CANNING HOUSE EDITION

latin american **economy & business**

November 2015 - EB-15-11

ISSN 0960-8702

CONTENTS

REGIONAL ECONOMY REVIEW

Brazil 3
Unhappy times for Joaquim Levy

Guatemala 5
What's Jimmy going to do?

Belize 7
Fragile Growth

Region 9
Interest rates: the only way is up?

REGIONAL BUSINESS REVIEW

Mexico 11
Yucatán bees sting Monsanto?

Mexico 12
The OECD reviews the pension system

Region 14
Corporate Radar

SPECIAL FOCUS

Honduras 15
Banco Continental and the Rosenthals' empire: orderly liquidation, so far…

Honduras 19
Meeting – and beating – expectations

REGIONAL MARKETS REVIEW

Region 21
A snapshot of the (very varied) levels of financial development in Latin America and the Caribbean

Peru 23
Avoiding the stock exchange downgrade

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

One to watch: the dollar on 10 December

As this issue went to press, Argentina was on the cusp of a major political transition. In a second round run-off ballot on 22 November the pro-government presidential candidate Daniel Scioli is due to face the opposition's man, Mauricio Macri, who the latest opinion poll say is ahead in the race. Whoever wins will take office on 10 December. And on that day all eyes will be on the peso-dollar exchange rate. There could be a mega-devaluation. Or not. Here we explain some of the options facing the new Argentine president.

For years Argentina has had a complex multi-level exchange rate system, in which the government has intervened heavily. Faced with persistent foreign exchange shortages (caused by disappointing exports, a large domestic fiscal deficit, and the country's limited access to international capital markets) the government has managed a controlled official exchange rate, alongside other financial rates (the most important of which is known as the 'contado con liquidación' or 'contado con liqui'). There is also a black market rate known as the 'dólar blue' which the government has unsuccessfully tried to suppress. It is widely recognised that the official rate overvalues the peso, as it has been adjusted more slowly than domestic inflation (the government has deliberately stopped publishing credible inflation data, but prices are widely believed to be rising at an annual rate of 25%-30%). The blue dollar reflects supply and demand outside official channels and as such possibly undervalues the peso. The entire multiple rate system is described in Argentina as a "cepo cambiario" which translates as "an exchange rate clamp" and rather accurately reflects the overall attempt to impose state controls.

From different starting positions both Scioli and Macri have each indicated that they will end or relax the "clamp". Starting out from a pro-government position but aware of the unpopularity of exchange controls with voters (particularly middle class ones), Scioli has spoken of a gradual easing of the clamp if he wins the presidency. From a much more pro-market position, Macri has spoken of reunifying all exchange rates and floating the peso entirely on his first day in office, if he wins. Both men have made exchange rate claims and counter-claims as part of their political battle. On 13 November, for example, Scioli claimed that Macri was planning a mega-devaluation, while on the other hand, if the voters gave him the presidency, Scioli said he would not devalue, thereby protecting workers' wages, and that he would guarantee "a dollar under 10 pesos". Macri retorted that no-one could guarantee the future level of the exchange rate, and that the 10-peso guarantee was "another of the government's lies". To put this in context, on the day that the candidates clashed on this subject, the official exchange rate closed at 9.63 pesos, while the blue dollar was at over 15 pesos.

Analysts agree that managing the exchange rate will be tricky, whoever wins the presidency. Jorge Brito, president of Banco Macro and of ADEBA (the association of Argentine banks), has suggested it would be best to gradually relax the clamp, perhaps over a 180-day period. The problem of a free float on day one would be the danger of overshooting. Brito said he thought the real value of the peso was probably close to the 'contado con liqui' rate (14.37 pesos on the day he was speaking). A survey of local analysts by financial portal Cronista.com suggested many also think the 14-peso level is most likely in December/January. At Ecolatina, former economy minister Lorenzo Sigaut said that if the next president unifies exchange rates immediately the unified rate will be around 14 pesos. If the next president adopts a more gradualist approach, he expects the official rate to be devalued "by at least an average of 2% a month". In a "mixed scenario" the dollar might start 2016 at around 12 pesos. Aldo Abram, of think tank Libertad y Progreso, said that even in the eventuality of a Scioli victory he was expecting an initial 25% devaluation and a 16-peso dollar by March.

A central issue, of course, is that the market level of the peso will also depend on a lot of other factors affecting foreign currency flows, such as the new government's signals on the fiscal deficit, on foreign investment, and on inflation. So all predictions are uncertain, but turbulence is possible.

"On 15 November the two candidates took part in a televised debate ahead of the run-off. Watched by an estimated 5m viewers, the debate, the first of its kind in Argentina's history, was seen as a final opportunity for either candidate to take a decisive advantage over the other. Neither came seriously unstuck during the debate that lasted just over an hour, but most analysts and polls indicated that Macri came off best."

