CANNING HOUSE EDITION

latin american economy & business

May 2014 - EB-14-05

ISSN 0960-8702

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

Latin American Newsletters since 1967

How deep is the coming recession in Argentina?

The debate in Argentina is no longer about whether there will be a recession or not this year, but about how deep it will be. The available indicators suggest the downturn intensified in the second quarter. It is not yet clear how the government, which has managed a decade of fairly consistent growth, will handle an economy that is now moving in the opposite direction.

Managing a recession is always tricky, but the team under Economy Minister Axel Kicillof has an additional handicap: because of data revisions it is now more difficult to get an accurate reading of what the economy is actually doing. Most analysts accept that the government is correcting some of the more blatant data manipulation that happened in the past: but comparing 'new' and 'old' numbers still introduces an element of confusion.

The government has revised all GDP data between 2005 and 2013. On 9 May, it published a new spreadsheet showing that growth in that period averaged 5.6% per annum, a full percentage point less than had been previously claimed. In March, Kicillof had cut the estimate for real annual GDP growth in 2013 to 3.0%, down from 4.9% previously.

These corrections have major implications for holders of GDP warrants – debt papers with payouts tied to GDP growth. Some US$1.4bn now seems to have been paid unnecessarily in 2008 (because growth in the revised series was only 3.1% in that year, not the 6.8% claimed at the time). On the other hand, the 2013 revision saved the cash-strapped government from paying out an estimated US$3bn.

What does seem to be beyond doubt is that the economy is heading for recession in 2014. According to the government's revised data, on a quarter-on-quarter basis GDP rose 1% in the third quarter of last year, and contracted by 0.4% in the fourth quarter. Given the sharp devaluation in January of this year, coupled with foreign currency shortages, uncertainty over inflation, falling real wages, and sharp increases in interest rates, everything suggests that first quarter GDP will fall again. Independent economists certainly think so. A *Reuters* poll of economists put the median forecast for 2014 at a 0.4% contraction in GDP. London-based Capital Economics compiles an Argentina Activity Indicator (AAI) which suggests that GDP grew by 2.8% in 2013 (quite close to the government's revised figure), but fell in Q413 and again, by around 0.5% year-on-year, in Q114, indicating that the economy is now in technical recession. Capital Economics expects a full year contraction of 1% in 2014.

Short-term indicators all point the same way. Industrial production was down by 4.5% y-o-y in March; auto production contracted a whopping 25.5%, construction activity fell 6.0%, retail sales 7.5%, home appliances 15.0% and finally new car sales (hit among other things by increased tax rates on luxury models) plummeted 35.5%.

According to the national statistics institute (INDEC), industrial employment fell 1.2% in the first quarter of this year. News from the car industry is particularly worrying for a government that traditionally gets a lot of electoral support from workers in the engineering sector. Iveco, Fiat's truck making division, announced it was laying off 700 workers, while Peugeot-Citroen suspended 1,000 labourers, who will receive 65% of their normal wages. General Motors said it was putting its 2,700 workers at its plant in Alvear, near Rosario, on an enforced four-day week. Moody's Investors Service issued a gloomy report noting that many Argentine companies are struggling with "significant debt coming due in the next 24 months, limited cash in relation to upcoming debt maturities, sizable negative cash flow, a lack of access to committed bank credit facilities, or some combination of these factors".

In early May, the Catholic University published its economic expectations index (IGEE) showing an overall fall of 18 percentage points in the year to March. Consumers are in a pessimistic mood, with 75% expecting their personal income situation to worsen over the next year.

One of the big question marks is how the government will position its policies during the coming recession. Ironically, after many years of condemning traditional IMF-supported adjustment programmes, Kicillof and other members of the economic team may decide they have no option but to do something similar themselves. This would mean letting market-based mechanisms work during the recession to assist a necessary rebalancing of the Argentine economy, one that will reduce domestic living standards levels and switch resources to the export sector, eventually rebuilding foreign currency reserves and pushing them up beyond their current danger levels.

> "Some claim that the government now faces an inescapable crossroads. It can accept the political cost of a recession at home and improve its external payments position – or go the other way, refusing to pay the political price, trying instead to boost domestic consumption but risking a new foreign payments default."

A second and diametrically-opposed option would be intensify market-unfriendly policies, such as state intervention, in an attempt to roll back the recession and stimulate domestic consumption ahead of next year's elections. At times, ministers seem to want to follow this course. They have tried to stop inflation through price controls (an effort which so far this year has had only mixed results). In early May, Cabinet Chief Jorge Capitanich, complaining about high interest rates, threatened banks with "regulatory action by the state". Many economists argue, however, that this second option, a kind of 'Venezuelan style' defiance of the market, would be doomed to failure.

In fact, some claim that the government now faces an inescapable crossroads. It can accept the political cost of a recession at home and improve its external payments position – or go the other way, refusing to pay the political price, trying instead to boost domestic consumption but risking a new foreign payments default. The soya harvest that started in March, by temporarily raising foreign currency earnings, might buy some time until about August some argue, adding that by then the government might be forced to devalue the peso again. Others say the crunch may come sooner. To avoid another maxi devaluation, the authorities may have to rely on a deeper recession, or on some kind of rapprochement with external creditors (such as the Paris Club) that would bring in new capital inflows, or on some combination of both.

However, it does look as if living with the recession is now an unavoidable part of the policy mix. This has led one analyst, Siobhan Morden at Jefferies, to argue that bad news (the recession) is in fact good news (Argentina's external finances improve). As she put it, "it is still too early to assess the extent of the economic recession, but we would interpret a worsening of the economic data as credit positive. This suggests that bad news is good news for Argentina, with an economic recession worse than 2% a necessary precondition to stabilise the external accounts and credit risk".

CHINESE FDI IN LATIN AMERICA

Likely to remain resilient

Even if problems in China's shadow finance system lead to a sharp slowing of its growth - and adverse consequences for the global economy - foreign direct investment (FDI) from China to Latin America will likely remain resilient over the coming years.

The fragility of growth in China is no secret. On 22 May 2014, HSBC noted that its flash purchasing manager's index (PMI) for China's manufacturing sector rose from 48.1 in April to a five month high of 49.7 in May. This indicates that overall activity is still contracting, albeit marginally. HSBC believes that output, new orders and output prices are rising. Hongbin Qu, HSBC's Chief Economist for China, suggests that the government's recent mini-stimulus, and lower financing costs, have had some impact: however, HSBC research suggests that conditions in China's labour markets have continued to deteriorate in recent weeks.

In its latest review of the economies of Latin America, the Spanish multinational banking group BBVA is looking for regional growth of 2.3% in 2014 and 2.5% in 2015. Aside from the softness in China's economy, BBVA considers that the region also faces challenges from two other quarters: slippage in the prices of raw materials, of which Latin America is a large exporter, and the tapering of asset purchases by the US Federal Reserve (which will reduce the funds that would otherwise be available to emerging markets).

"Chinese FDI into Latin America is driven largely by strategic issues relating to the particular industries in question."

BBVA's base case is that the Chinese economy will be able to maintain an economic growth rate of at least 7% per annum. However, BBVA recognises the possibility of a hard landing in China over the next year or so. It defines this as a fall in real GDP growth to around 6% per annum from H2 14 to H2 15, slippage in consumption growth from a little above 8% per annum to a little over 7%; and a slump in investment growth from the current 8% or so to 5% or less.

Such a hard landing would affect the region through various channels: through lower commodity prices, through reduced exports, through damage to household and business confidence in Latin America and most crucially, in our view, through a reduction in the general appetite of global investors for emerging markets risk. Although exports of minerals from the Andean countries (Chile, Peru and Colombia) would be hit hard under this scenario, BBVA notes that in all three countries the governments have ample scope to run counter-cyclical and expansionary policies. The biggest negative impact would be on Brazil: BBVA believes that economic growth in 2014 and 2015 would be 1.3% lower than otherwise, thanks to the hit to export revenues and the lack of scope for the authorities to ease policies. Argentina's soft commodity exports would also suffer, but the overall impact on that economy would be limited. Thanks to its proximity to the (now) steadily growing US, Mexico would be largely unaffected.

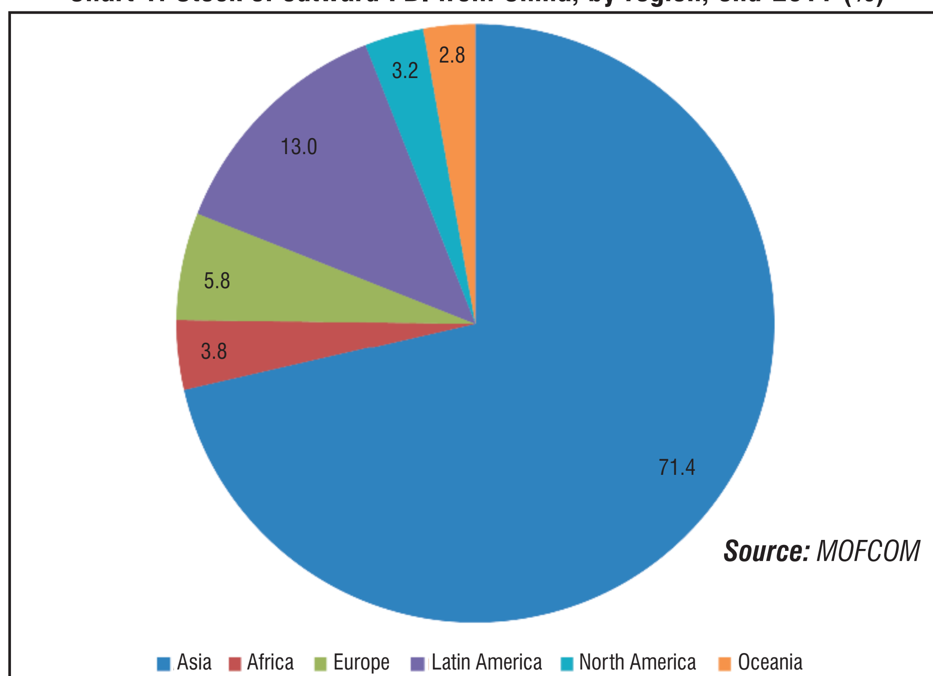
As BBVA notes, the most obvious catalyst for such a hard landing is a major crisis in China's sprawling shadow finance system. Unusually for a senior official at one of the world's most important central banks, Bank of England (BOE) Governor Mark Carney specifically alluded to 'downside risks from the consequences of the rapid growth of shadow banking in China' in his introduction to the BOE's latest inflation report on 14 May 2014. We believe that the likelihood of a crisis emanating from China's shadow finance system before the end of this year is at least 50%: it is possible that we are more bearish in this respect than BBVA (or the BOE).

