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CONTENTS

REGIONAL BUSINESS REVIEW

Mexico 4
Trouble at the top of the narco-business?

Mexico 6
Day of reckoning for Slim and Azcárraga?

Region 8
Coca-Cola Femsa upbeat despite profits squeeze

Colombia 8
Pacific Rubiales looks at Panama

Region 10
Balance of trade deteriorates

Region 11
Reductions in income inequality stopped in 2010

REGIONAL ECONOMIC REVIEW

Argentina 12
Another step towards orthodoxy?

Bolivia 14
The economy and the hand of government

Honduras 17
Following the money

Retailing in Brazil 19
Brazil's resilient retailers – fortune in adversity

Brazil 22
Made to measure

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Cuba's exchange rate unification: what will replace a flawed system?

Cuba's government has confirmed that it plans to abolish the 'convertible peso' (CUC) and to revalue the Cuban peso (CUC). As yet, there has been no comment on a key question: what currency regime will replace the present system?

Progress to date

The absence of proper money is a fundamental weakness for the Cuban economy. Neither the convertible peso (CUC) nor the national peso (CUP) serve as a wholly satisfactory measure of value. Neither do they serve as a very satisfactory medium of exchange, or as a unit of account.

The value of the CUC is currently fixed at par with the US dollar (CUC1:US$1): it can be exchanged for foreign currencies at banks in Cuba, but not outside the country. For accounting purposes, state owned enterprises have to use an exchange rate of CUP1:CUC1, at which the CUP is overvalued. At the 'cadeca' rate of CUP24:CUC1, which used is for personal transactions and by the growing private sector, the CUP is grossly undervalued.

The government first announced its intention to reform the currency system at the Communist Party congress of 2011. In October 2013, a further official statement confirmed that the timetable had been agreed. On 6 March this year, the *Gaceta Oficial* specified details of how companies should adjust accounts and set prices on 'día cero' (day zero), the day on which the CUC will be abolished and the CUP adjusted to a new level.

Key issues have not been clarified. It is not yet apparent what that new level will be. Pilot studies have involved state-owned enterprises undertaking transactions with CUP:CUC rates of between 12 and 7. However, there is no guarantee that the CUP will be adjusted to either of these limits, or anywhere in between. If the rate is adjusted to a level where, in foreign currency markets, the CUP is clearly undervalued, the living standards of many households (whose incomes are mainly/wholly denominated in that currency) will be depressed. Alternatively, an overvalued CUP would hamper the international competitiveness of Cuban businesses.

The date of 'día cero' is also a big unknown. There will be confusion, upheaval and short-term disadvantage to some sectors of the population and business whatever CUP rate is chosen. Naturally, the Havana government will want to minimise the disruption. For this reason, 'día cero' is unlikely to take place during the summer, when families – rather than the education ministry – bear the cost of providing lunches to children of school age during the holidays. Yet a delay of 'día cero' beyond the end of the year

runs the risk of loss of face for the government, given the announcements that have been made. The implication is that 'día cero' will likely be in the next four months, or between six months and nine months time.

The intention to unify the currency system was included in the '*lineamientos*' (policy guidelines) approved at the 2011 Communist Party congress, and the most recent statement on the subject was an official note published in October 2013, which merely confirmed that a timetable had been agreed, without giving details. The new document represents an important step. It provides the first confirmation that currency unification is to be achieved by the abolition of the convertible peso (CUC) and demonstrates that preparations are well under way.

The new currency regime

In September 2013, Latin News published a White Paper which looked at the issues that matter with currency reform in Cuba (*Cuba's dual currency system: the need for urgent reform*). We argued that unification of the two currencies, through the revaluation of the CUP and the elimination of the CUC, is necessary, but not sufficient to restore the functions of money to Cuba's economy. The new currency regime will have to provide a unit of account, a store of value and a medium of exchange both within the domestic economy and for international trade. In other words, the new currency regime will need to be fully convertible. The value of the CUP will have to reflect supply and demand and have sufficient stability to engender confidence outside the country.

We remain of the view that, whatever the rate that is chosen by the government for the CUP under the new regime, the currency will have to be underpinned by a fixed peg to a major currency. A free float would be impractical for Cuba, where there are many distortions arising from official subsidies and fixed prices and where financial markets are extremely underdeveloped. Currency volatility could be very damaging to economic activity and trade. By fixing many internal prices at levels that are way out of line with those which would prevail in a market-based economy, the government has made it very difficult to determine accurately what the purchasing power parity of the Cuban peso is, or the rate of inflation in Cuba. This means that a sliding peg, under which the currency is allowed to adjust to reflect inflation differentials between Cuba and the country of the currency in question, would be impractical.

A fixed currency peg, then, is the logical solution. Although economic relations with the US are severely curtailed by US sanctions, much of Cuba's external trade is denominated in the US dollar, so it would make sense for the CUP to be pegged against that currency. This is an arrangement that has long worked well for the oil exporting countries of the Gulf Cooperation Council (GCC) in the Middle East, for instance.

Of course, a peg against another currency, or basket of currencies, might be preferred for political reasons. The CUC could be pegged to the offshore traded Chinese renminbi (CNH). This currency is used extensively in Hong Kong and is fully convertible: it tracks the renminbi (CNY), which is used in mainland China. The CNY moves within a narrow band (2% in either direction) around a reference rate, set by the People's Bank of China, vis-à-vis the US dollar. If it were pegged against CNH, the CUP would be fairly stable against the US dollar most of the time. Another alternative would be for the CUP to be pegged against the euro. However, swings in the euro: US dollar exchange rate could have a significant impact on Cuba's economy.

In order to make a currency peg work, three things would need to happen. First, the Cuban government would need to set up a currency board. The currency board would hold the foreign currency reserves that would underpin the value of the CUP in the currency to which it is pegged. The currency board could be formally constituted as an element of Cuba's central bank. Alternatively, it could be independent of the central bank: in this instance, the central bank would neither hold the reserves underpinning the CUP nor be able to expand or reduce credit in the economy.

Steve Hanke and Kurt Schuler, two leading academic proponents of currency pegs, advocated the adoption of this kind of currency regime by Cuba's government in 1992. Hanke and Schuler incorrectly anticipated the collapse of the Communist government in Cuba and suggested that the US government could assist in the establishment of the currency peg. Even after President Raúl Castro leaves office (which he has pledged will be no later than 2018), the Cuban government would be very unlikely to accept an intrusion into national affairs by the US government. However, the Cuban authorities might be prepared to accept technical assistance from foreign experts.

Second, the currency peg would need to be credible. Above all, this would require that the currency board maintain, at all times, sufficient reserve assets to buy back the CUP that it issues. It would also help if the currency board be seen as a strong and independent institution with a clear and narrow mandate.

Third, Cuba would need to amass sufficient foreign reserves, in the relevant currency, to support the peg. Monetary liquidity (M2) varied between 37% and 47% of GDP in 2005-11, according to Cuba's office of national statistics (Onei) The United Nation's Economic Commission for Latin America and the Caribbean (ECLAC) estimates that, at current prices, Cuba's 2011 GDP was US$68.2bn. If the Cuban authorities were to seek, in the first instance, to achieve a domestic money supply of around 30% of GDP (the lower end of the 37%-47% band that existed in 2005-2011), they would need international reserves of around US$20bn.

Cuba's central bank does not publish details about the size (or composition) of the country's foreign exchange reserves. We tentatively estimate that the reserves amount to US$5.0bn or so, which means that the authorities would have to find another US$15bn. Given US sanctions against Cuba, and the government's poor record with defaults (in 1986 and the early 1990s), breakdown in negotiations with Paris Club creditors (2001) and suspension of repayments (2008-09, following devastating hurricanes), a bond issue of this scale would not be easy to undertake.

Nevertheless, it might be possible for a new Cuban currency board to receive support of unorthodox credits such as the governments of China, Russia, Brazil, Ecuador, Angola and, perhaps, Venezuela. The currency board could also offer the bonds to private sector investors who do not have US interests that could be threatened: examples include mainland Chinese financial institutions that have subsidiaries operating in Hong Kong.

When it happens, 'día cero' will be a momentous event in the economic history of Cuba. The selection of a particular rate vis-à-vis the US dollar to which the CUP is revalued will be one important aspect. The actual implementation of the administrative arrangements, which were published for the first time in the *Gaceta Oficial*, will be another. Much more crucial will be the introduction of a credible regime – probably a currency peg of some kind – that supports the value of a convertible currency. Without this, the revalued CUP will not perform the functions of money, and Cuba's most fundamental economic problem will remain unresolved.

Detailed instructions for 'día cero'

The three resolutions (19/2014, 20/2014 and 21/2014) published in the *Gaceta Oficial* describe, in detail, the procedures that enterprise accountants will need to carry out on the day when the CUC is abolished on 'día cero'.

Resolution no.19/24 explains how monetary and stock balances are to be reported, and Resolutions 20/2014 and 21/2014 provide instructions for setting wholesale and retail prices respectively. The details are complicated, with prices to be set by a combination of a 'cost-plus' rule and conformity to international and domestic market prices. Official approval has to be sought for the initial prices, with the ministry of finance and prices responsible for containing any inflationary surge and deciding whether some prices can be set below cost price (and therefore receive state subsidies). The *Granma* article makes it clear that in the process of training staff and trying out the procedures before 'día cero', further refinements are likely.

MEXICO

Trouble at the top of the narco-business?

Any important industry that loses three of its most powerful chief executives in less than a year is going to face some questions. How significant were the displaced leaders and who will take over from them? Is there a crisis in the making, or perhaps a change in the business model looming somewhere on the horizon? Or is the underlying business strong enough to continue, no matter who is running the show? All these questions are now being asked about Mexico's very large, very powerful (and completely illegal) drugs business.

The last Mexican president, Felipe Calderón (2006-2012) pursued a clear, high profile and very hard-line policy of 'war' against the country's drug running syndicates, with the aim of decapitating them. Most security analysts now agree that it was a failure. Fairly or unfairly, Calderón's decision to militarise the anti-drugs effort, throwing the country's armed forces into battle against criminal gangs, is considered to have come at a massive cost (over 70,000 deaths in the six years of his presidency), with very little by way of results: the drug syndicates appeared as powerful as ever at the end of his term, with the flow of illicit merchandise into the US undiminished.