Debate gives Macri the edge

On 15 November the two candidates took part in a televised debate ahead of the run-off. Watched by an estimated 5m viewers, the debate, the first of its kind in Argentina's history, was seen as a final opportunity for either candidate to take a decisive advantage over the other. Neither came seriously unstuck during the debate that lasted just over an hour, but most analysts and polls indicated that Macri came off best.

During the debate, Scioli maintained his second-round strategy of attacking his opponent aggressively, accusing Macri of planning a maxi currency devaluation that will bring a fall in living standards. "When you take the veil away what you see is this: the free market, austerity, devaluation", he warned. While Scioli's body language was tense, Macri managed to look relaxed while at the same time hitting back with some force. "Don't pretend to be my spokesman telling people that I'll do horrible things" he retorted.

Macri also went on the offensive against the government (among other things for its scarcely credible statistics on poverty), causing Scioli to protest that the current government will step down on 10 December and he alone will be fully in charge if elected (a sensitive subject given the widely held belief that outgoing President Cristina Fernández will seek to continue to exercise power and influence).

Mariel Fornoni of pollsters Management & Fit said that in image terms Macri came out strongest, noting that Scioli focused on a single issue – devaluation – while Macri was more of an all-rounder and proved better at connecting with voter concerns. Another respected pollster, Rosendo Fraga, said Macri emerged with the advantage because there was nothing in the debate likely to reverse his current lead in the polls.

Macri's lead still stands at around eight percentage points. A real-time smartphone poll organised during the debate by the local daily *Clarín*, and reportedly used by 15,000 people, had 63% saying Macri had won (but *Clarín* is backing the opposition candidate so it is possible that the self-selecting sample was skewed in Macri's favour). Writing for *La Política Online*, journalist Ignacio Fidanza made a key point: although the debate was close, and could have been described as a draw, given that he was coming from behind, Scioli needed "to demolish his opponent… and he wasn't able to do that".

There may still be surprises in the last days of the campaign, but the TV debate is widely seen as having been the event most likely to shift undecided voters. Closing rallies and speeches will be highly orchestrated. That means that the balance of probabilities is now pointing at a major political change in Argentina.

BRAZIL

Unhappy times for Joaquim Levy

The man with one of the most difficult jobs in Latin America – Brazilian finance minister Joaquim Levy – continues to be something of a political orphan. Since taking the job in January rumours of his imminent resignation or dismissal seem to have been almost constant. On 11 November former central bank president Henrique Meirelles denied that he had been "formally invited" to replace Levy, but he would not answer questions about whether there had been informal discussions on the matter. Here, we look at the economic policy debate.

Having to reduce a fiscal deficit in the middle of a recession is difficult, and the subject of passionate debate among economists. The theory is that decisive action to correct a fiscal imbalance can lead to a positive "confidence shock" encouraging private investment to increase and leading to the first "green shoots" of economic recovery. But the danger is that in a falling economy the cuts only cause further reductions in confidence, and prompt lower activity levels which reduce tax revenues and result in a kind of race to the bottom where repeated doses of austerity only make the situation worse, rather than better. Brazil, in this nightmare scenario, could end up like Greece, where governments have been applying austerity recipes for over five years, but where the economy has continued to contract unremittingly.

Brazil is of course not Greece – and has nowhere near the levels of sovereign debt that have played such an important role in the European country's protracted political and economic crisis. But other issues certainly make Levy's job intractable. The politics are to say the least, inauspicious. As the economy hit the rails late last year the centre-left government of President Dilma Rousseff turned to Levy, a financially orthodox banker, only reluctantly. Beyond the president's immediate circle there was – and still is – hostility to Levy's unpopular medicine. Two factors made things even worse. First, there is a deep structural problem: the discretionary proportion of Brazilian public spending is small, with the vast majority mandated by the constitution or by specific laws. This means that any finance minister has his hands at least partly tied. Second, with the threat of impeachment hanging over her, the president's authority has nose-dived and the two main parties in her coalition are internally divided and often at loggerheads with each other. The majority of congress has little or no loyalty to the finance minister and little short-term interest in seeing him succeed.

The bad news is that Brazil's economy is still worsening, rather than improving. London-based consultancy Capital Economics says Brazil is now looking like the "odd man out" in the region. Its assessment is that "While growth in Mexico, Chile, Colombia, and Peru appears to have accelerated in the third quarter, the recession in Brazil probably deepened." In other words the Latin American recession may be bottoming out, but not so in Brazil. There, the latest figures for the industrial sector show a year-on-year fall of nearly 10%. Inflation has been rising, the labour market is deteriorating, credit conditions are tightening, and consumer spending has dropped. The weaker currency may be helping the export sector, but not strongly enough to offset the other factors. Capital Economics estimates Q3 GDP fell by 3.5%, making this the deepest recession in the country since the 1990s. Other fore-

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casts are also sombre. On 12 November Banco Itaú said in a research note "Economic activity is not stabilising. Investment appears to have fallen more steeply than we expected. We are modifying our 2015 forecast to show a GDP fall of 3.2% (down from a fall of 3.0% previously). In 2016 we are now forecasting a further fall of 2.5% (down from a fall of 1.5% previously".

