puerto Rico is not Greece

It is reasonable to ask whether the crisis in Greece offers pointers for the situation in Puerto Rico. In both cases, the governments of relatively small entities of very large (and rich) polities have found themselves in financial problems as a result of structural and cyclical problems. In neither case do the governments have control of monetary policy.

However, the differences matter more. Greece’s government debt is a lot larger in absolute terms and relative to GDP than that of the government of Puerto Rico (and its agencies). Greece’s population was growing until 2009 (when it reached 11.19m, according to the IMF) and has since been falling (to 10.98m in 2015). The implication is that net emigration from Greece has been evolving a lot more slowly than the movement of people out of Puerto Rico.

The original (2010) bailout of Greece’s government was undertaken to prevent contagion in the bond markets of the ‘peripheral’ Eurozone countries. The latest negotiations are between (predominantly) government/supra-national creditors and the government. Dealings have raised questions over the rights of a sovereign government that used to preside over its own currency. Some parties have advocated heterodox solutions to Greece’s problems.

By contrast, Puerto Rican debt is held overwhelmingly by private sector investors within the US municipal bond market. Discussions are currently

focused on the extension of Chapter 9 of the US Bankruptcy Code to include the government of Puerto Rico and its agencies: this would facilitate an orderly restructuring of the debt. Puerto Rico is not a sovereign nation and its government has never presided over its own currency. There are no questions of heterodox solutions to Puerto Rico's problems: indeed, the identities of authors of the report that has been commissioned by the government mean that the Working Group is effectively following an IMF program.

COLOMBIA

Austerity on the cards, Cárdenas warns

After a decade of strong government spending, Colombia faces several years of tight budgets.

On 14 July the National Council for Economic and Social Policy (Conpes) approved the finance ministry's budget proposal for 2016. Although total expenditure is set to increase by 2.3% to US$60.5bn, there will be major cuts to investment projects, especially in the areas of mining, agriculture and housing. At a press conference, Finance Minister Mauricio Cárdenas announced that the budget represented a "policy of austerity."

With global oil prices remaining depressed, the government forecasts just US$1.2bn in oil revenues in 2016, down from US$8.5bn in 2013. The imminent entry of 1.0m barrels of Iranian oil onto the global market, following the end of international sanctions, has dampened optimism for a bounce in crude prices. Cárdenas and his team have been forced to make tough decisions.

Given the ongoing peace process (and continued military confrontations) with the Fuerzas Armadas Revolucionarias de Colombia (Farc), it is no surprise that the defence and justice ministries have escaped the cuts. However, overall government investment is set to fall by 11% to US$15bn. The agriculture ministry will see its budget slashed from US$1.2bn to just US$508m. Other ministries amongst the hardest hit are mining and energy (a 30% reduction), housing (20%), transport (21%) and environment (18%).

None of these cuts can be easily absorbed. Agrarian reform is a key component of the peace process and will require significant investment in a post-conflict Colombia. The upgrading of the country's road infrastructure is crucial to boosting the competitiveness of the country's agricultural and industrial sectors, and financing for major projects is already in jeopardy as legal challenges have stalled the sale of the state energy firm Isagen, the profits from which were earmarked for so-called fourth generation projects, including road infrastructure (*see below*). Likewise, the natural resources sector requires major investment to resolve the institutional and operational bottlenecks that likewise have frozen the development of new projects.

Cárdenas has pinned his hopes on an improving trade balance, with the weaker peso discouraging imports and increasing demand for local products (albeit this has yet to happen – *see below*). Importantly, the tax agency (DIAN) has seen its budget increased by US$1.5bn to ease the implementation of new tax reforms and crack down on evasion. The conservative opposition Partido Centro Democrático (PDC), the party of former president Alvaro Uribe (2002-2010), was quick to attack the cuts, accusing the government of relying too heavily on commodity prices and failing to put aside sufficient funds during the boom period to cope with the inevitable "rainy day".