An obvious question, therefore, is what the impact of such a hard landing might be on foreign direct investment (FDI) flows from China to Latin America. Latin America governments take varying positions towards neo-liberal orthodoxy, free trade and the importance of relations with the US; nonetheless, almost all welcome FDI from China. From the point of view of Chinese businesses (often, but not always, large state-owned enterprises), Latin America offers access to raw materials that are scarce at home, and other market opportunities.

According to China's Ministry of Commerce (MOFCOM), Asia received 71% of the stock of China's outwards FDI at the end of 2011. A similar percentage of the Chinese entities making this investment (but a lower percentage of the money involved) were manufacturing entities. The reasonable conclusion is that much of China's FDI involves investment in more cost effective operations in nearby (and culturally familiar) countries in (mainly) South East Asia. MOFCOM suggests that 13% of the stock of outwards FDI was destined for Latin America and the Caribbean. However, this figure includes investment that was channelled through regional offshore financial centres such as the British Virgin Islands (BVI) and the Cayman Islands. Conversely, it does not include (significant) investment into Latin American countries through offshore financial centres in other parts of the world (such as Luxembourg) **[Chart 1]**.

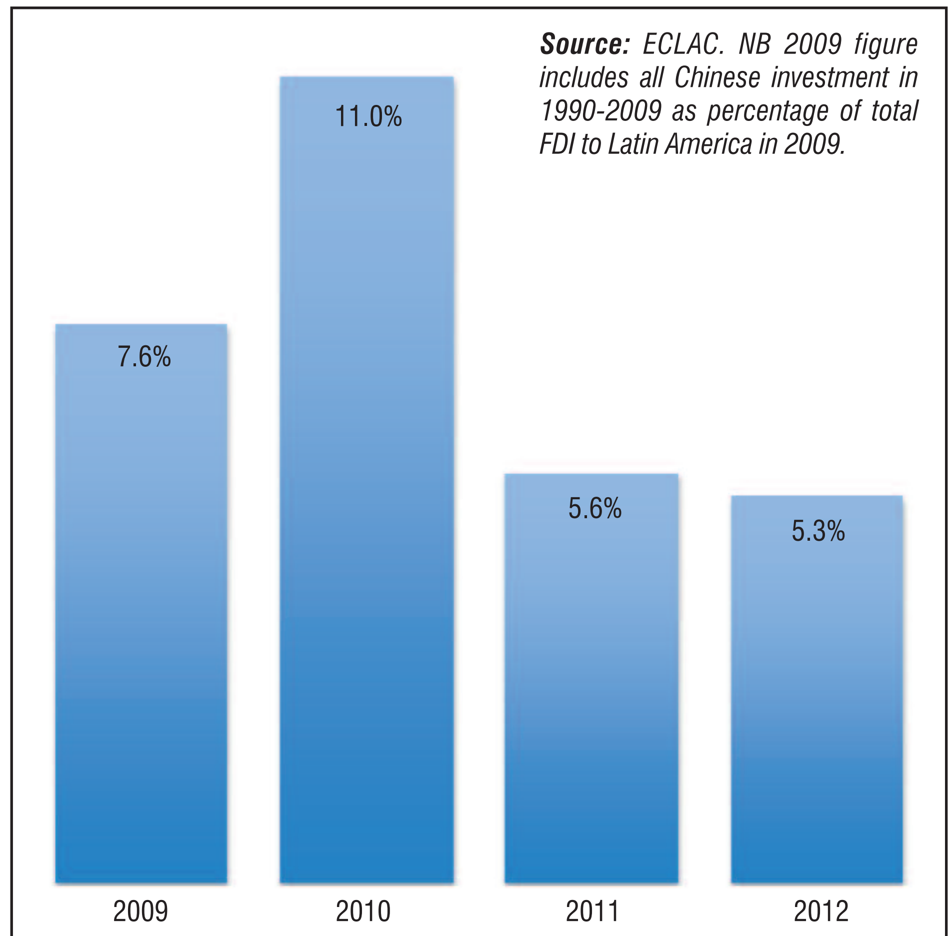
"The reasonable conclusion is that much of China's FDI involves investment in more cost effective operations in nearby (and culturally familiar) countries in (mainly) South East Asia."

Chart 1: Stock of outward FDI from China, by region, end-2011 (%)



In a working paper published in November 2013, '*Chinese foreign direct investment in Latin America*', the United Nations' Economic Commission for Latin America and the Caribbean (ECLAC) noted that the overall stock of Chinese FDI in Latin America had risen from around US$6bn at the end of 2009 to approximately US$40bn. Relative to its size within the global economy, Latin America has been the recipient of a large amount of FDI from China. However, in the overall context of all inwards FDI received by Latin America, China is a fairly unimportant source in nominal terms, whether or not the money is channelled through offshore financial centres. By analysing transactions that have been reported, and using non-official sources, ECLAC produced figures indicating that China accounted for a little over 5% of FDI in Latin America in each of the years 2011 and 2012. The corresponding figure was 11% in 2010, the first year of significant FDI from China to the region. (By contrast, China's total FDI in Latin America between 1990 and 2009 was less that the region received in calendar 2009 **[chart 2]**).

Chart 2: Chinese FDI as portion of total to Latin America



"A major theme has been participation in energy projects by the 'big four' state owned oil companies (China National Petroleum Corporation [CNPC], Sinopec, Sinochem and China National Offshore Oil Corporation [CNOOC]) and other Chinese energy companies."

ECLAC highlights a number of important features of Chinese FDI in Latin America. A major theme has been participation in energy projects by the 'big four' state owned oil companies (China National Petroleum Corporation [CNPC], Sinopec, Sinochem and China National Offshore Oil Corporation [CNOOC]) and other Chinese energy companies. Chinese groups are present in every country in Latin America that exports oil and gas, bar Bolivia and Mexico (where foreign investment in the energy sector is prohibited [although new reforms aim to change that]).

By contrast, Chinese mining companies have concentrated on projects in just two countries - Peru and Brazil. In part because of the unfamiliarity for the Chinese of business practices in Latin America, many of these mining investments are still at an early stage of development. Manufacturers have established operations to serve large local markets (especially Brazil), relying to the maximum extent possible on components that are sourced from China. As appears to be the case with outwards FDI from China generally, the numbers of investments by Chinese manufacturers are relatively large, but small in size. Since 2010, Brazil has accounted for well over half of all Chinese FDI into Latin America; Mexico and Chile for virtually none.

ECLAC's conclusions provide a useful framework within which recent developments involving (actual or potential) investment from China into Latin America can be assessed **[chart 3]**, as follows:

- The IMF's remarks underline the widespread consensus that slower than anticipated growth in China and lower commodity prices is the main source of risk to Latin American as a region over the coming year or so.

- The rise in the number of Chinese companies in Peru indicates that companies in China's energy and mining sector are, collectively, comfortable with the business environment in a country that is unfamiliar and, often,

Chart 3: Chinese FDI into Latin America: selected recent developments	
10-Feb-14	Gong Bencai, the head of the association representing Chinese firms in Peru says that the number of Chinese companies operating there rose from 100 in 2012 to 120 in 2013.
12-Feb-14	Mexico's investment agency Promexico calls for upgrading of transport and communications infrastructure in order to attract FDI from multi-nationals in Asia. Promexico Executive Director Marco Espinosa claims that 50% of companies with over US$10bn in revenue have considered moving part of their factories in Asia to North America.
26-Feb-14	Jinzhao Mining announces plans to submit an environmental impact study for the US$1.5bn Pampa de Pongo iron ore project to the government of Peru by mid-year.
19-Mar-14	IMF Western Hemisphere department director Alejandro Werner says that slower than anticipated growth in China and lower commodity prices are the two main external risks for Latin America's economies in 2014-16.
10-Apr-14	Huawei opens new HQ in Argentina, which will also oversee operations in neighbouring countries and Peru. Huawei looks to double production of smartphones in Tierra del Fuego to 320,000 units this year.
16-Apr-14	Glencore XStrata agrees to sell Las Bambas copper project in Peru to China Minmetals/ Guoxin IIC/ Citic Metal consortium for US$5.85mn.
17-Apr-14	Venalum and Sidor, elements of Venezuelan state-owned conglomerate CVG sign US$750mn agreement with China Minmetals
20-May-14	Institute of the Americas (IOA) energy program director Jeremy Martin cites CNH Commissioner Edgar Rangel, who notes that energy reform could bring US$30bn in investment and create 2mn jobs in Mexico.
Source: *Business News Americas*	

"The rise in the number of Chinese companies in Peru indicates that companies in China's energy and mining sector are, collectively, comfortable with the business environment in a country that is unfamiliar and, often, difficult."

difficult. China Minmetals, Guoxin International Investment Corporation and Citic Metal are, as a consortium, buying the Las Bambas copper project in Peru from the multinational Glencore X-Strata for US$5.85bn. Glencore X-Strata is looking to reduce the gearing on its balance sheet. It describes Las Bambas as "a long-life copper development project with prospective exploration options...which is at an advanced stage of construction and is scheduled to commence production in 2015." The project, located in Cotabambas, in Peru's Apurimac region, had gross assets of US$4.42bn at the end of 2013. Jinzhao Mining is proceeding slowly with the Pampa de Pongo iron ore project.