Recent criticism of Levy, attributed by newspaper *Folha de S. Paulo* to former President Luis Inácio Lula da Silva (who remains one of the most influential advisors to Rousseff) include the claims that he is no longer supported by the financial markets ("although they still like him"), that he lacks 'jogo de cintura' (a footballing term best translated as being comfortable and in control when on the ball), and that people are tired of his narrative and "need someone who can bring hope". These comments came despite Levy having won a small short-term victory, convincing a key congressional budget committee that there should be a single primary budget surplus target next year (rather than a band), equivalent to 0.55% of GDP for central government or 0.7% for the public sector as a whole.

On the other hand, critics point out that Levy's fiscal targets are constantly being eroded. The original plan had been to aim for a primary surplus equivalent to 1.1% of GDP in 2015, and most estimates now expect there to have been a deficit of at least 1% this year (possibly more if the government is required to correct the off-budget creative accounting tricks of prior years, known as 'pedaladas'). Alberto Ramos, an economist at Goldman Sachs, said of the constant slippage in fiscal targets: "Part of that is no-one's fault, it is the deep contraction of the economy that is impacting on revenue. But, on the other hand, it is a Catch 22…it is because they are not advancing on the fiscal that the economy does not respond, and if the economy does not respond, the fiscal gets worse. It is a vicious circle that they need to break."

"The question, of course, is whether the critics have realistic alternatives to Levy's austerity programme."

Folha de S. Paulo commented acidly that if the recession in the 2014-2016 triennium turns out to be as deep as forecasters now fear, with GDP down by around 7.8%, it will be getting close to "the second worst economic disaster of the last century", which the newspaper identified as 1990-1992 when GDP slumped by 8.4% during the presidency of Fernando Collor de Mello (who was impeached in 1992). The worst Brazilian economic disaster in *Folha*'s reckoning was 1981-1983, during the military dictatorship, when economic activity dropped by 12%.

The question, of course, is whether the critics have realistic alternatives to Levy's austerity programme. On a political level, at the end of October both the president's Partido dos Trabalhadores (PT) and its inconstant ally, the Partido do Movimento Democrático Brasileiro (PMDB), published critical documents. The PT's document, titled "Building a New Brazil" avoided some of the party's earlier direct criticisms of Levy and instead called for changes in his policies such as recommending higher taxes on the wealthy and lower interest rates. Lower interest rats, it was suggested, would reduce the fiscal burden of government debt service payments. The document also defended what it saw as the prior achievements of PT governments, listed as the expansion of the domestic market, growth in public sector investment, and rising standards of living for the country's workers. Some political groupings within the PT, such as the Mensagem faction, have nevertheless called for Levy and the entire economic team to be dismissed.

The PMDB published a draft position paper at the end of October, accusing President Rousseff of "making the wrong diagnosis" of the country's economic problems. The paper said that while fiscal responsibility is a

"necessary condition" for economic stability "it is not the motor that can drive economic development". It also rejected the president's assertion that the origins of Brazil's crisis lie with external factors in the global economy. The document was rather short on specifics but spoke in general terms of the need for additional measures "to unleash a new phase of sustainable growth and development".

In a recent interview Fernando Haddad, the mayor of Sao Paulo (and a member of the PT), acknowledged that some "important imbalances" had been allowed to develop in the Brazilian economy in 2013 and 2014, mentioning among them the exchange rate and administered prices. "There are disputed versions of how this came about. The government says these imbalances reflected its way of fighting the crisis and defending employment and living standards. The opposition says the imbalances were irresponsible. But the fact of the matter is that no-one now doubts the reality of those imbalances". Haddad went on to argue that the government is now trying to do two potentially contradictory things: to use interest rates to reduce inflation on the one hand, and to cut the fiscal deficit to stop the growth of national debt as a proportion of GDP, on the other. His suggestion was that "monetary policy is corroding fiscal policy; they need to be recalibrated". The implication is that he, like much of the rest of the PT, wants to see lower interest rates.

GUATEMALA

What's Jimmy going to do?

> "Morales has said he will not announce his ministerial team until December. Meanwhile there have been only glimpses of his thinking."