Colombia-Japan EPA

On 14 July Colombian and Japanese representatives met in Bogotá to initiate the XII round of negotiations for the Japan-Colombia Economic Partnership Agreement (EPA). Colombia's trade minister, Cecilia Álvarez-Correa, highlighted the importance of negotiating a trade agreement with the world's third largest economy and biggest food importer. According to trade ministry data, bilateral trade in goods between Colombia and Japan amounted to US$1.86bn last year. According to Álvarez-Correa, once a bilateral EPA deal is reached, exports of agricultural and industrial goods, as well as services, will be diversified. In last year's round of negotiations, which took place in Tokyo in May, progress was made in areas such as trade in goods, government procurement and rules of origin.

While this may be true, Colombia's fiscal laws have prevented major over-spending based on inflated price expectations. The same cannot be said of the rest of the continent. While the IMF forecasts real annual GDP growth of 3% for Colombia in 2016, the rest of the region is set to grow at an average rate of just 0.9%. Austerity may prove painful for Colombians, who have grown used to bullish growth, but the finance ministry argues that early implementation of conservative fiscal measures will allow the economy to set the bases for more sustainable medium term growth.

A fall in government revenues has given momentum to a future tax code reform

Twelve months ago, while other emerging markets succumbed to negative economic headwinds, Colombia appeared to be a dazzling exception to the rule. First quarter real GDP growth was 6.5% year on year, second only to China in the world's major economies. However, growth slowed to just 2.8% for the corresponding period of 2015 (*see box*). The fall in oil revenues and the failure of export industries to take advantage of the weaker Peso have underlined once more just how dependent the country is on commodities. Cardenas has a number of options open to balance the books, but none are appealing.

FDI plummets

On 14 July the central bank (Banrep) released figures showing that FDI in Colombia was US$166m in June, compared to US$$2.98bn in June 2014. This fall is primarily explained by a decrease in investment in the oil & mining sector. While there was a 13.4% increase in foreign investment in other sectors to reach US$261.6m, investment in the oil & mining sector fell by 40.1% year-on-year to US$746m.

The principle cause of the treasury's current woes is price of oil, which dropped from over US$100 a barrel (/b) in mid 2014 to under US$50/b for much of the first quarter of 2015. According to central bank data, petroleum exports brought in just US$3.9bn between January and March this year, compared to US$7.9bn in the corresponding period last year, an annualised drop of 50.6%. Coffee and coal exports both increased during the period, but industrial exports shrunk by 8% to US$2.3bn. This last figure is particularly worrying given that the weakening Peso, which has fallen from COP1,900/US$ COP to roughly COP2,855/US$ in late July, was expected to make Colombian exports more competitive.

With first quarter imports remaining steady at around US$14bn, Colombia's terms of trade are worsening and Fedesarrollo, one of the country’s leading think tanks, forecasts a trade deficit of US$13bn for the year, around 4.1% of GDP. The bearish performance of the oil and mining sector over the last two years also has slowed investment in these key sectors. Between 2013 and 2014, foreign direct investment (FDI) in Colombia, most of which is destined for the natural resource sector, fell by 41%. Meanwhile, this year’s current account deficit is expected to expand to 6.5% of GDP.

The timing of the slowdown could scarcely be worse as the government struggles to find funding for the post-conflict era, including infrastructure development an social policies aimed at easing the transition to peace in the countryside. The Organisation for Economic Cooperation and Development (OECD) forecasts that post-conflict social policies will cost 1% of GDP between 2015 and 2018. Meanwhile, as mentioned above, the government had planned to raise the US$2.2bn required for its participation in the private public partnership for road construction through the sale of Isagen. However, three separate lawsuits blocking the sale have led to uncertainty about the future of the deal.