• Two observers, Jeremy Martin at the Institute of the Americas of the University of California at San Diego (UCSD) and ProMéxico Executive Director Marco Espinosa, have alluded to the possibility of a sharp increase in Chinese FDI into Mexico, targeting the energy and manufacturing sectors respectively. Once new laws actually open up the energy sector to inwards FDI, we would expect Chinese players to buy assets in Mexico, given their enthusiasm for the region as a whole. Such purchases may involve JVs with Pemex or with other foreign multinationals also keen to take advantage of the liberalisation of Mexico's energy sector. We are far less convinced that China's manufacturers will be keen to relocate to Mexico. Although Mexico provides ready access to the US market, it is also characterised by competition from world-class and often multi-national businesses: China's manufacturers would be facing companies with established brands and distribution channels, as well as a deep understanding of what is (for the Chinese) an unfamiliar business environment; and (much) greater access to global capital markets. The Chinese manufacturers that have set up operations in Brazil have, to some extent, been shielded by that country's protectionist trade barriers.

• Huawei's expansion in Argentina (and other countries in the region) is a classic example of how Chinese manufacturers approach Latin America. The manufacturing operations support the import of Chinese-made components and know-how. We presume that Huawei receives substantial tax breaks to operate from Tierra del Fuego.

• The mid-April deal between China Minmetals on one hand and Venezuela's Venalum and Sidor on the other is a good example of how the agencies of the government of Venezuela can usefully provide access to large-scale funding through unorthodox sources (in this case, apparently, in order to boost production by the above units of the state-owned minerals conglomerate CVG): in return, Chinese influence with the Venezuelan government is increased.

In short, Chinese FDI into Latin America is driven largely by strategic issues relating to the particular industries in question. Whether or not a crisis in China's shadow finance sector produces a sharp slowdown in Chinese economic growth remains to be seen. In any event though, we would expect Chinese FDI in Latin America to remain resilient. In an environment of weaker commodity prices, it is possible that inwards FDI in the minerals and energy sectors could actually increase following a crisis - simply because assets would be for sale at lower prices than would otherwise have been the case. Conversely, as BBVA has noted, a crisis that is 'made in China' would have an adverse impact on Brazil, the largest regional economy, where on balance, it is more likely that inwards FDI from Chinese manufacturers would fall.

> "Among global emerging markets, Mexico stands out for the number of large retailers present in the local market."

REGIONAL BUSINESS FOCUS 2

RETAILING IN MEXICO

At the nadir of their fortunes

Almost all of Mexico's leading retailers have been affected by the recent softness in domestic consumption, which has persisted into Q1 14. However, they have also kept good control of costs and margins. When Mexican consumers open their wallets again, operating profits should surge.

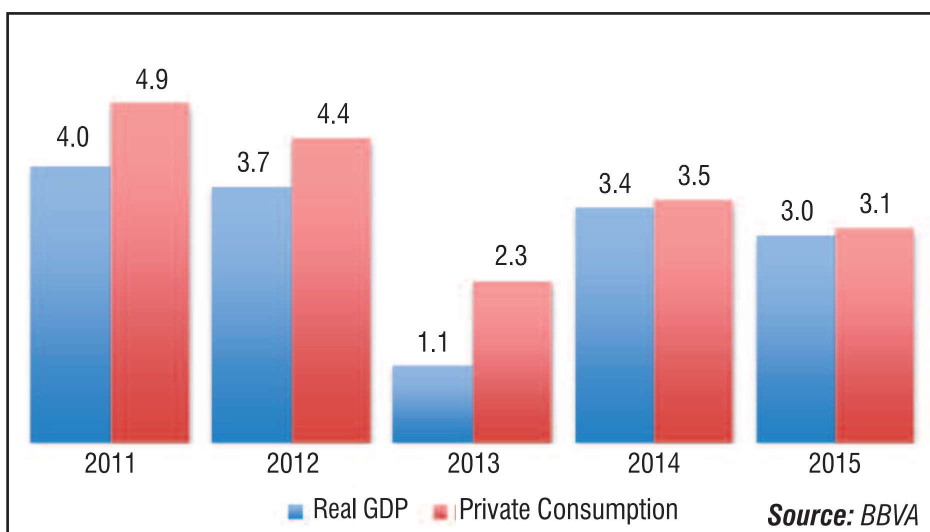
Among global emerging markets, Mexico stands out for the number of large retailers present in the local market. Earlier this year, the international consultancy Deloitte published its annual *Global Powers of Retailing Report* which, among other things, ranked the world's top 250 retailers in terms of 2012 revenues. The list included five Mexican groups - Soriana, FEMSA Comercio, Coppel, Chedraui and Liverpool. In the previous year, the ranking also had included Controladora Comercial. By way of contrast, the latest ranking included 10 companies from China/Hong Kong, three from Russia, one (Lojas Americanas) from Brazil and none from India. The only other Latin American names in the ranking were three Chilean groups - Cencosud, SMU and SACI Falabella.

Of course, Mexican retailers are not just competing with each other. The titan of the market is Walmart de México y Centroamérica (Walmex), the local operation of the US giant Wal-Mart. Wal-Mart topped the ranking in the *Global Powers of Retailing*, with overall sales in 2012 of US$469.2bn. Walmex's leadership is not just reflected in the absolute scale of its operation in Mexico, but also in the strength of the brands that it has established in the country. A ranking of the 10 leading retail brands in Mexico compiled by consultancy Interbrands includes three - Bodega Aurrera, Superama and Suburbia - that are part of Walmex's massive business **[chart 1]**.

Chart 1: Interbrands' 10 top Mexican retail brands of 2014			
Brand	**Est. Value**	**Format**	**Affiliation**
OXXO	US$2,615mn	Convenience store	FEMSA Comercio
Bodega Aurrera	US$1,016mn	Supermarket	Walmex
Liverpool	US$486mn	Department store	El Puerto de Liverpool
Elektra	US$385mn	Electrical goods and home fittings	Grupo Salinas
Superama	US$319mn	Supermarket	Walmex
Suburbia	US$173mn	Clothing	Walmex
Sanborns	US$118mn	Department store	Grupo Sanborns
Farmacias Benevides	US$76mn	Pharmacy chain	Farmacias Benevides
Nutrisa	US$44mn	Health food products etc.	Herdez
El Palacio de Hierro	US$16mn	Department store	Grupo Palacio de Hierro
Source: *Interbrands*			

Size and strength do not necessarily go hand in hand with growth. In part because of softness in the labour market, and in part because of the impact on household incomes of tax increases, private consumption spending in Mexico has been weak over much of the last two years. Real GDP and private consumption increased by 3.7% and 4.4% respectively in 2012. In 2013, the corresponding figures were 1.1% and 2.3% respectively, on calculations by Spain's BBVA. For 2014, BBVA expects real GDP growth of 3.4% and private consumption growth of 3.5% **[chart 2]**.

Chart 2: Mexico: Growth in real GDP and private consumption (%)



"Unsurprisingly, the latest figures published by the Asociación Nacional de Tiendas de Autoservicio y Departamentales (ANTAD - the Mexican retailers' trade association) make fairly depressing reading..."

Unsurprisingly, the latest figures published by the Asociación Nacional de Tiendas de Autoservicio y Departamentales (ANTAD - the Mexican retailers' trade association) make fairly depressing reading. On a same-store basis, sales were down relative to those of the same year-earlier month in December 2013 (-0.4%), January 2014 (-1.7%), February (-0.2%) and March (-2.4%). Sales had also fallen in September and October 2013. Taking into account the opening of new stores, year-on-year sales growth has been running at 2.0%-4.4% since the beginning of 2014. ANTAD noted that sales were up 2.4% year-on-year on a same-stores basis in April 2014, and by 6.8% including new stores; however, these figures were almost certainly influenced by the (positive) effect of the timing of Easter, which fell later this year than in 2013. ANTAD publishes figures for supermarkets, clothing and

footwear and general merchandise: all three series demonstrated similar patterns to the overall sales data.

For Q1 14, all the leading retailers - regardless of the format(s) of their outlets or specialisations in terms of merchandise - published results that pointed to anaemic growth in sales in relation to the previous corresponding period. Walmex, by far the largest of the majors, achieved growth in net sales of 2.1% to MXN101,405m, thanks in part to new store openings and gains in market share - achieved by price reductions in the Bodega Aurrera, Superama and Walmart Supercenter formats. Walmex also benefited from double-digit growth in small format outlets such as Bodega Aurrera Express and stand-alone pharmacies.

In its comments on its Q1 14 results (on 22 April), Walmex highlighted a number of challenges. Scot Rank, Walmex president and CEO, noted that consolidated general expenses had risen by 6.4%. 'The strongest increases were in utilities, as we had double-digit growth in electricity tariffs, infrastructure investments: mainly rents, depreciation and maintenance.' Walmex's personnel costs also grew faster than sales. Traffic has been falling at the Sam's Club retail warehouse clubs, which account for just over one quarter of Walmex's sales in Mexico. According to Mr Rank, Walmex is 'improving service to members and working on merchandise differentiation.'

Pharmacy appears to have been a relatively resilient sub-sector. Farmacias Benevides, which operates nearly 900 outlets in 155 cities in the north and west of Mexico, reported that, on a same stores basis, its sales rose by 3.4% in Q1 14 relative to the first three months of 2013. The company opened 16 new outlets in Q1 14, with the result that overall net sales were up 8.7%. Several of the leaders, including Controladora Comercial Mexicana, Liverpool, Sanborns and Soriana, reported that, on a same stores basis, net sales were lower in at least parts of their respective businesses **[chart 3]**.