The economic policies of Guatemalan president-elect Jimmy Morales are something of a mystery. The essential facts are, first, that Morales won the second round of the presidential elections on 25 October with a decisive 68.5% of the vote, presenting himself as an anti-establishment, anti-corruption candidate (his slogan was that he was "neither corrupt nor a thief"); second, that he has no prior political or policy-making experience (although he does have a degree in business administration, and as a successful television comedian he has run his own production company for 15 years); and, third, that his six-page election manifesto said very little about economic policy.

It is only now, after the elections and in the period running up to his official inauguration on 14 January, that some outlines of the new government's policies are beginning to emerge. It is probable that they are still under discussion. Morales has said he will not announce his ministerial team until December. Meanwhile there have been only glimpses of his thinking. During the campaign the candidate, who has described himself as a "nationalist Christian", said the 1% mining royalty (levied on companies like Goldcorp and Tahoe Resources of Canada) is "ridiculous" and "unjust" and will be reviewed by his government. However, he also added: "I'm not against mining, but we need to give the population a sense of certainty. If the law is unjust, no-one is going to want to respect it."

The president-elect has also rejected sending in the army to combat organised crime, saying he prefers to strengthen the criminal justice system. Since the country was not at war he suggested the army might be better used to support the economy – army engineers might, for example, help build roads and bridges and other infrastructure. A somewhat more unconventional suggestion was that the country's teachers be tagged with GPS trackers as

part of a campaign against absenteeism, and that poor children be given smartphones. He insists the smartphone proposal is serious, that a pilot will start in 45 schools, and that the project will be zero-cost for the government, with mobile operators Telefónica, Tigo, and Claro being invited to support the programme in exchange for sponsorship and advertising opportunities.

The political and economic preferences of "team Morales" are also somewhat unclear. He has insisted that his movement represents a break from the political establishment. As an evangelical Christian he is socially conservative, supporting the death penalty and opposing both same-sex marriage and abortion. His party, the Frente de Convergencia Nacional – Nación (FCN-Nación), has links to some of the country's previous right-wing military governments. But Morales says he will draw on talent across the traditional political divide and describes vice-president-elect Jafeth Cabrera (former dean of the University of San Carlos) as "a man of the left". Critically, the FCN-Nación has secured only 12 out of 158 seats in the Chamber of Deputies, which means that to govern Morales will need to do deals with the traditional parties. Despite the mood in the country, they are still a force to contend with and have not quite been swept off the political map.

"In one respect the president-elect has a great advantage. He inherits an economy enjoying stable and moderate growth. GDP grew 4.2% in 2014 and the Economic Commission for Latin America and the Caribbean (Eclac) is predicting 3.8% growth this year, rising to 4.0% in 2016."

Morales has already run into controversy over his choice for chief economic advisor in the transition team, José Ramón Lam, who is an economist and academic. Lam has begun to outline some of the policy details, saying that the new government's stance will be to cut excess spending, halt the growth in public debt, and reduce tax evasion. But one of Lam's previous employers, the Instituto de Problemas Nacionales de la Universidad de San Carlos (Ipnusac), says he was dismissed for plagiarising articles written by other academic researchers. Lam denies the charges (he says he left Ipnusac because he had a better job offer) and has been supported by Morales. The issue could escalate, particularly if Lam is offered a government position. Sociologist Carlos Guzmán-Bockler said Morales' claim that the allegations had not been proven was "puerile" since the plagiarised articles were on the public record. "This is serious" he said, adding: "If, right at the beginning, we have to question Morales' integrity and the credibility of his inner circle, what must we expect for the future?" Political analyst Gustavo Porras points out that precisely because Morales claims to represent a new, more ethical way of behaving "he is very vulnerable to these kinds of criticism". Porras believes the Lam affair is not of itself a major issue, "but if there are other similar cases there will be a big problem".

In one respect the president-elect has a great advantage. He inherits an economy enjoying stable and moderate growth. GDP grew 4.2% in 2014 and the Economic Commission for Latin America and the Caribbean (Eclac) is predicting 3.8% growth this year, rising to 4.0% in 2016. Inflation was only 1.6% in the 12 months to September. Exports, around 40% of which are shipped to the US market, rose 8% to US$10.8bn last year. Key export commodities include sugar, coffee, and bananas. Foreign currency reserves of US$7.558bn provide a safety buffer. The economy also receives a strong flow of remittances – around US$5bn a year – from Guatemalan migrant workers. The 2016 budget – currently before congress but awaiting revisions by the transition team, proposes a manageable fiscal deficit of around 1.8% of GDP. But insecurity is a problem. High levels of crime and violence have been calculated by the World Bank to cost the equivalent of 7.7% of GDP. In September last year an IMF team issued an Article IV consultation report which approved of the country's fiscal and monetary policies although it warned over a lack of long-term investment, and poor infrastructure and education, along with "institutional weaknesses and lack of security".