Minister Cardenas has tried to soothe doubts over the economy by comparing Colombia's situation with the rest of the continent, where the fall in commodity prices has had a similar effect. Compared with many of its neighbours, Colombia has low debt, a strong fiscal position (thanks to a law that prohibits fiscal deficits of over 2.2%) and a competitive exchange rate. Since the end of March, the oil price has recovered to around US$60/b and there is reason to believe that a lag-time in orders and payments was respon-

sible for poor industrial exports in the first quarter; and that they will benefit from the weaker Peso moving forward.

Nevertheless, the gaping hole left by the sharp and sudden drop in oil income has spurred the government into preparing what looks to be the largest root-and-branch tax reform in decades. The tax code has been changed twelve times since 1990, most recently in December 2014, when Law 1607 created a wealth tax and upped corporate tax. That reform is forecast to bring in an additional US$20bn in fiscal revenue in the coming four years, but it is not enough.

In February, the government recruited a team of nine professionals, from diverse backgrounds, who will be responsible for drafting a new tax code. Conveniently, the team has ten months to prepare, meaning that its final proposal will be unveiled after local elections in late 2015. The IMF and the OECD have both dipped their oar in with suggestions. In a June report, the IMF said a reform should have the objectives of "simplifying the tax structure, increasing progressivity, broadening the tax base and improving tax administration". The OECD, of which Colombia is a candidate country, suggests increasing the rate of Value Added Tax. At present, Colombia charges VAT at 16%, compared to an OECD average of 19.1%. An increase of 1% could bring in an additional US$2bn per year, according to the OECD.

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An increase in VAT appears to be the most viable and probable reform option on the table. The OECD's other suggestions: clamping down on evasion (estimated at US$20bn annually) and closing loopholes for so called non-profit organisations will be much tougher to implement and will require an overhaul of Colombia's tax agency, the DIAN. A simplified tax code and more use of technology would be a good start.

First quarter growth

The first quarter GDP result of 2.8% was a 3.7-percentage-point decrease over the 6.5% growth registered in the first quarter of 2014. According to Dane, seven economic sectors registered growth in the first quarter, of which five posted growth above the headline figure of 2.8%. Among these were construction (4.9%) and financial & real estate (4.4%). But manufacturing fell by 2.1% and mining by 0.1%. Despite the weak result, Cárdenas revised up his forecast for the year to 3.6%, arguing that activity will pick up in the second half. Cárdenas pointed out that Colombia's 2015 first quarter result was still higher than that of the region's largest economies, with Brazil posting growth of 1.6%, Peru 1.7% and Chile 2.5%. He suggested that Colombia could close 2015 with the second fastest growth of the region's largest economies, behind Peru (4.3%) and followed after by Chile (2.9%) and Mexico (2.8%), with contractions expected in Argentina (0.6%) and Brazil (-1.1%).

Not everyone is optimistic about Colombia's economic prospects this year. In its latest economic outlook, released on 3 June, the OECD cut its GDP growth forecast for Colombia from 4.4% to 3.3%. The OECD said it expected Colombia's growth to diminish this year as a result of "the gradual readjustment of investment and exports, due to weaker commodity prices in 2015".

LATIN AMERICAN ECONOMY & BUSINESS is published monthly (12 issues a year) by **Latin American Newsletters**, Intelligence Research Ltd., Hamilton House, Fourth Floor, Mabledon Place, Bloomsbury, London, WC1H 9BB, Tel: +44 (0)203 695 2790 Email: subs@latinnews.com or visit our website at: **http://www.latinnews.com**. Subscription rates will be sent on request. Overseas subscription sent by airmail. **EDITOR: EILEEN GAVIN**. **CONTRIBUTORS: ANDREW THOMPSON, ANDREW HUTCHINGS.** Printed by Quorum Print Services Limited, Units 3&4, Lansdown Industrial Estate, Gloucester Road, Cheltenham, Glos. GL51 8P.
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REFERENCES: Back references and cross-references in the current series will be made thus: EB-15-01 will indicate Economy & Business Report, 2015, issue 1.