> "General John F. Kelly, the head of US Southern Command (Southcom), recently testified before the US House of Representatives Armed Services Committee that the criminal networks transporting drugs and people to North America are "more efficient than FedEx could ever be". Kelly warned that the drug cartels are efficient organisations and are diversifying in pursuit of profit."

Nor were analysts particularly impressed by the change of strategy initially announced by Calderón's successor, President Enrique Peña Nieto, when he took office in December 2012. The new president took a 'softly-softly' line. He spoke of a more low-key, intelligence-led approach, with less media hype on the day-to-day battles and, apparently, less emphasis on taking out the drug kingpins. This new policy seemed vague and hard to pin down exactly. At worst, it seemed to boil down to no more than a desire to 'manage' the news agenda and keep the grisly drugs-related violence off the front pages.

But latterly even cynics have had to acknowledge that the Peña Nieto administration is delivering some real results. In the space of less than a year, three of the top Mexican narco-syndicate leaders have been taken out of action. In July 2013, Miguel Angel Treviño Morales, also known as '*Z-40*' or '*cuarenta*', the leader of the ultra-violent and feared Los Zetas cartel, was captured by the Mexican Navy. In February 2014, this was followed by the capture, again by the Navy, of the head of the world's 'most-wanted' man, Joaquín '*El Chapo*' Guzmán, leader of the Sinaloa cartel, who had evaded capture for over a decade since a daring prison escape in 2001. Then in early March came the news that Nazario '*El Chayo*' Moreno, reputedly the leader of the Los Caballeros Templarios (LCT) cartel, based in Michoacán state, had been shot dead in a gun battle. This development could not have marked a bigger contrast with the Calderón administration, since the latter had actually pronounced *El Chayo* dead in 2010, even though it never had a corpse to prove its claim. This time, it appears that *El Chayo* really has been taken out of circulation.

So what is happening? Various interpretations are possible. We can start by examining one of the most pessimistic. On this view, essentially, while some of the top leaders have been removed, in all other respects it is "business as usual" and the Mexican drugs business remains as important, as strong, and as profitable as ever as a supplier to the US market. New leaders quickly fill the gaps left by their predecessors. In a business prone to violent battles for control of territory, Los Zetas appear to have managed a fairly orderly transition. Since the capture of Treviño Morales (*Z-40*), it is widely believed that the organisation is now being run by his brother, Omar Treviño Morales (known as *Z-42*). In the Sinaloa cartel, the heir-apparent is Ismael *El Mayo* Zambada,

with Juan José *El Azul* Esparragoza also in a powerful position. “I have no reason to believe *El Chapo* did not have a good succession plan in place and Zambada has likely already taken the reins, with Esparragoza at his side” says Sylvia Longmire, a US drug war expert.

While not necessarily subscribing to the “business as usual” theory, two senior US army generals have expressed opinions which can be seen as supporting it. General John F. Kelly, the head of US Southern Command (Southcom), recently testified before the US House of Representatives Armed Services Committee that the criminal networks transporting drugs and people to North America are “more efficient than FedEx could ever be”. Kelly warned that the drug cartels are efficient organisations and are diversifying in pursuit of profit. In his view, organised criminal gangs are smuggling not just drugs but also weapons, mineral ores and illegal timber. Kelly’s Northern Command (Northcom) colleague, General Charles Jacoby, agreed. While congratulating President Peña Nieto on the arrest of *El Chapo*, he warned that the Sinaloa cartel is “strong and adaptable” and that the struggle against it will be “a long and hard battle”.

A second hypothesis is that while drug-running remains massively profitable, the removal of these three top leaders will spark a new war between their successors for market share. James Creechan, a sociologist and criminologist who taught at Culiacán University (in the city where *El Chapo* was finally captured), has warned that, “nobody knows what is going to happen and it’s really a great period of uncertainty”. Creechan suggests that the arrest of two of Zambada’s sons on trafficking charges in the US, coupled with rumours that one of them may have been the source of information that led to *El Chapo*’s arrest, could complicate the Sinaloa cartel succession scenario.

In this view it is possible that an internal war could break out; and rival groups would seize upon any sign of internal weakness or division within the Sinaloa cartel. Nathan Jones from Rice University comments, “if anyone is going to smell weakness, it is going to be Los Zetas.” At present the Sinaloa cartel controls large tracts of Western Mexico, including Baja California and major drug trading routes in the north and south. The LCT cartel has been strong in Michoacán, but has been forced on the defensive as a result of attacks from rival groups in Jalisco and the spread of the self-defence militias in various parts of the state. Los Zetas control significant parts of the Gulf Coast, and other smaller groups such as the Beltrán Leyva family also hold sway over smaller pockets of territory.

Sylvia Longmire, on the other hand, is not convinced that a war between cartels is in prospect. She believes that the Sinaloa cartel remains “too large and powerful” to be a takeover target. “The violence may temporarily increase in places where (Sinaloa) is already in conflict with other cartels like Los Zetas, but I think that will ease back to normal levels once things readjust,” she said, citing areas like Nuevo Laredo where the groups are “fighting for control of lucrative drug smuggling corridors.”

A feature of the ‘war between rival drug cartels’ scenario is that few analysts believe it can change things in a fundamental way. To date in Mexico and elsewhere, the fortunes of individual drug cartels have ebbed and flowed but the presence of the industry has remained a constant. Drug turf wars seem to leave a trail of violence, but in the long term do not seem to challenge the business itself.

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A third and interesting hypothesis is that the drug cartel ‘business model’ is past its heyday, and that in future the large ‘corporate’ cartels will be replaced by smaller and more localised gangs. Various analysts suggest that this may be the way things evolve in future, but they have different views as to the factors driving such a change.

For instance, Alejandro Hope of the Instituto Mexicano de Competitividad (IMCO) doubts whether *El Chapo*'s main lieutenant, *El Mayo* Zambada, will be able to hold the Sinaloa cartel together. He sees a period of violent fragmentation and internal struggles, accompanied by a move to more local, predatory and diversified criminal organisations dealing not only in drugs but also in extortion, theft and kidnapping.

On the other hand, Dr. James Creechan, a retired academic and Mexico security specialist, thinks the Mexican government is deliberately trying to break up the big cartels into smaller gangs. He attributes this in part to the advice given to President Peña Nieto by General Oscar Naranjo, the former head of the Colombian police force. "The government is going to be quite willing to live with a lot of little cartels in the sense that these little gangs may do local damage but can't do much warfare. In a way it's a kind of Colombian strategy" he comments.

MEXICO

Day of reckoning for Slim and Azcárraga?

The two giants of Mexican media and telecoms, respectively *Televisa* (controlled by the Azcárraga family) and América Móvil (controlled by Carlos Slim), have each officially been declared a "preponderant economic agent" in their sector of activity by the new industry regulator, Ifetel (Instituto Federal de Telecomunicaciones). The ruling means that they now face a series of restrictions designed to limit their power and promote competition from other players.

> "In 2012, the Organisation for Economic Co-operation and Development (OECD) conducted a study that suggested that the lack of fair competition had led to overcharging representing a cost of US$25.8bn per annum to Mexican consumers, along with low penetration rates."

Ifetel announced its decision for both groups on 7 March. On the telecoms side, it said that various operating companies within Carlos Slim's group had been found to be "dominant players". They included América Móvil subsidiaries Telcel (mobile telephony) and Telmex (fixed-line), as well as Grupo Carso (Slim's main holding company) and Inbursa (his financial company). Telcel has an approximately 70% share of Mexico's mobile telephony market, and Telmex controls around 80% of the fixed-line business. Ifetel has said it will apply "asymmetrical regulations" to reduce these very large market shares and promote competition. These will include a requirement that América Móvil share its telecoms infrastructure with other players, agreeing interconnection and usage rates with them; if no agreement is reached Ifetel can ultimately impose what it considers to be fair rates. It is expected that Telcel will be required to pay more to complete calls than it charges for incoming calls. Ifetel also has the power to take further "asymmetrical" steps to promote competition such as requiring local loop unbundling and the elimination of national roaming charges.

The economic consequences of América Móvil's market dominance have been debated for some time. In 2012, the Organisation for Economic Co-operation and Development (OECD) conducted a study that suggested that the lack of fair competition had led to overcharging representing a cost of US$25.8bn per annum to Mexican consumers, along with low penetration rates. According to the International Telecommunications Union (ITU), Mexico lags behind other countries in terms of Internet access: only 26% of households were online in 2012, compared to 45% in Brazil in the same year. Slim described the OECD report as "totally exaggerated" and questioned the data on which it was based.

Televisa is run by Emilio Azcárraga, grandson of the founder, who was also called Emilio and nicknamed *El Tigre* for his combative style. It has held a near-monopoly position for over four decades, and was known for its pro-government stance during the long period of one-party rule in Mexico under the Partido Revolucionario Institucional (PEI). Despite the emergence of the rival *TV Azteca* in the early 1990s, *Televisa* still controls nearly 70% of the Mexican broadcasting market. It said it too now would have to face asymmetrical measures imposed by Ifetel. These include having to "make its broadcasting infrastructure available to third parties on a non-discrimina-

tory and non-exclusive basis". It will have to make its transmission towers available to competitors and publish its advertising rates. *Televisa* will also be prevented from acquiring exclusive broadcast rights to programming with "unique characteristics that in the past have delivered high audiences", a definition believed to include events such as live coverage of World Cup football matches. Separately, Ifetel said that it was inviting bidding for 20-year concessions to run two new nationwide digital broadcasting networks.

Reactions to the new measures were broadly positive, although many noted that the established players could still resist the move towards greater competition. Duncan Wood, director of the Mexico Institute at the Woodrow Wilson International Centre, noted that "the ruling party [the PRI] is committed to following through on its impressive reform achievements of 2013 and to tackling the vested interests in the economy", while warning that "influence will not be reduced overnight; other players will face major obstacles in overcoming brand recognition and the dominant presence in the public consciousness of these firms". "Without exaggeration we are looking at a historic decision" said Raúl Trejo Delarbe, a media analyst at UNAM (Universidad Nacional Autónoma de Mexico). Alejandro Gallostra, an economist at BBVA, said the Ifetel requirements were "pretty tough" for *Televisa*, noting that they would speed up the arrival of new competitors in broadcast television, who can now access transmission infrastructure without having to build their own at a high up-front capital cost. Irene Levy of consumer advocacy group Observatel said the new conditions imposed on *Televisa* "look very good in my opinion" and were aimed at "promoting effective competition and avoiding the abuses of such a large company".