Many argue that a key problem is that Guatemala has enjoyed growth without development. GDP expansion in recent years has been insufficient to reduce the country's very high poverty rate. More than half – 54% – of the country's 15.5m population live below the poverty line. Hugo Maul, head of think tank Centro de Investigaciones Económicas Nacionales (CIEN), recently said: "In macroeconomic terms not much is going to happen in Guatemala in 2016. I don't think either inflation or GDP will accelerate. The fiscal deficit will lead to higher interest rates, but not worryingly so." Maul's point was that it may be relatively easy for the new government to deliver more of the same. Real change however, will require a major overhaul of the public sector to reduce rampant levels of corruption and boost efficiency, and despite the President-elect's clear mandate many are sceptical of the new government's ability to achieve such a transformation.

BELIZE

Fragile Growth

Prime Minister Dean Barrow returns to office for a third term at a time when Belize's economy is slowing and the government remains dependent on Venezuela to fund its spending.

"Data from the Statistical Institute of Belize in relation to imports through the first eight months of the year points to conditions that are mixed at best."

Belize's Bz$3,526mn (US$1,763mn[1]) economy, like many others in the Caribbean, is beset by high unemployment (11.3%), a substantial current account deficit (6.3% of GDP), challenged public finances (with a budget deficit of 5.2% of GDP and a primary deficit of 2.6% of GDP), and mounting government debt (of around 77% of GDP)[2]. Thanks mainly to lower energy costs, consumer prices have fallen by 0.7% over the first eight months of 2015.

And Prime Minister Dean Barrow returns to office for a third term at a time that growth is slowing. The economy contracted by 1.6% in the June 2015 quarter, with the result that growth through the first half of the year was 2.7%, according to the Central Bank of Belize (CBBz). In the first eight months of 2015, the value of exports from Belize were 15.7% lower than they had been in the previous corresponding period. The contraction was largely due to the fall in volumes – and price – of petroleum from the Never Delay and Spanish Lookout fields. However, values of agricultural products (and shrimp) have fallen, although revenues from exports of bananas have increased as a result of very strong growth in production (thanks in part to larger acreage) in the first three months of 2015. Meanwhile, the numbers of tourists visiting Belize have stagnated. **[1]**

Data from the Statistical Institute of Belize in relation to imports through the first eight months of the year points to conditions that are mixed at best. **[2]** Total imports rose by 3.5% to Bz$1,374mn. There was double-digit growth in imports of manufactured goods and machinery/equipment. However imports of food, beverages, and tobacco were down slightly. Lower oil prices contributed to a sharp fall in the value of fuel and lubricants imported relative to the first eight months of 2014.

The CBBz's data in relation to lending by banks from the end of December last year to the end of August 2015 also suggests that domestic demand has been soft. **[3]** Total loans outstanding at 31 August amounted to Bz$1,957.9mn, or Bz$24.9mn more than at the end of 2014. The growth was driven by an increase in lending to the secondary sector (mainly construction). Banks' lending for personal loans actually fell by Bz$15.9mn to

[1]The Belize dollar (Bz$) is pegged to the U.S. dollar at a rate of US$1: Bz$2.
[2]All figures IMF projections, as per its *World Economic Outlook*, October 2015.

Bz$426.7mn. Although the weighted average interest rates of the banks has been falling, credit remains expensive. According to the CBBz, the weighted average lending rate of the banks at the end of August was 10.29%. The weighted average deposit rate was 1.55%, with the result that the net interest margin (NIM) was 8.73%.

Chart 1: Value of Domestic Exports (Bz$mn)			
January-August	**2014**	**2015**	**Change**
Sugar	108.9	104.3	-4.2%
Molasses	8.2	5.6	-31.7%
Bananas	66.9	72.1	7.8%
Citrus	65.6	54.8	-16.5%
Petroleum	77.1	27.5	-64.3%
Other	67.0	62.0	-7.5%
of which: Papaya	*9.1*	*9.1*	*0.0%*
Shrimp/ Other Marine	71.8	66.3	-7.7%
Total	**465.7**	**392.6**	**-15.7%**
Memo: *Numbers of*			
Stay-over visitors '000	*222*	*221*	*-0.4%*
Cruise ship visitors '000	*582*	*582*	*0.0%*
Source: *various government agencies, cited by Central Bank of Belize, Monthly Economic Highlights - August 2015*			

Chart 2: Value of Gross Imports (Bz$mn)			
January-August	**2014**	**2015**	**Change**
Food, beverages and tobacco	186.0	179.9	-3.3%
Fuels and lubricants	261.5	216.2	-17.3%
Of which: electricity	*28.5*	*31.3*	*9.8%*
Oils, fats and chemicals	122.9	134.7	9.6%
Manufactured goods	240.1	266.8	11.1%
Machinery, transport and equipment	245.4	287.3	17.1%
Other goods	5.5	3.8	-30.9%
Export Processing Zones	86.3	76.6	-11.2%
Commercial Free Zone	179.9	208.8	16.1%
Total	**1,327.6**	**1,374.2**	**3.5%**
Source: *Statistical Institute of Belize, cited by Central Bank of Belize, Monthly Economic Highlights - August 2015*			