Although many of the retailers have a significant online presence, and ability to provide credit to their customers by way of credit cards, none alluded in their comments on Q1 14 results to growth in sales via the Internet. The implication is that online sales are also suffering from the general disinclination of Mexican consumers to buy.

However, the results also highlight the considerable strengths of Mexico's leading retailers. Aside from Farmacias Benevides, which is focusing on expansion, all the majors reported better growth in gross profits (i.e. net sales less cost of goods sold, or a useful measure of the performance of the retailing operations). Grupo Sanborns, which operates a variety of department stores, specialised stores and restaurants, reported an increase in gross profit: this was even though, on a same stores basis, sales were down by 2%-6% relative to Q1 13 in the group's various businesses.

All the majors alluded to substantial capital expenditure (Capex) during the first three months of this year. In some cases, this related to the opening of new stores; in others, to remodelling of stores and new sales/marketing strategies. The obvious conclusion is that the retailers have been able to pass much of the pain of weak demand onto their suppliers: this has provided them with a boost to cash flow that has enabled them to invest for the future.

It remains to be seen what might prove the ultimate catalyst for a recovery in retailers' revenues. For instance, it is possible that Q2 14 will, thanks to the clear improvement in the US economy, produce an improvement in remittances to, wages in and/or consumer confidence in Mexico. The figures published by ANTAD in June 2014 and July 2014 (in relation to the preceding month in each case) should provide a useful indication as to what is happening.

"It remains to be seen what might prove the ultimate catalyst for a recovery in retailers' revenues. For instance, it is possible that Q2 14 will, thanks to the clear improvement in the US economy, produce an improvement in remittances to, wages in and/or consumer confidence in Mexico."

First Quarter of 2014: What the leading Mexican retailers are saying

Grupo Comercial Chedraui SAB de CV
In brief: supermarket/ hypermarket and discount warehouse operator with 212 outlets in Mexico (Chedraui and Súper Chedraui) and 45 in USA (El Súper)
Net sales of MXN16,701mn (up 5.3%)
Gross profit of MXN3,313mn (up 6.0%)
Same store sales up 1.1% in Mexico and 1.4% in USA
Capex of MXN303mn
One store opened in Veracruz in 1Q14

Controladora Comercial Mexicana SAB de CV
In brief: 'Holding company that operates in the Mexican retail sector through hypermarkets and supermarkets, offering groceries, perishables and pharmacy, non-food items such as general merchandise and clothing as well as a restaurant chain' (Self description). Brands include Comercial Mexicana, Mega, Bodega, Sumesa, City Market, Fresko and Alprecio (199 outlets), as well as BeerFactory and California Restaurantes. (68 outlets)
Net sales of MXN10,616mn (down 0.8%)
Gross profit of MXN2,714mn (unchanged)
Same store sales down 0.9%
Capex of MXN250mn.
One Fresko outlet opened in Huixquilucan, México state

Grupo Elektra SAB de CV
In Brief: 'Latin America's leading specialty retailer and financial services company and the largest non-bank provider of cash advance services in the USA' (Self description) There are 3,781 points of sale in Mexico (Elektra, Salinas y Rocha, Freestanding branches and Blockbuster), 622 points of sale in Central and South America and 2,446 in North America (Advance America)
Commercial sales of MXN5,154mn (up 1%)
Gross commercial profit of MXN1,691mn (up 13%)

Farmacias Benevides SAB de CV
In Brief: Pharmacy chain with 899 outlets across 155 cities and 22 states in the north and west of Mexico.
Net sales of MXN2,976mn (up 8.7%)
Gross profit of MXN712mn (up 7.0%)
Same stores sales up 3.4%.
16 new stores opened in 1Q14.

FEMSA Comercio (element of Fomento Económico Mexicano SAB de CV)
In Brief: Retail arm of FEMSA conglomerate (with regional brewing and bottling interests). FEMSA comercio operates 11,856 outlets of small-format chain stores under various brands, including OXXO, 'the largest and fastest-growing chain of stores in Latin America.' (Self description).
Net revenues of MXN24,371mn (up
Gross profit of MXN8,102bn (up 12.2%)
Same store sales up 0.4%
Capex of MXN898mn
Net new openings of stores in 1Q14 were 135.

Grupo Sanborns SAB de CV
In Brief: 'The company has a unique portfolio of multiple formats including department stores, specialised stores, entertainment and electronics, convenience, luxury and restaurants.' (Self description). The main brands are Sears (80 units), Sanborns (168), iShop/Mixup (112) and Other (Central America, Sanborns Café, DAX, Saks Fifth Avenue and Boutiques - 64).
Net sales of MXN9,024mn (down 0.5%)
Gross profit of MXN3,644mn (up 1.0%)
'Same store sales in Sears, Sanborns and iShop/Mixup decreased 2.0%, 5.8% and 4.9% respectively.'
Capex of MXN298mn
During 1Q14, 3 iShops and one Sanborns Café were opened. 2 Sears stores were (planned to be) opened in April 2014.

El Puerto de Liverpool SAB de CV

In Brief: The company 'is the largest full-scale department store company in Mexico, with 102 unites in operation under three different brand names - Liverpool Fábricas de Francia and Liverpool Duty Free.' The company is present in 57 cities. Its real estate operations include 22 shopping malls in 15 cities. It is the third largest credit card issuer in Mexico, with over 3.5mn cards. (Self description)

Net sales of MXN12,790mn (up 7.0%)

Gross profit of MXN6,310mn (up 12.1%)

'Same store sales for department stores grew 2.3%, whereas for supermarkets, they declined by 2.7%.'

Capex 'related to expansion and modeling projects reached the amount of MXN1,213mn.'

During 1Q14, a Liverpool store and an Aéropostale boutique were opened in the Antea shopping centre of Queretaro city. In April 2014, three other outlets (one each of Sfera, Aéropostale and Chicos) were opened.

Organización Soriana SAB de CV

In Brief: Operates 261 Soriana hypermarkets, 122 Soriana supermarkets, 140 Mercado Soriana outlets, 103 Soriana Express outlets and 33 City Club outlets. The group is present in 32 states of Mexico.

Net sales of MXN23,823mn (down 6.0%)

Gross profit of MXN5,287mn (down 2.5%)

Same store sales (down 8.2%)

Capex of MXN251mn (down 64.6%)

Soriana has been opening stores in most of its formats, but especially Soriana supermarkets, Mercado Soriana and Soriana Express.

Walmart de México y Centroamérica (Walmex)

In Brief: Mexican operation of US-based retail giant Wal-Mart. Operates through Walmart Supercenter (243 outlets), Bodega Aurrera (437), Mi Bodega Aurrera (294), Bodega Aurrera Express (866), Superama (92), Suburbia (109), Farmacia Walmart (10) and Sam's Club (156) formats. Sam's Club discount operation accounts for about 26% of revenue.

Net Sales of MXN101,405mn (up 2.1%)

Gross profit of MXN22,393mn (up 3.6%)

New openings included 8 units in Mexico and 7 in Central America.

Walmex has been gaining market share thanks to price reductions (in the Bodega Aurrera, Superama and Walmart Supercenter formats). Small formats such as Bodega Aurrera Express and standalone pharmacies have achieved double digit growth. Superama's online grocery business has been growing. However, Sam's Club has been performing below expectations. (Company comments)

Source: *Company reports*

It is also possible that at least some of the retailers benefit from initiatives to promote their own consumer lending businesses. In an otherwise lacklustre Q1 14, Walmex reported that the number of Banco Wal-Mart cards issued was 34% greater than in Q1 13: sales to holders of Banco Wal-Mart cards were up 40% relative to the previous corresponding period.

Overall though, the clear recovery in the US economy and, as foreseen by commentators such as BBVA, the likely acceleration in Mexico's economic growth through 2014, means that the retailers should enjoy a significant bounce in revenues and gross profits at some point in the next 12 months. In good times and bad, the leading Mexican retailers benefit from the strengths that they need to compete with each other, to build valuable brands and to hold their own against the world's largest retail chain. Mexico's retail trade is an aspect of the economy that undoubtedly is world class. In Q1 14, though, the retailers were at a nadir in their fortunes.

REGION

Too many small businesses?

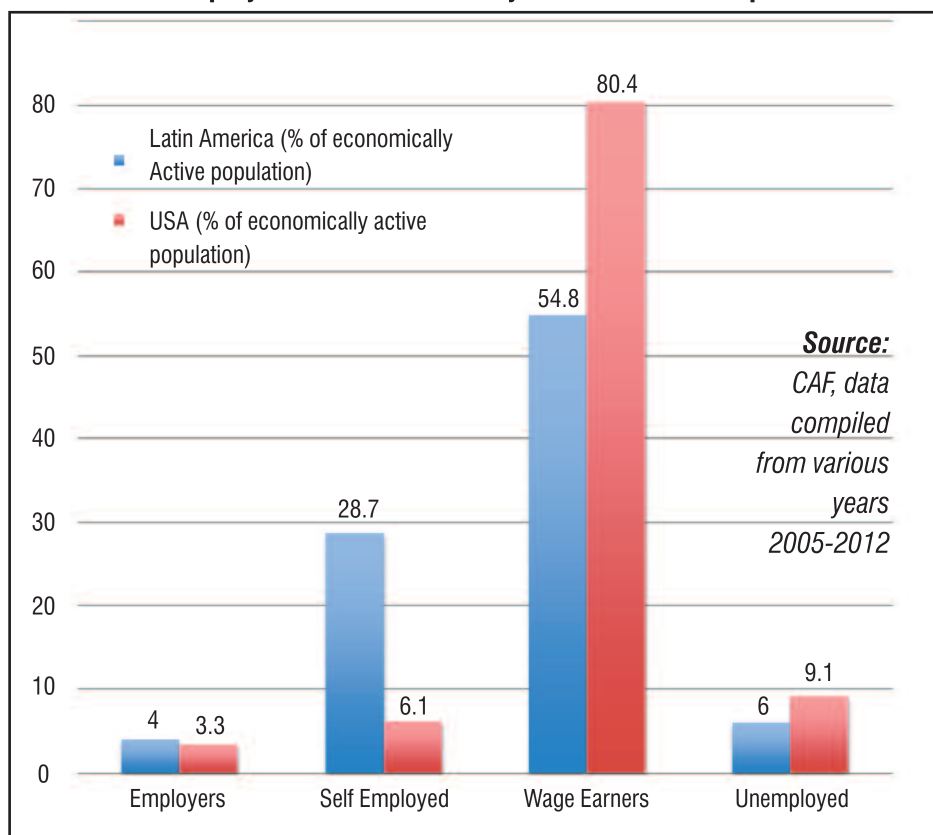
Small enterprises are often believed to play a very positive role in developing (and developed) economies: they are associated with innovation, flexibility and the ability to seize new opportunities in a way that ponderous, process-bound large organisations cannot. So it is perhaps surprising to hear that one of the conclusions of a 2013 report by the Development Bank of Latin America (CAF), is that Latin America has too many small businesses.