"While the new telecoms law...was approved last year, so-called secondary legislation' which contains much of the detailed regulations, has yet to be approved in congress....By some estimates, it could still take up to five years and very hefty investment for the two new national broadcasters to begin their transmissions."

At the same time however, other analysts noted that there was plenty of scope for the established players to mount legal challenges. Timing may also be important: while the new telecoms law – which among other things set up Ifetel – was approved last year, so-called secondary legislation' which contains much of the detailed regulations, has yet to be approved in congress. Indeed it is running behind schedule; some say this is because of intense lobbying by the Azcárraga and Slim families. By some estimates, it could still take up to five years and very hefty investment for the two new national broadcasters to begin their transmissions.

Paradoxically, in one scenario the power of both dominant groups might actually remain constant or increase: Carlos Slim has said he is interested in moving into television and the Azcárraga family wants to get into the telephony business. For Slim, the obvious next step would be to bid for one of the two new national TV licences (applications must be made by 17 June, with a qualification process and auction set to conclude by 25 March 2015). In a statement, *Televisa* said: "We are pleased that Ifetel is proceeding with the tender of new TV stations. It's an important event for competition. We hope the same applies to the telecommunications sector". Aware of this crossover possibility, Ifetel's president, Gabriel Contreras, said that neither group will be given a unified licence (allowing it to provide a full range of services such as TV, internet, and telephony), until it complies with all of the regulator's restrictions.

…Meanwhile in Ecuador

In early February, Ecuador's Superintendent of Market Control (Superintendencia de Control del Poder de Mercado, SCPM) levied a fine of US$138.4m on Claro- Conecel, the local subsidiary of América Móvil, for anti-competitive behaviour. Responding to a complaint filed by the state-controlled Corporación Nacional de Telecomunicaciones (CNT), a competitor in the mobile telephony sector, the SCPM said that Claro had 'impeded' its rivals by signing exclusivity contracts with landlords or landowners hosting its transmission towers. The fine represented 10% of Claro's turnover in 2012. The local subsidiary, which has around 15.5m subscribers and a 63.8% market share, described the fine as "unjustified and disproportionate": it accused the regulator of being inconsistent and said it would challenge the ruling through the courts. The number two mobile phone operator in Ecuador is Spain's Telefónica, whose mobile operator Movistar has a 32.8% market share; CNT follows in a distant third place with a 3.4% market share, according to official data.

REGION

Coca-Cola Femsa upbeat despite profits squeeze

Coca-Cola Femsa, the largest Coca-Cola bottler in Latin America, posted a 29% fall in profits in the final quarter of 2013, which came in at MXN3.07bn (US$234m). For the full year, net profits were down 13.4% at MXN11.5bn (US$865m).

The company said profits had been affected by the depreciation of the Venezuelan Bolívar, the Argentine Peso and the Brazilian Real. Lower costs for sugar in countries where Femsa has bottling operations was insufficient to offset the negative exchange rate effect, it added. Following a series of acquisitions, increased operational and financial costs also played a part in the fall in fourth quarter profits. Femsa noted, however, that total revenues in the quarter had increased by 12.1% when calculated on a currency-neutral basis, and when stripping out the effects of the acquisitions of Grupo Yoli in Mexico and Fluminense de Refrigerantes and Spaipa in Brazil. When currency fluctuations and the newly acquired units were included, total revenues grew by 8.5% year-on-year in the fourth quarter.

The acquisitions have increased Femsa's debts, and the company says it will cut back on its investment programme to allow it to begin reducing the debt burden. Chief financial officer Héctor Treviño said investment would be reduced from around US$800m in 2013 to US$600m-700mn in 2014, focused on increasing production capacity in Colombia and Brazil. Total debt stood at US$4.57bn at the end of 2013, up US$2.3bn on a year earlier. "We want to reduce our debt" Treviño said in a conference call in late February.

Femsa was nevertheless upbeat about the company's position. In a statement it said: "Despite the many challenges that we faced during 2013, including a tough consumer environment – especially in Brazil and Mexico – and a volatile currency environment across our operations, our company delivered double-digit currency-neutral top-line growth". It noted that the acquisitions in Latin America, along with Coca-Cola Bottlers Philippines Inc., made it the largest bottler of Coca-Cola products in the world, "now serving more than 346m consumers in 10 countries in Latin America and Southeast Asia", with a total of over 120,000 employees.

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The chief executive of the Monterrey-based company, John Santa María Otazua, said that in 2014 company staff was fully aware of "structural challenges in markets like Mexico, along with the challenges that some of our other franchises present". One of the issues in Mexico is a new government-imposed one peso (US$0.08) per litre tax on soft drinks, introduced amid concerns over the health effects of high consumption of sugar-sweetened beverages (Mexico has a high diabetes rate).

COLOMBIA

Pacific Rubiales looks at Panama

The Canadian owned, Colombia-based oil company Pacific Rubiales, which has shares listed in both countries as well as capital held via Brazilian Depositary Rights (BDRs), is thinking of moving its board of directors somewhere else entirely: to Panama.

According to a *Reuters* report in late February, which cited a senior management source in Pacific Rubiales, which is the largest independent energy producer in Colombia, the company is thinking of moving its board of directors to Panama for two main reasons. One is to minimise taxes. "The decision is to move the entire board to Panama, including vice-presidents. Pacific is now a more international company, and Colombian taxes are higher than

Panamanian taxes," the source said. The second reason is to allow the company greater flexibility to manage its distribution and sales. While over 90% of the company's oil production is still Colombia-based, it seems executives have decided that Panama is an ideal platform from which to manage expansion into countries like Peru, Brazil, Mexico, Guatemala and Suriname. Pacific Rubiales' business model involves significant oil deliveries to the US and Europe on spot markets, and for these types of contracts Panama is deemed a good sales location. The source said that at a later date the entire marketing and distribution operation might be moved from Colombia to Panama.

Although the company stressed that it was not closing its Colombia management office, the decision to consider relocating at least part of the headquarters away from the country comes after a difficult year. Lower international oil prices, a depreciating Colombian peso, concerns over emerging markets in general, and worries over the future of a key production bloc have combined to give the share price something of a battering. The value of the company's shares plunged 38% during the course of calendar 2013. This reflected various factors. Earnings in the five quarters to Q313 came in consistently below analysts' consensus forecasts. Crude oil prices reached a two-year peak in August 2013, but dropped 9% in the period running from then to February 2014. The collapse of the Argentine peso in early 2014 also triggered general investor nervousness and a 'flight to safety' away from perceived high-risk emerging markets.

"In February, Amylkar Acosta, Colombia's mines and energy minister, who also sits on Ecopetrol's board, said it had received "with great interest" a proposal from Pacific concerning arrangements for the field after June 2016."

An important factor affecting investor perceptions has been the fact that one of the company's main assets, its 42% share in the Piri Rubiales field in the Llanos Basin in Colombia, is due to come to an end in June 2016, when the concession terminates. This single field represents over half (56%) of Pacific's daily crude oil production. If nothing else were to change, Pacific could therefore lose roughly half its revenue and profitability in two years' time – a prospect guaranteed to alarm already nervous investors.

That said, there are strong signs that Pacific will meet the 2016 challenge and keep crude output on an upward trend. Ahead of releasing its fourth-quarter 2013 results, management was saying that output for the full year was expected to have grown by between 3% and 5%. Through its US$1.45bn acquisition of Petrominerales last year, Pacific now controls additional blocs under development in the Llanos (CPE-6 and Rio Ariari), which when fully on-stream should represent some 70,000 barrels per day (bpd), more than the 65,000 bpd at risk when the Piri Rubiales concession ends. These blocs produce light crude that can be used to dilute the company's heavy crude output from other wells. The purchase of Petrominerales also gives Pacific a valuable 5% equity stake in the OCEANSA pipeline. Another plus for the company is its proprietary STAR technology, which has demonstrated its ability to increase oil reservoir recovery rates; boosting production and therefore reserves.

In fact, STAR may be the key to leveraging some kind of continuing presence for Pacific in the Piri Rubiales field. When the concession terminates in 2016, the field is due to revert to Ecopetrol, Colombia's state-owned oil producer. In February, Amylkar Acosta, Colombia's mines and energy minister, who also sits on Ecopetrol's board, said it had received "with great interest" a proposal from Pacific concerning arrangements for the field after June 2016. It was suggested that Pacific was offering the rights for Ecopetrol to use STAR in return for a share of the output extracted. Pacific would not itself comment on what had been proposed, but analysts believed the chances of a mutually beneficial deal looked good.

The company itself is bullish about the future. It has estimated that the acquisition of Petrominerales will allow it to boost its total oil production by between 15% and 25% this year (up to between 148,000 and 162,000 bpd). The forecast includes production from assets in Latin America, although roughly 95% of the total will remain Colombia-based.

Balance of trade deteriorates

Across Latin America, trade balances are deteriorating. While different factors are at play in different countries, changes in the global economy seem to be affecting the region as a whole.

Brazil posted a US$2.13bn trade deficit in February, the biggest in two decades. Exports rose 2.5% year-on-year to US$15.93bn, while imports jumped 7.3% to US$18.06bn. A poor performance in the first two months of 2014 followed on from a fairly dismal 2013, when the country registered a whopping current account deficit of US$81.37bn, equivalent to 3.66% of GDP, on data from the central bank (BCB).

Although generally better placed, Mexico also had something of a bad start to the year on the trade side. In January, the trade deficit was US$3.19bn, up from US$2.85bn in the same month in 2013. Exports fell 1% year-on-year, while imports rose 0.3%. The trade deficit for 2013 as a whole was a small US$1.02bn (on exports of US$380.18bn versus imports of US$381.21bn). Elsewhere, trade balances deteriorated in a number of countries including Argentina, Colombia, Chile, Peru and Venezuela.