Chart 3: Domestic bank lending to clients (Bz$mn)		
	Change Dec 14- Aug 15	**Outstanding 31-Aug-15**
Primary sector (mainly agriculture	2.6	254.6
Secondary sector (mainly construction)	29.4	599.7
Tertiary sector (tourism, distribution and real estate)	8.8	676.9
Personal loans	-15.9	426.7
Total	**24.9**	**1,957.9**
Source: *Central Bank of Belize*		

It appears that the economy would have been even weaker in recent months but for higher spending by the government. According to the CBBz, total government spending increased from Bz$445mn in the first five months of 2014 to nearly Bz$490mn in the first five months of 2015. Spending on wages and salaries rose by about Bz$14mn; purchases of goods and services by about Bz$8mn. Capital expenditure increased by Bz$18mn.

Over the first eight months of the year, the government's domestic borrowings rose from Bz$376mn to Bz$432mn. Public sector external debt increased by Bz$69mn to Bz$2,321mn. There were new borrowings of Bz$125mn (of which Bz$59mn came from the government of Venezuela, Bz$21mn came from the government of Taiwan, Bz$16mn came from the Inter-American Development Bank, and Bz10mn from the Caribbean Development Bank). Repayments (mainly Bz$21mn to the government of Taiwan, Bz$11mn to the Caribbean Development Bank, and Bz$10mn to the Inter-American Development Bank) amounted to a little over Bz$52mn. Interest payments amounted to Bz$67mn: this included Bz$53mn to Bank of New York, which accounts for about 45% of the outstanding external debt of the public sector of Belize.

The government of Venezuela accounts for about 11% of the outstanding external debt and, as noted, a much higher percentage of recent borrowings of the public sector (through PetroCaribe and/or on highly concessional terms). It is therefore impossible to avoid the conclusion that Belize would be hard hit if, for whatever reason, the government of Venezuela became unwilling or unable to continue to support energy importing countries elsewhere in the region. There is no obvious catalyst for growth in the event that the government has to rein in spending. The expansion of Belize's economy is fragile.

REGION

Interest rates: the only way is up?

"Peru's central bank caught the markets by surprise on 10 September with a 25bps rise in its key interest rate to 3.50%. The aim was to squeeze out excess inflation."

Peru did it on 10 September. Chile did it on 15 October. Colombia did it for a second month running on 30 October. Neither Mexico nor Brazil have done it – not yet, anyway. Most analysts now expect the US Federal Reserve to do it in December. Are Central Banks across the region all hiking their benchmark interest rates and ushering in a new era of tighter monetary policy?

Peru's central bank – Banco Central de Reserva del Peru (BCRP) – caught the markets by surprise on 10 September with a 25bps rise in its key interest rate to 3.50%. The aim was to squeeze out excess inflation. The BCRP has a 1.0%-3.0% target range for inflation, and the actual rate has been running higher – at 3.90% in the 12 months to September. The bank said, however, that the high inflation rate reflected a series of one-off factors including a seasonal peak in food prices and the effect of the El Niño weather pattern. The interest rate was left unchanged in October, and analysts have been suggesting that there won't be any further upward moves until the end of 2015 or early 2016.

Chile's Central bank increased its reference interest rate by 25bps to 3.25% on 15 October. In a statement it made clear that the decision was taken to tackle persistent above-target inflation. The bank is trying to keep inflation in a 2.0%-4.0% range. In September, however, 12-month retail inflation in the country was 4.6%. The bank warned that "additional adjustments" to monetary policy are likely – code for signalling another rise in the base rate may be on the way. But analysts believe Chile is likely to see no more than a short tightening cycle, as the depreciation of the Chilean peso (seen as an important factor driving retail prices) is now stabilising and the economic recovery remains relatively weak.

The Colombian central bank surprised most analysts (and President Juan Manuel Santos) with a 50bps rise in its key rate to 5.25%, announced on 30 October. This was the second monthly tightening move, bigger than the 25bps increase most of the market had been expecting. Here, the main moti-

[3] Carlos Cáceres, Yan Carriere-Swallow and Betrand Gruss

vation appears to have been the fear that the economy could be moderately overheating. Twelve-month inflation to September was above the Colombian target of 2.0%-4.0% at 5.35%, attributed by the bank to the depreciation of the Colombian peso and the consequent increase in the price of imported raw materials. The bank also edged up its 2015 GDP growth forecast to 3.0% (up from 2.8% previously). President Santos made it clear that he thought the bank had overreacted. "I thought it was exaggerated, and I told the finance minister that 50 basis points rather than 25 is too much, it risks applying the brakes on the economy too sharply" the president said, although he took care to say he respected the central bank's independence.