According to the CAF report, entitled *Emprendimientos en América Latina: desde la subsistencia hacia la transformación productive (2013)*, about one third of Latin America's employed labour force (28%) is currently working in a small company of some kind.

In some countries, such as Honduras, the proportion rises higher, to around 45%. Pablo Sanguinetti, head of the CAF research team that wrote the report, doesn't mince his words. "There are too many small companies in Latin America", he says. His basic argument is that too many people end up working in small businesses, not from a positive desire to become an entrepreneur equipped with the necessary tools to succeed, but simply for a lack of alternatives. Because of this, many of these businesses bump along a survival path, unable to spread their wings and perform any kind of economic take-off.

"Of the total number of small businesses in the region, CAF estimates that only 25% - one in four – have the capacity to break out and achieve dynamic growth."

Self Employment Not Necessarily An Aide To Development?



The numbers in part explains the problem. Proportionately, there are many more small businesses in Latin America than in developed economies. While one in three Latin Americans are running his or her own business, the

proportion in the US is only one in ten. This is linked to the much greater size of the informal and non-wage earning sector in Latin America. In the US, 80.4% of those in employment are wage earners, while in Latin America the average comes down to only 54.8%. Within this regional average, the proportion of wage earners relative to the total in employment in Latin America is lowest in Bolivia (37.2%), Peru (41.5%), and Colombia (41.7%). It is highest in relatively more developed local economies such as Argentina (71.3%), Costa Rica (70.6%) and Chile (68.5%).

The fact that many Latin Americans form small businesses as a survival strategy also skews the structure of the sector. Sanguinetti says over 90% of small businesses in the region are very small, with less than four employees. Within this group, the vast majority have no employees at all, but are single-person enterprises or *cuentapropistas*. "They are there, not because they are able to run a dynamic business, but basically because they have no other employment opportunities" Sanguinetti says. Given poor initial skills, low productivity, and limited or zero access to training, most of these companies are therefore unable improve their capacity and skills base, and in consequence are poorly placed to manage a growth transition to the formal, wage paying sector. This is described as an "informality/low productivity trap". Of the total number of small businesses in the region, CAF estimates that only 25% - one in four – have the capacity to break out and achieve dynamic growth.

"They are there, not because they are able to run a dynamic business, but basically because they have no other employment opportunities."

Pablo Sanguinetti

The report notes that its findings have important implications for economic policy. It suggests that some governments counter-productively use the tax system to limit the growth of larger, more productive companies, while offering incentives for the "creation and survival of micro-enterprises that provide employment only for the founder and a few family members, and which offer poor value added." Instead, it recommends a "multidimensional approach" around promoting four key factors in the small company "ecosystem": business talent, innovation, access to finance and skills training programmes.

URUGUAY

The new battle: marijuana vs. tobacco

Highlighted by President José 'Pepe' Mujíca's visit to Washington for a meeting with his US counterpart Barack Obama on 12 May, many commentators have been intrigued by the apparently different treatment of tobacco and marijuana in the small South American country. As if to emphasize the contrast, a week earlier, when new regulations allowing the production and sale of marijuana came into force, the Montevideo senate approved a bill further tightening controls on the sale of tobacco.

Uruguay's experiment with legalising marijuana has been widely reported. Starting this year, it is becoming legal to grow, sell and consume the drug. Under fairly tight state control, pharmacies will sell marijuana at less than US$1 a gramme. While individuals will be able to grow up to six cannabis plants per household for their own consumption, the government is also launching a licensing process for private companies that want to produce the drug for sale through the network of pharmacies. Citizens will be allowed to smoke marijuana in public places where smoking is permitted, but not in workplaces. The government says legalisation is an experiment designed to decriminalise use of the drug, and remove the raison d'être of the drug cartels.

Until recently, the headline-grabbing debate on marijuana distracted attention from Uruguay's progressive tightening of health and other controls on another,

more long-standing and legal drug, tobacco. Mujíca's claim in the White House (made to ex-smoker Obama) that up to 8m people a year are dying from tobacco-related illnesses raised attention, as did the fact that the US tobacco giant Philip Morris is suing Uruguay for US$25m in damages (the company says earlier reports of a US$2bn compensation demand were inaccurate).

Uruguay's recent tobacco story goes back to the presidency of Tabaré Vázquéz (2005-2010), like Mujíca a member of the left-wing Frente Amplio coalition. Vázquéz, a medical doctor and cancer specialist (and the odds-on favourite to win this year's presidential election) was the main architect of tougher legislation on tobacco consumption. In 2006, Uruguay became the first Latin American country and the fifth worldwide to ban tobacco smoking in enclosed public spaces. A 2009 law requiring that graphic health warnings should cover 80% of the surface of cigarette packets followed. That legislation also bans companies from retailing 'sub-brands' (such as Marlboro Red or Marlboro Gold; the argument is that consumers may be led to believe, incorrectly, that some sub-brands, such as 'Lights', are less health-threatening than others). Up for discussion in congress now is a new proposal that cigarette packages should not be displayed at all (customers would have to request them over the counter).

Philip Morris, a proto-typical 'big tobacco' company, with annual sales of US$77bn (greater than Uruguay's GDP of some US$50bn), decided to fight back. Taking advantage of the fact that its corporate headquarters are located in Lausanne, Switzerland, in 2010 the manufacturer of Marlboro, L&M and other popular brands filed a case against Uruguay at the World Bank's International Centre for Settlement of Investment Disputes (ICSID), arguing that the 2009 law violated a Switzerland-Uruguay bilateral investment treaty by infringing intellectual property rights. The ICSID heard arguments from the Philip Morris legal team in March, and will hear Uruguay's position in September. Philip Morris is also preparing similar actions against Australia and Thailand.

"With tobacco, they are bringing to heel a legal industry that is accustomed to operating with scant control, while with marijuana they are taking an industry out from the shadows and putting it under better control."

Whatever the outcome of the ICSID case, there is now a fierce debate in Uruguay itself over whether the government is being consistent over the treatment of these two recreational drugs. Claudio Piacenza of Uruguay's national chamber of commerce (CNC) says the key issue concerns "business rights to trade freely in what is a legal, commercial activity". He says plans to "regulate" tobacco sales are acceptable (citing Colombia as an example), but "prohibition measures" which he implies Uruguay is now getting close to, are not. Constitutional expert Martín Risso says the latest tobacco legislation offers only a "partial vision" of the problem, as it is seeking to protect public health without taking due account of other constitutional rights such as "business, industry, and trade freedoms".

Many accuse the government of being inconsistently 'soft' on marijuana and 'hard' on tobacco. Opposition Senator Carlos Moreira (Partido Nacional) objects to the fact that marijuana will be exempt from the IMESI tax on non-essential consumer items, which is levied at a whopping 68% on cigarettes (government officials say the IMESI may be applied to marijuana at a later date). According to Moreira, "we are making it easier to buy marijuana, and sanctifying marijuana sales. This law will end up encouraging marijuana consumption". Others disagree.

John Walsh, a drugs expert at the Washington Office on Latin America (WOLA), a lobby group, says the government is being consistent. "With tobacco, they are bringing to heel a legal industry that is accustomed to operating with scant control, while with marijuana they are taking an industry out from the shadows and putting it under better control," he maintains.

Bad news – or a buying opportunity?

There has been a lot of bad news recently about Petrobras, Brazil's state-owned oil and gas giant. Production has been weak, first quarter profits were down, there have been massive cost overruns on refinery investments, an expensive accident in offshore operations, and a financially disastrous purchase of a refinery in the US. The financial mistakes have raised allegations of corruption. Is this a nightmare in the making, just as Brazil steps further into the global spotlight with the commencement of the FIFA World Cup and in the middle of a general election year? Or, as some contrarian investors argue, are these bad headlines merely distracting attention from the company's underlying strengths and providing a buying opportunity?

Petrobras chief executive María das Graças Silva Foster has a lot in her in-box at the moment. In the first place, the company's recent performance has been disappointing. First quarter results showed that profits fell by 40.8% year-on-year to US$2.28bn (measured per ADR, they fell from 60 US cents in Q1 2013 to 34 cents in Q1 2014). Net operating revenues dropped 5.1% to US$34.49bn. Lower profits were attributed to weaker international oil prices coupled with slightly lower output and rising exploration costs. Total oil output, from both Brazilian and international fields, was down 0.8% to 2.53m oil-equivalent barrels per day (bpd), some way below the 2.7m bpd peak achieved in 2010 and not surpassed since. Average international oil prices were down 10.7% on year-ago levels, while the average prices of oil sold within Brazil fell by 4.8%.

"Pre-salt output now represents 17% of total production, and Petrobras says it will rise steadily to 52% in 2018."