Deteriorating trade balances can be explained by a number of factors. Commodity prices have fallen, with weaker prices for copper (affecting Chile and Peru), iron ore (Brazil), crude oil (principally Ecuador, Venezuela, and Mexico). Domestic economic imbalances, including high inflation and multiple exchange rate regimes, have been an important factor in Argentina and Venezuela.

Smaller trade balances – or larger deficits – have been a factor in a general deterioration of current accounts across the continent. Most Latin American countries are now running current account deficits. Some have regularly posted deficits in the last 5-6 years (Brazil, Colombia, Mexico), while others have gone from a current account surplus to a deficit (Peru, Chile). Some analysts think the new move to larger and more generalised current account deficits is a danger signal: they believe it could add up to a repeat of events in the late 1990s, when growing concerns over these imbalances led investors to take fright, triggering a financial crisis.

In a recent research note, London-based analysts Capital Economics pointed out that with the exception of Mexico, the current account deficits of 2013 were comparable in size to those of 1998. However, it does not see a crisis coming around the corner now, as it did then. This, it says, is for two main reasons. The first is that the deficits "are now funded by more stable forms of external finance", with less reliance on short-term bond and equity markets, and more reliance on long-term inflows of foreign direct investment (FDI). In all countries except Brazil, net FDI inflows exceed the current account deficit (in Brazil FDI covers three-quarters of the deficit). The second is that Latin American countries now have greater accumulated levels of foreign currency reserves – a buffer against sudden financial turbulence – than they did in the late 1990s.

"It does not see a crisis coming around the corner now, as it did then. This, it says, is for two main reasons. The first is that the deficits "are now funded by more stable forms of external finance", with less reliance on short-term bond and equity markets, and more reliance on long-term inflows of foreign direct investment (FDI)."

While it doesn't see a crisis, Capital Economics notes that there still is some cause for concern. It argues that Latin American economies have used their rather more stable positions to boost consumption rather than investment, raising questions over sustainability. As the research note says, "there is no evidence that large current account deficits have gone hand-in-hand with higher rates of investment. At best, investment as a share of GDP has remained stable over the past five years. But in Brazil, and to a lesser extent Chile and Mexico, it has actually fallen. In other words, the authorities have taken advantage of cheap and plentiful foreign finance over the past five years to fund a consumption binge rather than much-needed investment". The net result, the paper concludes, is that Latin American economies are more exposed than they need have been to tightening global monetary conditions.

Reductions in income inequality stopped in 2010

According to a new report from the World Bank, while Latin America has made fairly robust progress in poverty reduction, its record on reducing income inequality in recent years is at best patchy and stop-go in nature. Progress came to a halt in 2005, edged forward again in the following four years, and then stopped again in 2010.

According to the February 2014 report (*Social Gains In the Balance – A Fiscal Policy Challenge for Latin America and the Caribbean*), the region made some impressive gains in the first decade or so of the 21st century. The proportion of the region's total population of 600m people living in extreme poverty (defined within the region as living on less than US$2.50 a day) was halved between 2003 and 2012 to 12.3%. This period also saw the (broadly-defined) middle class emerge as the largest single income group in the region. When compared with global trends, extreme poverty in Latin America has fallen almost as fast as in East Asia.

But there are worries about the sustainability of these gains. First of all, the process is geographically-lopsided. According to the report, the Southern Cone region, including Brazil, has led the way, but it has proved much harder to achieve effective poverty reduction in Central America and Mexico. Secondly, the factors contributing to poverty reduction - general economic growth on the one hand and moves towards a more equitable distribution of income on the other - are also lop-sided in their contributions. In fact, over two thirds of poverty reduction (68%) can be attributed to Latin America's general GDP growth rate, while just under one-third (32%) has come from income redistribution. The problem now is that regional growth is slowing down. In Latin America and the Caribbean, overall real annual GDP growth was 4.3% in 2010. This had fallen to 1.3% by 2013, and growth is predicted at a below-trend 1.7% in 2014. Less growth will mean less poverty alleviation.

“The factors contributing to poverty reduction - general economic growth on the one hand and moves towards a more equitable distribution of income on the other - are also lop-sided in their contributions.”

Gini coefficients: selected countries and years

	2007	2008	2009	2010	2011	2012
Argentina	0.474	0.463	0.452	0.445	0.436	0.425
Bolivia	0.554	0.514	0.497		0.463	0.466
Brazil	0.559	0.55	0.545		0.536	0.531
Chile			0.52		0.508	
Colombia		0.558	0.555	0.551	0.537	0.535
Costa Rica				0.481	0.486	0.486
Ecuador	0.543	0.506	0.493	0.493	0.462	0.466
Guatemala					0.538	
Mexico		0.506		0.478		0.494
Paraguay	0.521	0.51	0.497	0.518	0.526	
Peru	0.497	0.471	0.463	0.451	0.457	0.453
Uruguay	0.479	0.465	0.465	0.455	0.437	0.415

Source: *World Bank, Social Gains In the Balance – A Fiscal Policy Challenge for Latin America and the Caribbean, February 2014.*

The World Bank therefore asks the obvious question: could more be done on the redistribution side to offset the lower contribution from growth? The report looks at two main areas: the potential contribution from redistributive fiscal policy on the one hand, and action to promote more equal access to basic goods and services for all children in Latin America on the other. It says the contribution of fiscal policy to poverty alleviation has been modest. Countries that have been most successful on this front are Brazil, Mexico, and Uruguay, but all they achieved was a 0.03 reduction in the Gini coefficient (a measure of income inequality in which 1.00 represents theoretical maximum inequality and 0.00 represents theoretical perfect equality). Latin

America’s overall Gini coefficient averaged 0.54 in 2000, making it the most unequal region in the world. By comparison, the European Union’s average Gini coefficient was 0.30 in the same year, and in East Asia it was 0.46. A problem for Latin American countries seeking to use fiscal policy to reduce the Gini rate is their relative overreliance on indirect taxes (such as value added tax [VAT]), which are easier to collect, but are regressive in nature.

The World Bank report does praise ‘conditional cash transfer programmes’ (CCTs), whereby social payments to low-income families are linked to requirements such as ensuring that children attend school and have regular health check-ups. These CCT programs aim to give children a more equal set of ‘life chances’. But overall the World Bank report warns, “Because recent trends suggest that the decline in inequality may have halted, promoting more inclusive growth will be central”. It goes on to note that: “Recalibrating fiscal policy and providing better basic goods and services are two important instruments for inclusive growth. The findings of this brief… underscore that Latin America and the Caribbean are not fully achieving their potential in reducing inequality.”

Some analysts highlight different approaches. George Gray Molina of the United Nations Office for Latin America notes that Mexico and Brazil are following different tacks. “The fiscal reforms in Mexico are creating a favourable atmosphere for entrepreneurs and are focused on reducing inequality through economic growth. Brazil, on the other hand, has opted for social protection programmes, focusing on reducing inequality through public investment.”

“Recalibrating fiscal policy and providing better basic goods and services are two important instruments for inclusive growth. The findings of this brief... underscore that Latin America and the Caribbean are not fully achieving their potential in reducing inequality.”

REGIONAL ECONOMIC REVIEW

ARGENTINA

Another step towards orthodoxy?

On 25 February, Argentina's government reached an agreement with Spain's Repsol in relation to the April 2012 expropriation of a controlling interest in the main local energy group Yacimientos Petrolíferos Fiscales (YPF). This is the latest in a series of rather orthodox, investor-friendly moves by the government led by President Cristina Fernández in the last nine weeks or so. Financial market participants perceive that financial risks have reduced. We agree. A ‘virtuous circle’ of lower inflation, falling interest rates and a stronger currency remains some way away, and will be difficult for policymakers to achieve: however, this outcome is no longer an impossible scenario.

On 17 March, the ratings agency Moody’s Investor Services reduced its rating for Argentine government bonds from B3 to Caa3, and changed the outlook from stable to negative. At the same time, Moody’s lowered its ratings for the government's foreign legislation debt.

Moody’s decision was driven by two factors. One is the steep fall in Argentina’s foreign reserves, which have contracted from US$52.7bn in 2011 to US$27.5bn presently. The agency noted that, in lacking access to international capital markets, the Buenos Aires government is reliant on foreign reserves in order to service its borrowings, and pointed out that the government is facing US dollar debt payment obligations of US$20bn between now and the end of 2015.

The other factor worrying Moody’s is ‘an inconsistent policy environment that increases the likelihood that official reserves will remain under pressure this year and next.’ The agency noted that ‘despite talk of lowering energy subsidies, the government has not reduced ongoing fiscal imbalances.’ Moody’s therefore expects that the monetisation of the fiscal deficit will continue feeding inflation.

Meanwhile the central bank's policy of higher interest rates and faster currency depreciation will have a negative impact on economic growth. Political challenges will also reduce the government's room to manoeuvre, as unions heavily resist official efforts to keep this year's wage settlements below expected inflation. Moody's also suggested that the ongoing discussions between the government and its Paris Club creditors in relation to outstanding debts will likely take months to be finalised.

Meanwhile, on the same day as the Moody's downgrade, Bank of America published a research note suggesting that the investment appeal of the Argentine government's US dollar-denominated bonds had improved. Bank of America analysts said they were looking for foreign reserves to grow in coming weeks on the back of export revenues for Argentina's soybean harvest. They were also reasonably confident that official energy subsidies would be reduced, and finally; in contrast to Moody's, they were upbeat about the prospects of a deal with the Paris Club creditors.

Bank of America also highlighted the series of investor-friendly moves taken by the government in recent weeks. As we discussed last month, the government has adopted a new inflation index that is considered more accurate. Given that the previous measure had for some years been discredited and seen as grossly understating the actual level of inflation in Argentina, this initiative, implemented with the help of the International Monetary Fund (IMF), was widely applauded.

February inflation

Inflation slowed to 3.4% in February, from 3.7% in January, under the new inflation index, the government reported on 17 March. Some private economists expressed renewed scepticism at the latest figure, having expected a result closer to 4%.