The Brazilian central bank, in contrast, held interest rates steady in October. Because of persistent inflation and in part to offset loose fiscal policy, Brazil's Selic rate stands at a nine-year high of 14.25%. Among the world's top ten economies, Brazil has the highest benchmark interest rate. The dilemma facing Copom, the bank's monetary policy committee, is that with the economy in recession both the government and much of the private sector would like to see the Selic rate come down. But high domestic inflation and global conditions point in the opposite direction, towards further tightening. Copom's October statement did not rule out an eventual upwards move, although it did say the Selic rate would remain stable for a time. Analysts say Copom is hoping that the recession (GDP could drop by as much as 3% this year according to consensus opinion) will eventually reduce the rate of inflation. However, there are as yet few signs of that happening with retail prices up by 9.77% in the 12 months to mid-October. Nominally, Copom's target is to reduce inflation to 4.5% by the end of 2016. The danger for Brazil appears to be one of prolonged stagflation.

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There was no movement either in Mexico, where the central bank – Banco de México (Banxico) – has left interest rates untouched at 3.0% for 17 consecutive months. While the Mexican peso has also undergone significant depreciation against the US dollar this year, inflation has remained at record low levels – 2.5% in the 12 months to September, comfortably at the low end of the 2.0%-4.0% target range. In addition Mexican economic growth has remained sluggish. The country benefits from its close trade and manufacturing links with the US. While much of South America is exposed to the negative effects of the expected interest rate normalisation in the United States, Mexico (and arguably much of Central America) is supported by the recovery in the US economy that is seen as the benign precursor to the eventual tightening of the US Federal Reserve's prime interest rate.

While, as this short account shows, each country's situation is somewhat different, there are some broad themes and shared dilemmas. One is that the fall in commodity export prices – a negative shock to the terms of trade – has triggered significant depreciation of Latin America's mainly floating currencies. In the year to 9 November the Brazilian real has depreciated by 43% against the US dollar, while the Colombian peso has fallen 23.1%, the Chilean peso 15.8%, the Mexican peso 13.7% and the Peruvian Nuevo Sol by 11.2%. Weaker currencies are seen as helping Latin America adjust and reduce current account deficits, but they have some unwanted side effects. One is that weaker currencies may cause an inflationary pass-through that may of itself prompt a need for domestic interest rate hikes. However, it seems the pass-through effect varies in intensity by country, and has been greatest in Chile and Colombia, and less strong in Brazil and Peru. With imports representing only 15% of GDP the pass-though effect in Brazil is small: inflation there is more of a local, rather than an imported problem. A previously

“Most analysts argue that a return to the commodity price boom or to expansive global credit is not around the corner. At a recent seminar organised by the Brookings Institute in Washington another IMF official, Robert Rennhack of the Western Hemisphere department, insisted that “the change in the external global environment is permanent” meaning that Latin America “will have to adapt”.”

[4]*OECD Review of Pension Systems* – Mexico, October 2015

[5]A defined benefit pension system is one where the risk of being unable to pay future pension obligations rests with the plan sponsor. For some sponsors and – previously, as was the case in Mexico – entire systems, the actuarial value of future obligations can be enormous. A defined contribution pension system is one where the risk of inadequate assets at retirement is borne by the individual worker. In a defined contribution system, the sponsor will not accumulate an actuarial liability.

existing pass-through effect in Mexico appears to have gone into reverse this year, with both the peso and the inflation rate falling together.

A second overriding question is whether the much-expected tightening of US interest rates will push Latin America more deeply into recession. According to research by three IMF economists[3] the effects of a US Fed rates increase should be manageable, although long-term interest rates will rise. The authors comment: “Countries with flexible exchange rates and credible monetary and fiscal frameworks should be able to continue providing support by keeping short rates low where needed”. The paper also asks whether Latin American interest rate movements tend to follow the US (what it calls a “spillover effect”) or whether they move in step because they are reacting to similar conditions in the global economy. Its conclusion was that domestic macroeconomic conditions are the predominant factor, but that spillover effects are “significant and relatively large” in Mexico and Peru.

Most analysts argue that a return to the commodity price boom or to expansive global credit is not around the corner. At a recent seminar organised by the Brookings Institute in Washington another IMF official, Robert Rennhack of the Western Hemisphere department, insisted that “the change in the external global environment is permanent” meaning that Latin America “will have to adapt”. Rennhack went on to say that Peru, Chile, Mexico, and Colombia, all growing at over 2% this year, were in a better situation to do so than Venezuela (where the IMF is forecasting that GDP will slump by 10% amid a three-digit inflation rate), Argentina (where an economic adjustment would be required in 2016), and Brazil (where the “complicated political situation” had pushed the economy into recession).