Beyond these disappointing numbers, there are wider worries about Petrobras finances. To fund its ambitious deepwater exploration programme off Brazil's Atlantic coast, the company has borrowed heavily and is now one of the most-highly leveraged and least profitable oil companies in the world. The company's debt stands at US$114.3bn, taking the debt-to-equity ratio to 0.81. Petrobras is said to owe US$11.50 for every barrel of oil it has yet to produce. Its high debt-to-equity ratio compares with 0.48 for France's Total, and only 0.15 for Chevron of the US. Norway's Statoil, perhaps more directly comparable because it too is state-owned, has a ratio of 0.48.

Graças Foster has also had to contend with bad headlines – a collection of recent stories that suggest there are major problems inside the giant corporation. One came in April, when it was revealed that Italian contractor Saipem SpA had dropped a steel pipe it was trying to attach to a Petrobras offshore oil rig in the Atlantic. It was not just any pipe, but a piece of equipment 2.3kms long, which sank 1,800 metres to the ocean floor and is not recoverable. The cost of the accident has been put at around US$2.0m.

More serious allegations have been made about refinery purchases. Three main refineries are in the frame: the Abreu e Lima refinery near Recife, the Comperj refinery in Rio de Janeiro and a refinery in Pasadena, Texas. The two Brazilian refineries, built for Petrobras by contractors, appear to have experienced massive cost overruns. The cost of the Abreu e Lima heavy crude refinery, initially budgeted at US$2.5bn and supposed to be part funded by Venezuela's state oil company Petróleos de Venezuela (Pdvsa), increased by over seven times to reach US$18.5bn, making the 230,000 bpd facility, now due to open at the end of this year, possibly the most expensive refinery in the world (the cash-strapped Pdvsa never put in a cent in the end). The 150,000bpd Comperj refinery is set to cost US$13.5bn by the time it

“Among the Petrobras bulls, a number point out that the company’s desire to expand refining capacity is strategically correct.....Petrobras is in fact trying to add 1.5m bpd of refining capacity in the next ten years, as a way of reducing its costly diesel and petrol imports.”

opens in 2016, four years later than planned and 61% over the original budget. On 20 March, Paulo Roberto Costa, former head of refining and fuel supply at Petrobras, was arrested as part of an investigation into alleged corruption. The Brazilian press has christened the affair Operation Lava Jato (‘car wash’) because of its suspicion that this was an elaborate fraud and money laundering operation.

The searchlight has also been shone on the decision by Petrobras to buy a refinery in Pasadena, Texas, in 2006. The refinery had been acquired a year earlier by Belgian company Astra Oil for US$42.5m. Despite this, Petrobras paid US$360m for a 50% stake, and then a further US$820m for the other 50%, this second transaction apparently triggered by a clause forcing the buyer to take full control in the event of a disagreement between the partners. There are also questions over the role of Petrobras board of directors in the approval of the contract (one of its members at the time was Dilma Rousseff, now president of Brazil). The company now admits incurring a loss of around US$500m on the operation: opposition sources claim it was probably double that.

As a result of these allegations, Petrobras has opened a number of internal investigations and the Brazilian parliament has appointed two special commissions of enquiry (upper and lower house), for an initial 180-day period, to which Graças Foster and other officials have already been summoned for testimony. Appearing before the senate commission at the end of April, Graças Foster admitted the Texas refinery purchase was “a bad deal” motivated, she said, by the company’s desire to acquire international heavy crude downstream refining capacity. The chief executive denied, however, that it was a fraudulent operation. She can expect more appearances to be forcing their way into her diary; some journalists suggest that with the World Cup due in June/July, the senate recess due in August, and Brazil’s general election due in October, this investigation may end up being extended into a second 180-day period.

Not everyone thinks that Petrobras is dangerously incompetent and corrupt, as a number of opposition politicians have alleged (and it is the case that corruption allegations typically tend to be levelled against the flagship national champion in election years). In fact, some equity analysts argue that the company still has good fundamentals.

Some of the optimists highlight expectations that Petrobras will be able to turn around production, largely reaping the benefits of its investment in exploration and production of it vast offshore ‘pre-salt’ reserves. The pre-salt reserves lie very deep, below layers of water, sand, rocks, and salt, but are very large, est. at about 15bn barrels of recoverable oil. In 2008, output from the pre-salt areas was only 3,000 bpd, but according to latest data it has risen to 428,000 bpd. Pre-salt output now represents 17% of total production, and Petrobras says it will rise steadily to 52% in 2018. Under the special pre-salt operating framework, Petrobras must be the obligatory operator of all future pre-salt fields, with a minimum stake of 30%. Some also argue that there is plenty of scope for gains from better cost control. “The company has the ability to recover profitability and its market value over the course of 2014, mainly through efficiency gains and increasing operational capacity” says Nataniel Cezimbra, an analyst at Banco do Brasil.

Among the Petrobras bulls, a number point out that the company’s desire to expand refining capacity is strategically correct (while of course not condoning the cost-overruns and corruption). Petrobras is in fact trying to add 1.5m bpd of refining capacity in the next ten years, as a way of reducing

its costly diesel and petrol imports. The government controls domestic petrol and petroleum product prices, so ultimately holds the key to the profitability of refinery operations. Those who wish to buy Petrobras shares must therefore be betting that the next Brazilian government will ensure the profitability of downstream operations.

ARGENTINA

Who Cries: Repsol or Argentina?

Repsol, the Spanish oil major, has finally disentangled itself from Argentina. It had held a majority stake in Argentina's Yacimientos Petrolíferos Fiscales (YPF) and was caught out when the Argentine government renationalised YPF in May 2012, effectively expropriating most of the Spanish company's shares. After a series of international lawsuits, the Buenos Aires government and Repsol finally agreed a US$5bn compensation package payable in Argentine government bonds. On 23 May Repsol said it had sold all the bonds and its remaining shares, netting a total of US$6.3bn.

Company officials noted that Repsol's share price had climbed to EUR20.65 on 26 May 2014, above the EUR17.48 registered on 16 April 2012 (the day before the renationalisation was announced). At the darkest point of the dispute with Argentina, when investors saw little chance of compensation being paid, Repsol's share price had slumped to EUR10.96. It is hard to assess the net cost of the entire affair. In Repsol's initial court submissions, it had demanded some US$10bn in compensation for the expropriation, and it has in effect settled for considerably less. On the other hand, the outcome of legal action was uncertain; perhaps the only sure thing was that it would have dragged on for many years. Most of Repsol's shareholders appear relieved that the dispute is over.

"It eventually dawned on Argentine officials that the dispute with the Spanish company was frightening away other investors in general, and oil and gas majors interested in the gigantic Vaca Muerta shale oil and gas reserves in particular."

Having had its fingers burnt in Argentina, the company now seems inclined to follow a more cautious investment strategy. Although it retains interests in Latin America (including an offshore block in Brazil's Santos basin in partnership with Brazil's Petrobras, China's Sinopec and the UK's BG, which recently reported good test results), it has suggested that it will now focus on acquiring assets in lower-risk OECD countries. Finance Director Miguel Martínez has said Repsol will be looking at investments in industrialised countries, including the US and Norway, where it can achieve an 8% or higher investment return. Repsol remains strongly interested in non-conventional hydrocarbons assets such as shale oil. Agencies including Moody's Investors Service recently raised Repsol's rating, arguing that the cash injection from exiting Argentina, along with the sale of gas assets, allows the company to improve its debt profile and strengthen its finances.

Argentina too may be sighing in relief that the Repsol affair is now behind it (even though it was arguably an affair almost entirely of the Argentine government's own making). It eventually dawned on Argentine officials that the dispute with the Spanish company was frightening away other investors in general, and oil and gas majors interested in the gigantic Vaca Muerta shale oil and gas reserves in particular. In the words of Ernesto López Anadon of the Argentina Oil and Gas Institute, "Argentina is sitting on a potential energy bonanza, if it could just get its act together and not squander it". Vaca Muerta rights are mainly owned by YPF, and any international company would be cautious of the knock-on effects of an outstanding YPF-Repsol dispute. By settling the dispute, Argentina hopes to clear any roadblocks to that bonanza eventually becoming a reality.

MEXICO

Which way is the economy pointing?

In the first half of 2014, it is becoming evident that the Mexican economy is in a transition phase. While the government is adamant that it is gathering strength and, indeed, that a full-bodied recovery is just around the corner, some analysts, including the national statistics institute (Inegi), suggest that the country may actually be in technical recession. Surely they can't both be right?

The problem has been posed by two data series published by Inegi as part of its Sistema de Indicadores Cíclicos (SIC – system of cyclical indices). They are a coincident and a leading indicator of economic activity, each compiled from a weighted mix of data on output, manufacturing production, retail sales, unemployment and imports. The index is reported as a monthly percentage above or below Mexico's long-term economic growth trend. And the bad news is that it has been pointing the wrong way for a long time now.

Under Inegi's definition, a recession occurs when the coincident SIC index has been below long-term trend for nine months or more. In May, the agency reported that the coincident SIC index for February this year was 0.4% below trend, and that this was the 21st consecutive month of negative readings. These numbers prompted some economists to agree that Mexico is actually in a technical recession. However, it is important to note that the consensus view is much more bullish, with analysts expecting on average 3.0% growth this year.

"We now have almost a year and a half of a government that has achieved many reforms, that has promised many things that have not materialised in economic growth or improvements in Mexican's incomes."

Finance Minister Luis Videgaray, along with other members of the government and a number of Mexican business leaders, was quick to deny any talk of the R-word. They favour the definition used, among others, by the US Federal Reserve, which calculates that a recession occurs when economic growth falls or decelerates for two consecutive quarters. "It would be openly incorrect to say that an economy that's growing, and doing so faster than last year, is in recession", the minister said. The government had been saying that after GDP growth slowed sharply to 1.1% in 2013, it would accelerate to 3.9% this year. Videgaray played down the importance of the SIC numbers. However, on 21 May the central bank (Banxico) reduced its 2014 growth forecast for this year from a 3%-4% range down to 2.3%-3.3%.