On 25 February, the government reached a settlement with he Spanish energy company Repsol in relation to its expropriation of a Repsol's 51% stake in YPF. Repsol is being compensated with two packages of US dollar denominated bonds. The packages will have an aggregate market value of no less than US$4.67bn and a maximum nominal value of US$6bn. In the event that Repsol is able to sell the bonds for more than US$5bn, the Spanish company will return the excess to the Argentine government. Both parties also agreed to end litigation (*see sidebar*).

Nearly a month later, in mid March, a majority of financial market participants appear to agree with Bank of America's optimistic assessment, rather than the negative view of Moody's. Between 16 February and 19 March, the Argentine peso has depreciated marginally, moving from ARS7.79/US$1 to ARS7.94/US$1. This movement is consistent with the sliding peg currency regime operated by Banco Central de la República Argentina (BCRA, the central bank). Over the same period, the Dolar Blue rate, which applies to black market transactions undertaken with currency dealers in central Buenos Aires, has appreciated, from ARS11.90/US$1 to ARS10.95/US$1. The Dolar Bolsa rate, at which institutional investors may gain access to foreign currency by buying debt securities in pesos and then selling them in US dollars, has also appreciated, moving from ARS10.56/US$1 to ARS10.09/US$1.

In other words, the premiums to the official rate of both the Dolar Blue and the Dolar Bolsa rates have narrowed further. Currently, the premium of the Dolar Blue rate stands at 37%, having been at a little over 50% in mid-February. For much of the second half of 2013, the premium was in a range of between 50% and 65%. In May last year, when the Dolar Blue rate rose above ARS10/US$1 for the first time, causing a minor shock, the premium was about 100%. The Dolar Blue rate will always carry a premium to the official rate in order to recognise the time and cost to currency dealers of obtaining suitcases full of US currency; the fact that the premium has been converging towards the (depreciating) official rate indicates that recent policy actions are having some effect.

We agree with the 'optimists'. We remain of the view that the risks of a full-blown financial crisis arising from a fall in foreign reserves, which was widely feared in mid-January this year, are in fact low. We caution that the probability of such a crisis is not zero; but the crisis would have to be the result of an exogenous shock - such as unanticipated problems with Argentina's soybean harvest - port workers are threatening to strike, for instance – or potentially a negative outcome in the country's ongoing legal case with 'holdout' creditors.

Even if a major financial crisis were to occur, the Fernández government would still have a number of options, although we concede that these would largely be of the unorthodox variety. Unorthodox solutions in this context include borrowing from Chinese sources and issuance of US dollar certificates of deposit (Cedins) and economic development bonds (Bodes) on attractive terms, with a view to attracting the 'Blue dollars' circulating within Argentina.

As Bank of America pointed out; the latest moves by policymakers (including the devaluation of the currency and the increase in interest rates by the BCRA in late January and early February) are, in fact highly orthodox. The deal with Repsol is very significant, as it indicates that the government is, in fact, able to place bonds with foreign creditors in mainstream financial markets: this augurs well for the forthcoming negotiations with Paris Club creditors.

Last month we argued that Argentina might move towards a virtuous circle of lower interest rates and true currency stability. Crucially, the government would need to manage the inflationary expectations both of investors and local workers. With the Badlar rate (paid by private banks on wholesale deposits in local currency) at about 26%, the objective should be to produce a situation where the new (and accurate) measure of inflation looks likely to fall below this level. This would also facilitate the tricky wage negotiations with the country's politically powerful unions.

Crucially, the Buenos Aires government will need to stop monetising it's spending through a compliant central bank. As we noted in mid-February, these are not easy tasks, but they are not impossible either. By moving towards more orthodox policies in the last four weeks or so, the government has made these tasks a little easier to achieve.

Repsol

Repsol agreed to accept US$5bn in compensation for the expropriation of its shares in YPF, less than the US$10.5bn it originally demanded, but probably more than what it could get after an expensive legal battle. Under a complex package, Repsol will receive three separate dollar-denominated series of Argentine bonds with a face value of US$5bn and a potential additional US$1bn worth of bond issues. As Argentine bonds trade at a variable discount of face value, Repsol has been careful to insist that it is their cash, rather than face value that matters. The net result, depending on how and when the company sells the bonds, and on options for payment of back interest, is that it can expect a cash payment of somewhere between US$4.67bn and US$5.17bn. In exchange Repsol will drop all legal action against Argentina, and it is free to hold on to, or sell, its remaining 12% YPF shareholding. Antonio Brufau, the Repsol chairman, declared himself "satisfied" with the deal and hinted at a possible sale of its remaining assets. "We no longer have any legal constraints to keep the remaining 12% stake in YPF", he said. "Therefore we'll look into all available options".

Govt. vs. the unions

To mark the start of the school year in late February/early March, teachers across Argentina staged strikes in demand of higher pay. National unions have accepted the government's order of mandatory conciliation, by which strikers are obligated to return to work while negotiations continue. In Buenos Aires province, however, the teachers' union is refusing to accept the order. Four million Argentine students have been affected by the industrial action. Salary negotiations with the federal government will resume on 13 March.

So far the Fernández government has proposed a 22% pay increase, payable in three instalments. Unions rejected the offer, principally because the last instalment would not have been paid until next year. In Buenos Aires, the teachers have rejected an initial offer of a 30.9% increase. The unions are setting their sights on a pay increase of between 42% and 60%. Jorge Capitanich, the cabinet chief, has called these demands "fiscally unviable".

Speaking in the senate on 12 March, Capitanich acknowledged the right of the teachers to strike, but said that it should not be "at the cost of the pupils". He pointed out that the Fernández-led government had invested heavily in the education sector in recent years, in terms of teachers' salaries, improved school buildings, and access to educational resources and technology.

Annual wage negotiations, which run between March and April, are set to be particularly fraught this year, with the government desperate to persuade unions to accept salary increases that are below inflation. Based on January's figures, which the government argues is not a representative month given the peso's devaluation, annual inflation could be around 30%.

Given the sharp rise in inflation, the government is now attempting more orthodox economic policies. The central bank has played its part by tightening monetary policy, but so far the Fernández administration has shown little appetite for the more politically sensitive task of cutting public spending.

Repsol deal removes another hurdle

With the Repsol settlement, Argentina has removed one obstacle in its way to attracting foreign investment in its potentially vast shale oil and gas field at the Vaca Muerta formation, in the province of Neuquén. The agreement is also another step towards Argentina's rapprochement with the international community, with the US

State Department describing it as a “positive step”. Argentina needs investment to develop Vaca Muerta. Shortly before the expropriation of 51% of its shares, Repsol said the reservoir contained 22.5bn barrels of oil. Whether Repsol stays or the government manages to find a new investor, the challenges of operating in Argentina remain considerable.

Factoring in inflation of close to 30% in 2013; the continued volatility of the peso; and the difficulty of drilling in the formation, the cost of developing a well in Vaca Muerta is estimated to be between US$8m and US$10m. A similar well in the US would cost between US$2m to US$3m.

President Fernández had ordered the expropriation of Repsol’s assets in a bid to halt a steady decline in production. Natural gas production has been falling since 2004, oil production since 1998, forcing Argentina to import more hydrocarbons. Such costly measures have eaten into the country’s dwindling supply of foreign reserves. But two years on from the expropriation, production continues to decline, as conventional oil and gas fields run dry. Without the expertise to develop the non-conventional reserves, and no foreign companies willing to invest, the potential of the Vaca Muerta has remained largely untapped.

YPF has signed a deal with the US oil giant, Chevron, to develop one part of the formation, in an investment worth US$1.2bn; and another with US company Dow Chemical, worth US$120m to help extract shale gas. However, this piecemeal approach has been heavily criticised by energy analysts.

Vaca Muerta

The Vaca Muerta formation is around 30,000 square kilometres, and YPF has rights to drill in 40% of the area. Other companies, such as ExxonMobil, Total and Royal Dutch Shell do operate there, however, though on a much smaller scale. The settlement with Repsol has already provided the Argentine government with some rewards. During the course of the three-month negotiation over the final fee, Argentina signed a deal with Malaysia’s state oil company, Petronas, to jointly develop shale oil in Vaca Muerta.

BOLIVIA

The economy and the hand of government

Bolivia's government is increasing its control over the economy in several ways. However, this is unlikely to unsettle investors, given the very favourable position of the economy and its good future prospects.

In its 10 February report following its latest Article IV Consultation with the government of Bolivia, the International Monetary Fund (IMF) highlighted two ways in which the leftist government led by President Evo Morales is increasing its control over the economy. One is the ongoing use, since 2009, of the central bank (Banco Central de Bolivia, BCB) as a source of funding for public sector entrerprises and development projects (including FINPRO, an investment fund). As of late 2013, total lending by the BCB to such organisations and projects amounted to US$2.2bn, or 7.5% of GDP. However, approvals amount to US$5.3bn, or 17.8% of GDP: these amounts include approvals for lending by the BCB to the state-owned energy company Yacimientos Petrolíferos Fiscales Bolivianos (YPFB) equivalent to 6.8% of GDP.

The IMF argues that these arrangements run the risk of inadequate transparency and budgetary control. Instead, the Fund advocates that the government should use the financial surpluses that it generates from the key hydrocarbons sector, which was nationalised in 2006, to establish a sovereign wealth fund (SWF). “Proper management of these resources could achieve the government's objective of spreading Bolivia's wealth across generations, help mitigate boom-bust cycles, and maintain the competitiveness of the non-commodity sector”, it suggested.

The IMF is also worried about various possible outcomes deriving from the new Financial Services Law (Ley de Servicios Financieros, 2013). The new law gives the government the ability to impose ceilings on lending rates and credit quotas. It also gives the authorities the ability to control deposit rates. As a result, banks' lending margins could be compressed. In addition, credit could be directed, at the wrong price, to sectors of the economy that are not well placed to absorb the new funds.

Another potential consequence foreseen by the IMF is that “increased intervention in financial institutions and regulatory uncertainty may discourage investment in the financial sector”. The functions and powers of the also-new ‘Financial Stability Council’ are unclear. Perhaps more seriously, the

new legislation allows clients to terminate contracts with financial institutions without incurring any penalty.

All this is happening at a time that the government is the respondent in numerous international court cases involving multinational companies seeking compensation for the expropriation of their Bolivian assets from (mostly in the energy sector) over the last seven years or so. As out sister publication *Latin American Regional Report: Andean Group* noted in February 2014, investors were unsettled by the Morales government's refusal to pay the entire US$41m in compensation to a UK power group, Rurelec, in accordance with a ruling issued by the Permanent Court of Arbitration (PCA) in The Hague. Other pending compensation claims are larger. These include a US$1.49bn claim before the International Centre for Settlement of Investment Disputes (ICSID) brought by Pan American Energy (PAE) in relation to the government's seizure of its subsidiary, Chaco (a natural gas producer), in early 2010.

Public sector now contributes over a third of GDP

According to the most recent (February 2013) US State Department Investment Climate Statement on Bolivia: "In 2005, income from state-owned business in Bolivia represented only a fraction of a percent of the Gross Domestic Product (GDP). As of 2011, [the] public sector contribution to GDP (including SOEs, investments, and consumption of goods and services) has risen to more than 34%"

Nevertheless, as we noted last month, none of these current disputes appear to have had an adverse impact on inwards foreign direct investment (FDI), which rose by a double digit amount through the first half of 2013. According to a 6 December 2013 BCB report FDI flows were US$962.5m in the first half of 2013, up 14.1% on the same period of 2012. The hydrocarbons sector accounted for two thirds (66.3%) of this total (up from 57.7% in 2012), followed by manufacturing (19.3%), transport (4.6%) and mining (6.1%). Spain was the biggest investor, accounting for US$415m of the total inflow (up 109% on 2012), followed by Sweden (US$142m, up 37%) and Brazil (US$81m – down 32%).

A draft investment law – a key demand of international partners like the European Union (EU) – is due to be ready in April for discussion by the legislature.

Indeed, the IMF's latest report underlines the very strong overall condition of Bolivia's economy (**see chart 1**). In essence, the Fund expects steady growth and moderate inflation in 2014, in the context of a balanced budget, a current account surplus and net international reserves that are very large by any relevant metric (US$14.7bn as of 14 March 2014).

Chart 1: IMF Projections for Bolivia

	2013	2014
Real GDP Growth %	6.7	5.4
Average CPI Inflation	5.7	6.8
Public Sector Revenues (% GDP)	38.6	37.3
Overall Fiscal Balance (% GDP)	0.6	-0.4
Current Account Balance (% GDP)	4.0	3.1
Net International Reserves (US$mn)	14,535	16,089
Credit to Private Sector (% GDP)	42.1	42.5
Deposits (% GDP)	51.7	54.5
Broad Money (% GDP)	68.5	71.0
US Dollar Deposits (% Total Deposits)	23.8	21.3
Nominal GDP (US$bn)	44.0	48.5

Source: *IMF Country Report 14/36 - Staff Report for the 2013 Article IV Consultation*

The banking sector is well capitalised and also in a strong position overall. Credit to the private sector amounts to 42.1% of GDP - a not-particularly high level for a country with Bolivia's per capita income - while the deposit ratio is 51.7%. US dollar deposits account for around 24% of the total: however, the IMF is looking for the percentage to fall.

Meanwhile, the Morales government (in power since 2006) has achieved a substantial reduction in poverty and is making progress towards the United Nations (UN) Millennium Development Goals. In sum, the situation and the prospects of Bolivia's economy - over both the medium and long term - are very positive. Investors are unlikely to be unsettled by the government's latest moves to increase its control over the economy.

Export growth continued apace in 2013

Total exports were valued at US$12bn in 2013, up 3.4% year-on-year on 2012, according to preliminary figures published on 6 February by the Instituto Boliviano de Comercio Exterior (Ibce). Traditional exports, dominated by hydrocarbons (oil, gas and minerals), made up 80% of that total (US$9.6bn), with traditional export growth driven by higher volumes (+16%). Hydrocarbons exports alone generated US$6.59bn for Bolivia in 2013, up 13% year-on-year. In other words hydrocarbons exports generated 55% of the county's total export revenues last year. They rose 13% in volume terms, on stronger demand from Brazil, the main customer. Meanwhile, non-traditional exports, which include soya and its derivatives, were valued at US$2.4bn, up 14% year-on-year, with volume growth of 29%.

HONDURAS

Following the money

The new government led by by President Juan Orlando Hernández is moving to accompany its tough military security policy with a financial attack on organised crime in the country. On 10 March the national defence and security council (CNDS), which is headed by the president, launched an intervention in the public transport sector, citing the need to stamp out an extortion industry that generates almost US$28m annually.

Bus and taxi companies are the main targets of so called 'war tax' (*impuesto de guerra*). Extortion generates an estimated HNL25m (US$1.29m) a month in the capital Tegucigalpa and its sister Comayagüela alone, according to calculations by the national security secretariat. That amounts to HNL300m (US$15.5m) a year. In the country's second main city and main business hub, San Pedro Sula, located in the violent and drug-gang afflicted northern part of the country, extortion amounts to an estimated HNL20m (US$1.0m) a month, or HNL240m (US$12.4m) a year. Combining the two cities (where some 15,200 buses operate), that's a whopping HNL540m (US$27.9m) a year.

In the past four years, some 350 public transport workers, including bus and taxi company owners, drivers and other workers have been murdered, on official estimates. According to the national human rights commissioner, Ramón Custodio, 153 taxi drivers (and 32 passengers) were assassinated in 2012-2013, with impunity in 90% of cases. Last year alone there were 114 fatalities (between taxi drivers and passengers), with firearms used in 87% of cases, making taxi driving a "high risk" job, the commissioner noted. Custodio added that some of the extortion could be linked to corrupt police.

Extortion carries a tough prison sentence of 15-20 years in Honduras, although given the widespread impunity, that's no deterrent. The new Fuerza Nacional Antievasión (FNA), set up in January at the request of the president, will lead the intervention to combat the crime. President Hernández said that transport and security authorities had been ordered to come up with an integral security plan for the sector "within a week", to include the use of "appropriate technology" to monitor the circulation of buses, as well as the installation of closed circuit security cameras at all main bus stations and principal taxi ranks. He added that among other things, the procedures for extending operating permits for bus companies provided by the Dirección General de Transporte (DGT) would also be modified (presumably to crack down on corruption there), while all urban and inter-urban bus routes would also be subject to revision, for security reasons.

Hondutel retires 1,500 pre sell off

The bankrupt state telecoms company, Hondutel, is retiring 1,500 employees with immediate effect as it prepares to sell off 49.5% of its shares to a private partner. Despite its national fixed line monopoly, Hondutel has been posting annual losses of US$200m and is practically bankrupt. In January, the national congress appointed a board (junta interventora) to lead the privatisation process. A trust to administer the company finances has also been created. It is unclear whether the company has found a willing partner yet.

“I want to send a message to transport workers, to those I listened to on the campaign trail, who called for decentralisation, for transparency, that they could make their payments via banks, this proposal includes all that. And to those that have been delinquenting, we know already and we are going to take actions”, he declared.

A week previously, on 3 March, the proactive new president ordered that the country’s 17 customs posts be intervened “immediately” in a bid to crack down on irregularities. At a press conference the minister of the presidency, Reinaldo Sánchez, expressed full government support for the head of the national tax agency (Dirección Ejecutiva de Ingresos [DEI]), Miriam Guzmán, who also heads up the new FNA. Guzmán was one of the very first appointments announced by Hernández after his election in November 2013 and appears to be a key figure in the new administration. Calling on Hondurans to report “any kind of irregularity”, Sánchez warned that any customs agency staff found to be “confabulating” with tax evasion would be sacked and brought to justice. President Hernández stressed that the government intended to do what was necessary to return “peace, tranquillity and transparency, and Hondurans should know that every cent in tax is going to be used as it should be”.

In late February the government had ordered airports intervened as part of the fight against drug trafficking and other criminal activity, including money laundering. On 26 February, a newly constituted inter-agency force, Fuerza Interagencial de Seguridad Aeroportuaria (Fisa), took over the country’s four main airports - Toncontín (Tegucigalpa), Ramón Villeda Morales (San Pedro Sula), Golosón (La Ceiba) and Juan Manuel Gálvez (Roatán) - be taken over.

President Hernández ordered the creation of that new unit in early February, after Panamanian airport authorities seized eight suitcases from three Hondurans en route from Toncontín stuffed with almost US$7.2m in hidden cash. The Honduran authorities later suspended 25 police agents, two anti-drug agents and five security staff at Toncontín over the incident.

The Fisa unit comprises some 300 officers drawn from the national police and the army, as well as civil aviation and migration officials. The national police spokesperson, Julián Hernández, told reporters that the unit would be “in charge of luggage inspections, both incoming and outgoing, and any security-related situation”. Rubén Martell, director of the police special investigations unit (Servicios Especiales de Investigación de la Policía), said the Fisa would be stationed “permanently” at Honduran airports so as to “counterattack crime in its various manifestations”. He added that it would carry out “monitoring, controls and inspections” to “identify and combat crime”, which suggests that it has a fairly broad mandate.

Clawing back precious tax revenues

On official estimates, tax evasion costs the Honduran treasury about US$1.1bn in lost annual revenues. The fiscal deficit in 2013 widened to 7.7% of GDP, from 5.9% in 2012, the ratings agency Moody’s Investors Service suggested in a statement accompanying its latest (27 February) downgrade of the country’s credit rating to B3 (from B2). The cash-strapped Tegucigalpa government is in talks with the International Monetary Fund about a new stand-by loan agreement; a delegation was due in Washington DC on 17-18 March for discussions about conditions. The last US$212m loan expired in March 2012 and the previous government led by President Porfirio Lobo said it was unable to reach agreement with the IMF on a new one, citing the Fund’s tough fiscal prescriptions.

Remittances

Family remittances, originating mostly in the US (home to an estimated 1.0m Hondurans, both legal and illegal), rose 3.76% in the first two months of 2014 to US$454.9m, from US$438.4m in the equivalent year-earlier period, according to the central bank of Honduras (BCH). In calendar 2013, remittances totalled US$3.12bn, up 7.9% on 2012’s US$2.98bn. The BCH expects an inflow of US$3.2bn in 2014, as the US economy (and employment) recovers. Remittances are a key source of foreign exchange for Honduras, which ended 2013 with total international reserves of US$3.0bn, up from only US$2.5bn at end-2012.