Whatever the actual word used (and of course the R-word is highly politically sensitive for the government), it is clear that the economy is finely balanced. Many economists and business people that have enthusiastically supported the government's ambitious structural reform programme also note that it is unlikely to have a positive effect on growth until 2016 at the earliest (and some argue that the key energy reforms will not really boost GDP until 2018). In the meantime, they suggest that shorter-term macroeconomic management is falling short. "We now have almost a year and a half of a government that has achieved many reforms, that has promised many things that have not materialised in economic growth or improvements in Mexican's incomes" says Gerardo Esquivel, an economics professor at the Colegio de México.

Some argue that the timing of the fiscal reform – which led to increases in some taxes from the beginning of this year – has been counter-productive. "Fiscal reform hit consumption in a way that was much harder than the government expected" says Deborah Riner of the American Chamber of Commerce (Amcham) in Mexico City. Walter Molano of the Instituto Mexicano de la Competividad agrees. "We had a tough first quarter'" he says. "Why? The fiscal reform was recession inducing. We still have a strong export sector that is doing well. But I would say that the domestic market is in a recession, if you take out the figures for exports".

A big fall in government spending last year, as the new administration under-executed its budget allocations, may have also been a factor. Writing in *El Economista*, analyst Luis Miguel González noted: "The finance ministry says it has released the funds, but they don't seem to be reaching companies or households, perhaps because they are held up in government offices. Mexican public spending in 2014 is like Flight 370 of Malaysian Airlines. All we know is that it left Kuala Lumpur, but no-one can find it". In the government's defence, many now recognise that the spend is beginning to work its way through the system, and the latest data shows a 19% year-on-year increase in actual spending during the first two months of this year.

"Mexican public spending in 2014 is like Flight 370 of Malaysian Airlines. All we know is that it left Kuala Lumpur, but no-one can find it."

González makes a wider point. He argues that without structural reforms, Mexico's economic growth is in fact capped at not more than 4% per annum. Reforms are needed to get to 5% and higher. But in the meantime, the economy needs to be closer to its potential. In the third and fourth quarters of last year, it was way below 4%, with growth at only 1.4% and 1.7% respectively. This may not be a recession, he argues, but at the very least it is a "crisis of underperformance". In his view, the Mexican government will fall short of its growth targets for the second year in a row.

But he does agree with the consensus view that things will get better in the second half of this year as the US economy – so important for Mexico – continues to strengthen, as secondary or enabling legislation on telecoms and energy reforms are approved, and as, "with a bit of luck" increased government investment spending makes an appearance.

PERU

Super-charged Cusco

Many Latin American governments and economists wish they could achieve 'Chinese' rates of growth, shorthand for consistent year-on-year GDP expansion in the high single percentage digits. The benchmark has certainly been set high: China's economy expanded by no less than 54% in 2008-2013. And yet…according to the Instituto Peruano de Economía (IPE), the city and administrative region of Cusco did a little better, achieving 59% growth in the same period.

"If Cusco were an independent country, it would be number one in the [global] growth ranking over the last five years."

Cusco, with a population of just over half a million, is clearly top of the list of Latin America's boom cities. "If Cusco were an independent country, it would be number one in the growth ranking over the last five years" says Miguel Palomino Bonilla, a director at IPE. When measured over the 2001-2012 period, Cusco slips behind China but remains ahead of Nigeria, Panama and India. It is still an outperformer: in those 11 years global economic GDP expanded by 53.4%; the Peruvian economy surged ahead by 96.9%, and Cusco was way out in front with 142.8%. It was therefore growing at nearly three times the global GDP rate. "Cusco's growth is above all due to mining and hydrocarbons, construction and services", says Bonilla "and we all know there has been very strong growth in tourism".

The data gathered by IPE is impressive. It estimates that Cusco's GDP grew by 12.2% in 2013. Employment has risen sharply, and there is evidence of rising skills levels in the workforce. Distribution of income has also improved, with the Gini coefficient (an index which ranges from 1.0, which represents absolute inequality, down to zero, representing theoretically perfect equality) falling consistently since 2007 down to 0.46, just below the 0.47 for Peru as a whole. Perhaps critically, Cusco now has a diversified local economy, with mining and hydrocarbons representing 31% of GDP (up from only 2% 30 years ago), followed by services (21%), construction (17%), retail (11%), agriculture (8%), public sector services (7%) and manufacturing (5%).

The IPE does identify a number of problems however, among them low agricultural productivity (18% of the economically active population is involved in agriculture, which produces only 8% of the city's GDP). IPE's analysis of regional competitiveness across Peru suggests that the city does relatively poorly in areas such as institutional strength, health and education. There have been improvements in reducing corruption and labour skills, but setbacks in school attendance and security. Public spending has grown strongly, but appears to be unevenly distributed. Only 21% of Cusco region's roads are in good condition, and the supply of running water is often interrupted during the day.

PERU

Getting ready to tackle hard pockets of rural poverty

Peru is not just growing fast – it is also achieving significant reductions in poverty levels. It is estimated that one million Peruvians will emerge from poverty in 2014-15.

"While some analysts questioned the comparability of the data, the poverty rate fell sharply to 27.8% in 2011. Under the current presidency of Ollanta Humala, the rate declined further, coming down to 23.9% in 2013. Roughly one in four Peruvians are now considered poor, compared to one in two twenty years ago."

Hugo Perea, chief economist at BBVA Research, expects Peru to continue achieving higher-than-5% real annual GDP growth over the next few years, and for the country to make significant reductions in the poverty rate, thanks to a combination of employment growth and social programmes. "The trend for poverty to fall has been favourable over the last few years, reflecting good growth and good macroeconomic policy making, which taken together have allowed for an increase in the standard of living" he says. In Perea's view, the key to maintaining sustained poverty reduction is to keep real annual GDP growth above 5%. He notes that the government's main social programmes are directed at alleviating extreme poverty, and designed to help people who would not normally be affected by private sector growth. Direct assistance is therefore justified, in his view, as the most effective way of helping those in greatest need, but it should be coupled with more general efforts to improve productivity and competitiveness across the economy.

According to data from the national statistics institute (INEI), after worsening in the 1990s, Peru's poverty rate began to fall in the noughties. The proportion of the population living in poverty rose from 49% during the first presidency of Alberto Fujimori (1990-1995) to 52% in his second term in office (1995-2000). During the presidency of Alejandro Toledo (2001-2006), the rate rose in 2004 and 2005, but then changed direction, reducing to 49.1% by 2006. During Alan García's second term in office (2006-2011), the INEI's methodology for calculating poverty rates was changed. While some analysts questioned the comparability of the data, the poverty rate fell sharply to 27.8% in 2011. Under the current presidency of Ollanta Humala, the rate declined further, coming down to 23.9% in 2013. Roughly one in four Peruvians are now considered poor, compared to one in two twenty years ago.

The Instituto de Economía y Desarollo Empresarial (IEDEP), which is linked to the Lima Chamber of Commerce, projects that around one million Peruvians will be lifted out of poverty in 2014 and 2015 if the economy continues to grow at somewhere between 5.5% and 6.0%, comparable to the pace of GDP expansion achieved in 2013. As might be expected, poverty rates vary from region to region, with the poorest being Cajamarca and Ayacucho. Poverty is defined as not being able to afford a basic basket of consumer necessities, calculated as requiring 292 Soles (approximately US$104) per household member per month in 2013. Extreme poverty is defined as not being able to afford a basket of goods worth 155 Soles (US$56) per household member. Based on these estimates, in 2013 there were 7.3m poor people in Peru, with 1.4m of them living in extreme poverty.

Finance Minister Luis Miguel Castilla has argued that as the poverty rate comes down, so further reductions become more difficult to achieve through economic growth alone. He says this is because there are "hard pockets" of rural poverty which have few links to the market economy. The IEDEP suggests that some 94% of the reduction in the poverty rate achieved so far is the result of economic growth, while the remaining 6% can be attributed to direct transfers through social programmes. IEDEP executive director César Peñaranda notes, "it is important to boost private investment and increase productivity because this develops the economic growth cycle, which will ultimately deliver an irreversible eradication of poverty".

Javier Escobal, a poverty specialist at Grupo de Análisis para el Desarrollo (GRADE) highlights an encouraging trend. In recent years, rural poverty rates have begun to fall faster than urban ones. Escobal believes this is mainly due to a combination of public and private investment in rural areas, which have been better connected to the market economy as a result of road building, the extension of the electricity grid, and the arrival of telecommunications. He says that the catalysing effect of infrastructure investment has been a key driver of rising rural income levels in rural areas such as Apurímac, Junín, Cusco, and Ayacucho.

"The IEDEP suggests that some 94% of the reduction in the poverty rate achieved so far is the result of economic growth, while the remaining 6% can be attributed to direct transfers through social programmes."

PANAMA

(Almost) no clouds on the economic horizon

Panama's rather complex current political situation stands in sharp contrast to its economic situation. Both the economy and the banking system are in good shape. Risks are identifiable, but the economy and the financial sector are well placed to cope.

As our sister publication *Latin American Weekly Report* said in its 15 May edition, the unexpected victory in the 4 May presidential election of Juan Carlos Varela will produce wheeling, dealing and some uncertainty in the weeks leading up to his investiture on 1 July. The El Pueblo Primero (EPP) alliance, of which the president-elect's Partido Panameñista (PPA) is part, controls only 13 seats in the new 71-member unicameral legislature. Outgoing president Ricardo Martinelli's Unidos Por Más Cambios (UPMC) alliance controls 33 seats. Given the poor state of relations between Varela and Martinelli, the logical solution is some kind of deal between the EPP and the Partido Revolucionario Democrático (PRD). The PRD controls 24 seats in the legislature, is the traditional rival of the PPA and is led by defeated presidential candidate Juan Carlos Navarro. For his part, Navarro has indicated that he is prepared to discuss a joint legislative agenda with Varela.