Thousands of NGOs lose legal status

On 7 March Interior Minister Rigoberto Chang cancelled the legal status of the local NGO Comité por la Libre Expresión (C-Libre), which monitors the freedom of expression in Honduras. The move followed the publication in the daily gazette of a decree rescinding the legal status of 5,429 NGOs. In early March decree issued by the Unidad de Registro y Seguimiento de Asociaciones Civiles (Ursac), which sits under the interior ministry. Chang said that of an estimated 18,000 "private development organisations" operating in the country, upwards of 5,000 would have their status revoked. On 19 January the former interior minister, Áfrico Madrid (2012-2014), was quoted by the daily *El Heraldo* as saying that following a two-year evaluative process in 2010-2012, some 4,800 NGOs had their status removed as December 2013. Some NGOs complain that the government is moving against those that are critical of it; the government says that many of them operate outside the law and with zero transparency, routinely flouting criteria requiring them to submit annual financial accounts etc. Madrid said of 12,000 NGOs vetted by the interior ministry, some 7,200 were "properly registered" as of December 2013. Chang did not say how he had arrived at his higher estimate of 18,000, which is high for a population of 7.9m.

RETAILING IN BRAZIL

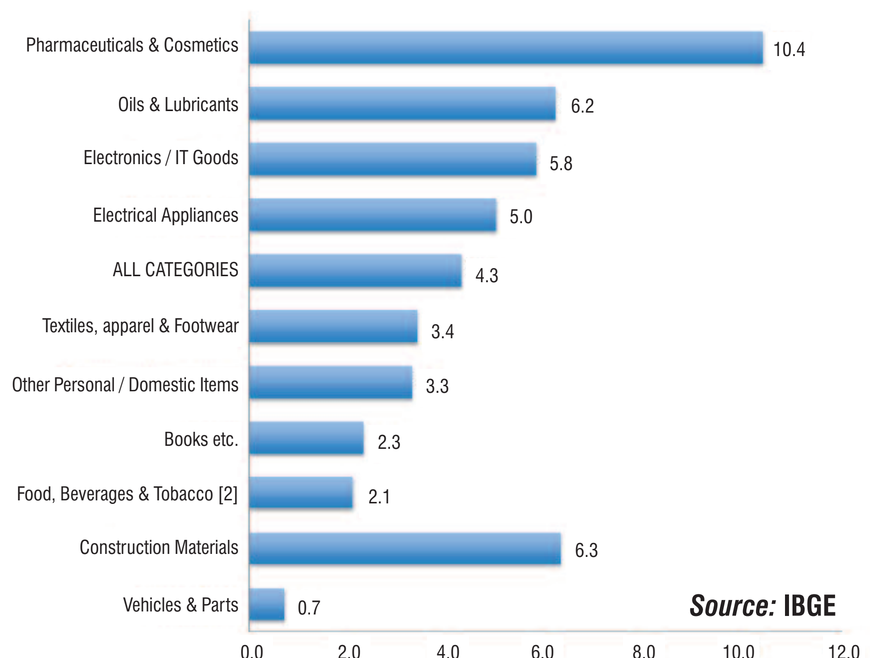
Brazil's resilient retailers – fortune in adversity

Most of the major retailers in Brazil performed well in 2013 - in spite of an often challenging economic environment.

For Brazil's retail industry as a whole, the last year brought slow growth, but it was far from disastrous: this was thanks to sustained demand for discretionary consumer items with relatively low ticket prices. According to national statistics institute (Ibge), sales volumes across all categories (both discretionary and staple) was 4.3% higher in the year to January 31 than in the previous corresponding period (*see chart 1*). For pharmaceuticals and cosmetics, growth in sales volumes was - just - into double digits. There were three other categories of goods for which the growth in sales volumes was 5.0% or more: electric appliances, electronics/IT goods and oil and lubricants.

"As in the rest of the world, online retailing has been booming. According to the department store group Lojas Renner, the number of consumers taking advantage of e-commerce in Brazil rose by 10m, or 20% last year."

Chart 1: Growth in sales volumes in the year to 31 January 2014 (%) [1]



1. Relative to the previous corresponding period
2. Via supermarkets and hypermarkets

Growth in sales volumes for consumer staples was pedestrian. Volumes of textiles, apparel and footwear sold increased by 3.4%. For 'other' personal and domestic items, the corresponding figure was 3.3%. Most significantly, volumes of food, beverages and tobacco sold via supermarkets and hypermarkets increased by just 2.1%.

The Ibge's data highlights two other issues. Sales of big ticket consumer discretionary items have been soft. Sales of vehicles and parts, for instance, grew by just 0.7%. Thanks in part to the building boom associated with the FIFA 2014 World Cup and the Rio de Janeiro Olympics in 2016, demand for construction materials has remained firm, with volumes increasing by 6.3%. Neither vehicles and parts nor construction materials are included in the overall total cited above.

Focusing on corporate successes, rather than difficult conditions

Some of the leading retailers in Brazil - such as GPA, the holding company for leading chains like Pão de Açucár, Extra and Assaí - commented on difficult economic conditions in their reviews of operations through 2013: however, they were the exceptions, rather than the rule. In general, retailers placed much greater emphasis on positive developments arising from corporate strategies which, in some cases, had been in place for years. GPA itself, for instance, noted that it had increased market share in food retailing via "competitive pricing" (*see chart 2 overleaf*).

"If we were to use one word to describe Brazilian retailers, it would be 'resilient'. All have clearly identifiable strengths, such as well entrenched brands, scale and (near) nationwide distribution. Without exception, the major retailers have endured previous economic conditions that were far more challenging than the current prevailing winds."

Many of the retailers have been in expansion mode, and have been expanding their networks of outlets and distribution centres. The French group Carrefour, for instance, noted that its Atacadão hypermarket business had nearly 100 outlets across Brazil by the end of 2013. Clothing retailer Cia. Hering opened 77 new stores last year. In accordance with its SEMPRE MAIS BRASIL program, Lojas Americanas has doubled its number of outlets, to 838, since 2010: this includes 109 stores that were opened last year. Lojas Americanas also inaugurated its fourth distribution centre, in Uberlândia, Minas Gerais. GPA's GPA Malls business added 45,000 square metres of gross leasable area, to a total of 288,000 square metres. Cosmetics group Natura invested around BRL554m (US$236m) in logistics, as well as in new production facilities in Cajamar and Pará.

The main exception appears to be the Brazilian operation of the US giant Walmart. Over the course of 2013, Walmart closed 25 underperforming stores in Brazil (and a similar number in China). Walmart also has faced an upsurge in litigation arising from staff cuts in Brazil as the company rationalised its operations in the country.

As in the rest of the world, online retailing has been booming. According to the department store group Lojas Renner, the number of consumers taking advantage of e-commerce in Brazil rose by 10m, or 20% last year. Gross revenues of B2W Digital, the 62.2% subsidiary of Lojas Americanas which claims to be "the leading e-commerce company in Latin America", surged by 28.5% to BRL7.9bn. Among much else, B2W Digital announced a BRL2.4bn (roughly US$1.0bn) capital increase and set up its [B] Seller platform, which gives other merchants the opportunity to operate their own online stores. At the end of 2013, B2W Digital announced the launch of four private label brands - Newme (health/beauty), Meemo (petshop), Topdesk (stationery) and Orb (furniture).

GPA's food business was an exception in that operating profits (EBITDA) slipped by 12.4% to BRL604m (US$256m). For most of the retailers, EBITDA actually rose by double digit amounts in 2013. For the GPA group as a whole, EBITDA increased, albeit by 3% to BRL3.8bn (US$1.6bn). Cia. Hering undertook a major reorganisation, so that the business will be organised around

> “Brazilian retailers - like their counterparts in other parts of the world - understand the benefits of multi-channel distribution: for now, though, B2W Digital appears to be the pre-eminent online retailer.”

Chart 2: What the Brazilian retailers are saying about operations in 2014

Carrefour:
*'Aiming at continuous improvement of its offer and price image to enhance the shopping experience, notably in its three largest markets, France, Brazil and Spain.'

Cia. Hering:
*'2014 begins with important challenges in the economic outlook, with uncertainty regarding the consumption environment and cost pressures to be administered.'
*'The company is planning to open 30 stores in the Hering Kids format and 70 Hering Stores throughout 2014.'

Lojas Americanas:
*'Throughout 2014, we will continue strengthening our multi-channel structure aiming to bring more convenience to our consumers and to offer the best purchase experience.'
*Since 2010, in accordance with its 'SEMPRE MAIS BRASIL' program, the company has doubled the number of bricks-and-mortar stores and has established a presence in three new states - Acre, Amapá and Tocantins.
*B2W Digital is in the middle of a three year expansion plan, allowing the company to move forward in its strategy of being closer to the customers.' B2W Digital recently bought three specialist IT companies - Uniconsult, Ideais and Tarkena - along with Click-Rodo, a transportation company that specialises in logistics for e-commerce. During 2013, B2W Digital boosted its storage capacity by 60%, opening three new distribution centres. 'Other notable achievements included the choice of B2W Digital to operate the entire Ambev online store, including its technological and logistics platforms, and the FIFA online store, which offers licensed products exclusive to the FIFA Brazil 2014 World Cup event.'

Lojas Renner:
*'The outlook is one of higher inflation, interest rates above those of recent years and GDP recording moderate growth.' Renner plans to invest BRL533mn: this includes 25-30 new Renner stores, 6-10 new Camicado stores and 15 new Youcom units. The company will also invest in store remodellings and IT improvements.

Natura:
*'We estimate total capex in 2014 of BRL500mn, with an increased share allocated to IT to expand the Natura Network and to improve and integrate transaction systems in the international operations.'
*'Productivity gains in our network will be driven by increased buying frequency and a greater number of categories purchased by our consumers ...'
*'Despite the ever more competitive environment, we are confident that we have created the conditions for our consultants to more and more business with Natura.'

Walmart:
*'We have initiated actions in Mexico, Brazil and China to improve our operating performance, and this is a priority.'

Sources: **Company reports released in February and March 2014.**

each of its major brands. Carrefour highlighted “excellent performance” across all of the various retail formats that it operates in Brazil.

Brazilian retail in 2014: more of the same

We would draw four conclusions from all this. First, because most of the retailers handle several (or numerous) product categories, they are naturally protected against weakness in any one. Second, thanks to their relationships with their suppliers, good control of costs and the strength of their brands, they have generally not suffered from any erosion in margins. This is at a time that rising inflation (with the Ibge’s main IPCA index up 5.68% in the 12 months to February 2014) would normally be expected to have had some impact on consumers' disposable income. Third, geographic expansion (typically from the South or the Southeast of Brazil towards the Northeast and the West) has brought several of the retailers into contact with first time customers. Finally, Brazilian retailers - like their counterparts in other parts of the world - understand the benefits of multi-channel distribution: for now, though, B2W Digital appears to be the pre-eminent online retailer.

This year will be the second of three years during which B2W Digital is expanding in such a way that it "comes closer to its customers". B2W Digital has bought specialist IT companies and has taken other steps to (dramatically) increase its logistics/distribution capacity. B2W Digital is also becoming a substantial provider of solutions to other retailers/ brand owners that want to distribute online: B2W Digital recently has won clients including the brewery giant Ambev and, in advance of the Brazil 2014 World Cup, FIFA.

Comments from the various other retailers vis-à-vis 2014 suggest that they expect the main trends of 2013 to continue. None of them expect overall consumer spending to increase rapidly: however, several are confident that they will be able to increase the efficiency of their own networks. Natura, for instance, is looking for its customers to buy a greater variety of products, and with increased frequency, from its 1.28m sales consultants across Brazil. New stores are being opened and others are being remodelled. Investment in distribution, logistics and IT will be considerable.

If we were to use one word to describe Brazilian retailers, it would be 'resilient'. Although some have undertaken substantial initiatives in consumer finance, (e.g. introducing own-brand credit cards), they are not depending for growth on increased spending by already-indebted consumers. All have clearly identifiable strengths, such as well entrenched brands, scale and (near) nationwide distribution. Without exception, the major retailers have endured previous economic conditions that were far more challenging than the current prevailing winds. They are now very well placed to benefit from the improving economic situations - and expectations - of lower income groups, as they look to step up into Brazil's new middle class.

Industrial production recovers from low base

Industrial production rose 2.9% month-on-month (m-o-m) in January, recovering from December's steep 3.7% m-o-m contraction, the worst monthly fall since December 2008. It fell 2.4% year-on-year however, according to the Ibge's IP index. The Ibge revised down December's annual result to 2.5%, from an earlier 2.3%. Capital goods output rose 10% m-o-m in January, bouncing back on a low base from a sharp 11.65% m-o-m contraction in December. Within this, automotive sector output rose for the first time in four months (8.7% m-o-m), as collective vacations ended. Consumer goods rose 2. 3% m-o-m and intermediate goods 1.2%. Of the 27 industrial sectors surveyed, 17 expanded in January from December.

BRAZIL | ECONOMY

Made to measure

The cut in the official primary surplus target to 1.9% of GDP for 2014, from 2.3% previously, was welcomed by private economists as an overdue 'reality check'.

Announcing the move at a press conference on 20 February, Finance Minister Guido Mantega said the government would freeze R$44bn (US$18.44bn) in public spending to meet the primary surplus target, up from R$38bn last year. "Our projections are attainable and realistic and conservative, so we should deliver this result in December," he stated. The revised projection is based on real GDP growth of 2.5% year-on-year in 2014 (down from a previous forecast of 3.8%), with inflation of 5.3% (down from 5.8% previously).

Markets welcomed the move and the Real rose 1% in response to close the day at R$2.37/US$, its strongest level since 21 January. Yet fiscal analysts remain slightly sceptical as to whether the government will be able to deliver on its promise ahead of President Rousseff's bid for re-election in October. Steadily shrinking primary surpluses mean that the overall budget deficit hit a three-year high of 3.2% of GDP in 2013, up from 2.48% in 2012.

Energy subsidies

Following shock blackouts affecting 6m people across 11 southern and eastern states on 11 February (which the government insisted had nothing to do with the increase in demand caused by the heatwave being experienced in much of the country), the Rousseff government on 13 March announced new measures in support of electricity distributors struggling with high power costs on the back of the recent drought, and also in an effort to contain inflationary utility prices rises this election year. Under the package, the government will provide an additional R$4.0bn (US$1.7bn) of financial support (i.e. subsidies) for power distributors, who have been forced to pay more for thermal power to cover a drop in hydroelectricity supplies, while

the country's electricity clearing house will also be permitted to see up to R$8.0bn in private financing to support the distributors. The government will also auction off any excess electricity in April Gradual electricity prices rises will be allowed as of 2015 only, when Rousseff hopes to be safely back in the Planalto for a second four-year term.

Treasury secretary Arno Augustin said the R$4.9bn in subsidies would be covered by an extension of a corporate tax settlement program and possible tax increases this year, with specifying. Critics said the measure was a short-term fix to repress inflation in an election year and expressed scepticism as to the government's insistence that the measures will be fiscally neutral.

Govt denies electricity rationing on the cards

The federal government puts the prospect of energy rationing in the country at just 2%-3%, below the 5% that the main grid operator, Operador Nacional do Sistema Elétrico (ONS), works with on a permanent basis, according to Paulo Pedrosa, executive president of Associação Brasileira de Grandes Consumidores Industriais de Energia e de Consumidores Livres (Abrace), who made the announcement on 18 March after a meeting between the government and electricity sector representatives. Operators told Energy Minister Edison Lobão that the main hydro plants in the country were in a 'delicate' situation, with reservoirs, particularly in the populous and industrialised south and south east of the country, at their lowest levels since 2001. Hydro plants provide about 70% percent of Brazil's power. The last major blackouts were in 2001, following a previous drought. Pedrosa said the Rousseff government had painted a 'much more positive scenario' than feared, although some of the government's optimism seemed to be founded on long-range weather forecasts projecting rain soon.

Water shortages are already forcing supply restrictions

Brazil's main water utility, Companhia de Saneamento Básico do Estado de São Paulo (SABESP), in mid March began limiting the amount of water it supplies to the state of São Paulo, after the federal and state water agencies ordered the company to conserve its primary source by reducing the water drained from the Cantareira reservoir by 15.5%. The Cantareira is the biggest of six reservoirs supplying metropolitan São Paulo, home to 20m people and one of the host cities in the upcoming Fifa World Cup in June and July. On 12 March, Mauricio Tolmasquim, president of the state energy research agency Empresa de Pesquisa Energética (which sits under the energy ministry), said the drought affecting the country since early this year may be worst in 80 years.

Credit

According to latest data from the local consultancy Tendências Consultoria Integrada (TCI), household credit for 2014 is projected to post its lowest rate of expansion since 2003. Faced with rising interest rates, Brazilian consumers are tightening their belts. The reluctance to spend will not help to accelerate Brazil's sluggish economy, and suggests that, in an election year, voters are increasingly conscious of the slow-down. Though President Rousseff is still riding high in the opinion polls, Brazil's unimpressive economic performance provides her opponents with some ammunition.

When adjusted for inflation, the rate of credit growth in 2014 is projected to be 7.8%. In 2013, it was 9.8%, and in 2012 and 2011 it was well over 10%. Between 2004-2011, credit growth averaged 18.7% a year. "After a consumer credit party, this will be a year of moderate growth", Mariana Oliveira, an economist from the TCI, said. Oliveira attributed the slow-down primarily to banks' attempts to limit mortgage lending. In 2010, mortgage lending grew by 47%; this year, it is predicted to be 18%. Following the rise in the Selic, real estate loans rose on average 0.6% in 2013, reaching 36%. According to Oliveira, that figure is set to rise to 39.6% in 2014.

Trade deficit worsens

According to the industry and trade ministry (Mdic), in mid March reported an accumulated year to date trade deficit of US$5.78bn, on exports of US$39.6bn and imports of US$45.3bn. The trade account tends to be in deficit in the first quarter, ahead of the agri harvest, however the size of the deficit this year has alarmed some private economists. Brazil is facing a combination of global lower commodity prices and problems in Argentina, its main market for manufactured exports.

Continued overleaf

The banks themselves, however, have a different explanation for the tightening in consumer credit. José Ramos Rocha Neto, the head of loans and financing at Bradesco, says the rise in the Selic has a marginal impact on consumers. Instead, he argues that Brazilians are merely becoming cannier. “That behaviour of six years ago, when the consumer was happy to rack up credit, has diminished. He is more aware”, he said. Rocha said banks were responding by trying to reduce their consumers’ personal indebtedness by switching them to cheaper lines of credit.

Nicola Tingas, the chief economist of the Associação Nacional das Instituições de Crédito, Financiamento e Investimento (Acrefi), said the Brazilian credit market is maturing. Requests for payment by instalment are also slowing, indicating either reluctance by shopkeepers to extend credit or unwillingness on the part of consumers to commit to expensive purchases.

Still no real sign of traction

The central bank’s IBC-Br grew a better-than-expected 1.26% month-on-month in January as strong retail sales of items like air conditioners in the hot weather offset most of the sharp downturn in December (-1.4%), the central bank noted on 14 March. It rose just 0.93% year-on-year, however.

The latest (14 March) consensus forecast of local private economists compiled by the central bank for its weekly ‘Focus’ report was unchanged, with a forecast for real annual GDP growth of just 1.7% in 2014, down from 1.8% a month previously. The industrial production forecast was 1.4%, down from 1.9% a month previously. Inflation forecasts were lifted to 6.11%, on higher February results, when the IPCA index was 5.68% year-on-year at the start of the school year.

Exports of raw materials fell 8.5% year-on-year in February to US$7.17bn, with semi-manufactured exports down 8.7% and manufactured exports down 9.2%. Meanwhile a weaker Real makes imports more expensive. Fuel imports rose 7.9% year-on-year in February. The Real was trading at R$2.33/US$ on 19 March, from R$2.38/US$ on 2 January. A year ago it was at R$1.98.

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