Fortunately, all this flux is happening at a time that the economy is still in pretty good shape. Real annual GDP growth slowed from above 10% in 2012 to 8.0% in 2013, according to the International Monetary Fund (IMF). According to the IMF, the deceleration reflected "mainly a decline in Colón Free Zone activity and in Canal traffic". The IMF anticipates that the rate of growth will continue to slow over the coming years **[chart 1]**. Nevertheless, the economy should still be expanding by almost 6% per annum in real terms in 2018. This is in the context of annual inflation of around 3% over the next five years and unemployment of below 5% of the labour force.

Other metrics are also encouraging. Government revenues and spending are more or less in balance. In 2013, the fiscal deficit was 3% of GDP, which was below the ceiling allowed under the Social and Fiscal Responsibility Law (SFRL): this was in spite of what the IMF described as "strong public investment". At around 42% and 39% of GDP respectively, gross and net debt are

Chart 1: Panama's economy, as the IMF sees it							
	2012	**2013e**	**2014e**	**2015e**	**2016e**	**2017e**	**2018e**
Gross domestic product, constant prices (% change)	10.80	8.00	7.20	6.90	6.41	6.20	5.91
Gross domestic product, current prices (US$bn)	35.94	40.33	44.79	49.46	54.21	59.12	64.12
Gross domestic product per capita, constant prices (US$bn)	7,055.33	7,485.33	7,882.47	8,277.56	8,651.97	9,026.04	9,389.98
Total investment (% GDP)	28.63	30.00	29.80	29.30	29.10	28.90	28.00
Gross national savings (% GDP)	18.01	18.09	18.30	18.10	19.59	19.96	20.30
Inflation, average consumer prices (Index)	164.43	171.06	177.56	183.95	190.20	196.29	201.20
Volume of imports of goods and services (%)	5.69	8.20	5.45	5.05	6.64	5.18	4.45
Volume of exports of goods and services (%)	4.96	5.25	6.59	6.23	11.11	7.88	7.33
Unemployment rate (%) total labour force	4.18	4.50	4.50	4.50	4.50	4.50	4.50
Population (mn)	3.66	3.72	3.79	3.86	3.93	4.00	4.07
General government revenue (% GDP)	25.13	24.57	24.56	24.56	25.08	25.19	25.10
General government total expenditure (% GDP)	26.61	27.59	27.57	26.55	26.58	26.19	25.60
General government primary net lending/borrowing (% GDP)	0.07	-1.01	-1.18	-0.04	0.47	0.95	1.42
General government net debt (% GDP)	39.14	38.18	38.66	38.74	36.63	34.63	32.44
General government gross debt (% GDP)	42.62	41.28	41.45	41.27	38.93	36.74	34.39
Current account balance (US$bn)	-3.82	-4.81	-5.15	-5.54	-5.16	-5.28	-4.94
Current account balance (% GDP)	-10.62	-11.91	-11.50	-11.20	-9.51	-8.94	-7.70
Source: *IMF World Economic Outlook forecasts, as of 27 May 2014*							

fairly low by most standards and are set to fall. The current account deficit is running at about 12% of GDP, but should also diminish over time. At around US$5bn, the current account deficit is of an absolute size that is easily manageable, and can be covered by inwards foreign direct investment (FDI) or portfolio investment.

The latest data pertaining to Panama's banking sector, published by the Superintendencia de Bancos de Panamá (SBP) provides additional reassurance **[chart 2]**. Domestic credits, which are well balanced between commercial loans, mortgage loans, personal consumption loans and construction loans, rose by a little under 10% (or by less than nominal GDP) over the year to the end of January 2014. Domestic loans are only slightly less than domestic private deposits of US$33bn, which have been rising slightly more rapidly than the credits. Panama's banks are liquid and profitable. Private sector deposits from outside Panama have stagnated at around US$20bn. Although the total assets of the banking system (US$98bn) and total deposits (US$70bn) are large in relation to nominal GDP (US$40bn), there is no evidence of excesses.

Chart 2: Panama's International Banking Center	
Selected metrics as at 31 January 2014. Comparison refers to 31 January 2013	
Total assets of banking system: US$98.14bn, (up 8.1%).	Total domestic credit of US$35.29bn, (up 9.7%)
Total deposits of US$70.28bn	Main sectors of domestic credit portfolio: commercial (28.9%) mortgages (28.8%) personal consumption (20.3%) construction (10.5%)
Total domestic private deposits: US$32.48bn, (up 10.7%)	Return on assets of 1.61% (down 0.01pp)
Total foreign private deposits of US19.91bn, (down 1.0%)	Return on equity of 15.73% (up 1.01pp)
Average liquidity level of 60.7%, versus minimum of 30%	***Source:*** *Superintendencia de Bancos de Panamá, Banking Activity Report, January 2014*

Unsurprisingly, the IMF press release on 9 May 2014 following the conclusion of its latest Article IV consultation with the government of Panama was upbeat. "The economy continues to enhance its regional and global logistics role for the movement of goods, capital and people." Among other recommendations, the IMF suggested that the "authorities to step up their efforts

to strengthen the anti-money laundering and combating the financing of terrorism (AML/CFT) regime, including implementation of the AML/CFT assessment report."

The comprehensive AML/CFT assessment report was published by the IMF in January 2014. Among other things, the report noted that Panama's AML/CFT framework was not "fully in line" with the recommendations of the Financial Action Task Force (FATF). Among other things, the AML/CFT law does not extend fully to Panama's insurance sector, to casinos, to real estate brokers, lawyers, accountants and other providers of corporate services, or dealers in precious stones. "Resident agents providing corporate services are covered under a specific law that provides a limited range of customer identification requirements and are subject to strict secrecy provisions that severely limit or prohibit access to information by the supervisors and the Financial Intelligence Unit" (FIU - which the IMF regards as being under-resourced). The IMF noted that "at the time of the mission, the authorities had no concrete plans to address these shortcomings."

It remains to be seen what steps the new Varela administration takes to implement the recommendations of the IMF in relation to the AML/CFT law. However, the work undertaken by the World Economic Forum (WEF) for its *Global Competitiveness Report 2013-14* suggests that Panama could benefit from further structural reform. The WEF assessed Panama as being the 40th most competitive country overall, of the 148 evaluated. In Latin America, only Puerto Rico (in 30th place) and Chile (34th) were rated more favourably. However, Panama rated less well (in 66th or 68th place) in terms of institutions, health/primary education and higher education/training. Businesses surveyed identified the inadequate training of the workforce, the inefficiency of the government bureaucracy and corruption as being the most problematic factors for doing business. They were seen as being a lot more challenging than other issues such as restrictive labour regulations or crime/theft **[chart 3]**.

"For most businesses and investors looking at opportunities in Panama, a more crucial question is: how will the (currently robust) economy and financial system cope in the event of the most likely external shocks over the next year or so?"

Chart 3: The most problematic factors for doing business in Panama

For most businesses and investors looking at opportunities in Panama, a more crucial question is: how will the (currently robust) economy and financial system cope in the event of the most likely external shocks over the next year or so? In March 2014, the Inter-American Development Bank (IDB) published a report, '*Global Recovery and Monetary Normalisation - Escaping a Chronicle Foretold*', which considered the impact of three developments, or shocks.

The first was stronger than expected economic growth in the US, which the IDB defined as a GDP acceleration from 2.8% in 2014 to 4% in 2015. This

outcome would serve to reduce the funding that would be available generally for emerging markets. In view of the nervousness on global financial markets during 2013 about the impact of a tapering of asset purchases by the US Federal Reserve, this outcome would likely give rise to a new round of volatility, including a fall in US equity prices. Accordingly, the second shock envisaged by the IDB was a drop in US equity returns to 3%-4% in 2014-16. Thirdly, the IDB considered the implication of a slowing in economic growth in China (perhaps as a result of a crisis in the shadow finance system) from above 7% presently to around 5.5% in 2016.

The IDB's analysis found that, for Latin America as a whole, the three shocks would have a limited impact. The IDB's base case is that the region would achieve real growth of 3.3% annually in 2014-16. In the event that all three shocks occurred, the corresponding figure would be marginally lower, at 3.2%. In essence, the benefits of lower prices for commodities (especially oil) and/or proximity to the US for some countries almost offset the impact of lower prices for commodities (and reduced volumes of sales to China) for other countries in South America.

Panama was not among the countries for which the IDB published specific forecasts. However, given that the country is an importer of energy, and thanks to the Canal and the Canal Zone a beneficiary of trade between the US and the rest of the world, it is possible that the economy would receive a boost in the event that all three shocks occur. The IDB's base case scenario is that nearby Costa Rica, for instance, will achieve real growth of 4.1% annually through 2014-16: if the three shocks occur, the equivalent figure is 4.5%.

The bottom line is that Panama's currently unsettled political situation is at odds with its healthy headline macroeconomic situation. Although there are areas in which the new Varela administration could usefully pursue reforms, the economy will remain one of Latin America's (and the world's) outperformers - virtually regardless of what happens in coming months in the US and China.

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LATIN AMERICAN ECONOMY & BUSINESS is published monthly (12 issues a year) by **Latin American Newsletters**, 61 Old Street, London EC1V 9HW, England. Telephone +44 (0)20 7251 0012, Fax +44 (0)20 7253 8193 Email: subs@latinnews.com or visit our website at: **http://www.latinnews.com**. Subscription rates will be sent on request. Overseas subscription sent by airmail. **EDITOR: EILEEN GAVIN**. **CONTRIBUTORS: ANDREW THOMPSON, ANDREW HUTCHINGS.** Printed by Quorum Print Services Limited, Units 3&4, Lansdown Industrial Estate, Gloucester Road, Cheltenham, Glos. GL51 8P.
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