REGIONAL BUSINESS REVIEW

MEXICO

Yucatán bees sting Monsanto?

The Mexican Supreme Court (Suprema Corte de Justicia de la Nación – SCJN) has delivered a setback to Monsanto, the US agro-industrial corporation, by issuing a temporary injunction preventing the cultivation of genetically modified (GM) soya in the states of Campeche and Yucatán. It is a story that involves bees, honey, and the European Union.

The SCJN injunction, issued on 11 November, suspends Monsanto’s permit to cultivate GM soya in an area of 235,500 hectares across the states of Campeche and Yucatán. The current permit dates back to May 2012 when it was issued by the previous Mexican government. It had been challenged in the courts by local indigenous community beekeepers, who have traditionally exported around 90% of their honey to Europe. But their business was hurt when sales plummeted after the EU found traces of GM pollen in Mexican honey and banned imports in 2011. Critics have claimed that large-scale soya farming in the area leads to deforestation and a reduction in the diversity of local fruits and flowers, which in turn leads the bees to produce less tasty or lower quality honey. Some 11,200 honey producers are said to be affected, providing a livelihood for 25,000 families. The Yucatán peninsula produces around 10,000 tons of honey every year; Mexico accounts for 10% of global honey exports. It is also claimed that the GM soya is sprayed with glyphosate-based herbicides that have been linked to cancer.

Considering the complaint, the five SCJN judges ruled unanimously that the way the permit had been issued contravened Article 2 of the Mexican constitution and other legislation such as the Biosecurity Law, which require that local communities be consulted before decisions of this type, that may affect their livelihoods, are taken. In this case the court said the agriculture, livestock, fishing, rural development and food ministry (known by its acronym Sagarpa) had failed to carry out any meaningful consultation.

The SCJN decision means that Monsanto cannot cultivate GM soya in the area until local communities are properly consulted. It was not immediately clear how long this might take. According to Jorge Fernández, the lawyer representing the local communities, a rapid consultation process would not be appropriate, as local inhabitants need to be given "clear and honest" scientific information, properly translated into local languages and dialects. Fernández said that although he welcomed the SCJN decision, he noted that the justices had been silent on the question of compensation for environmental damage, which had been recognised as an issue by lower courts.

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Monsanto responded by saying it respected the SCJN's decision and would study the full text of its ruling when it was released. However it also rejected any claimed link between its GM soya seeds and damage to the honey industry. "We do not accept accusations that put us as responsible for deforestation and illegal logging in the municipality of Hopelchén, Campeche, or any place in the Republic, because our work is rigidly attached to the guidelines provided by law" it said in a statement. It added that 44,000 hectares have been planted with soya in the Yucatán peninsula, of which 13,000 have been planted with Monsanto seeds.

In October, before the ruling was announced, Monsanto's head of regulatory affairs for northern Latin America, Eduardo Pérez, had told *Reuters* news agency in an interview that the company was aiming to double its sales in Mexico over the next five years. To achieve that, he said it was setting its hopes on the use of more advanced technology in the production of maize. Monsanto was investing around US$20m a year in seed research and development in Mexico, a sum that could be doubled "to the extent that new technologies are permitted, we're talking about GM maize, precision agriculture, or other technological innovations". In fiscal 2015 Monsanto had global sales of US$15bn, of which US$400m came from Mexico. Around 70% of its Mexican sales came from modified seeds, 10% from herbicides, and 20% from the sale of cotton, sorghum, soya, and vegetable seeds. The use of GM maize is also being challenged in Mexican courts.

MEXICO

The OECD reviews the pension system

In mid-October 2015, the Organisation for Economic Cooperation and Development (OECD) published a report on Mexico's pension system[4] that had been commissioned by the Comisión Nacional del Sistema de Ahorro para el Retiro (CONSAR – the relevant regulator). In general, Mexico's shift from an unfunded defined benefit[5] (DB) system to a properly funded defined contribution system (DC) is going well. However, the OECD has identified a number of areas for improvement.

Prior to the mid-1990s, Mexico's DB pension system was funded on a pay-as-you-go basis by the government. Following a reform of the Social Security

Law in 1995, individual DC accounts were introduced for private sector workers affiliated with the Instituto Mexicano del Seguro Social (IMSS). Workers who had contributed to the system up to that time were given the option of drawing benefits at retirement either according to the old DB formula or according to how much had accumulated in their DC Accounts. In 2007, public sector workers affiliated with the Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado (ISSSTE) were given the choice of staying with the old DB system or (receiving a bonus to recognise their past membership of the DB system) transferring to a new DC system with individual accounts. Some government agencies have also moved their pension plans from a DB to a DC basis.

Mexico is, therefore, well advanced in a shift from an unfunded DB pension system to a fully funded DC system, where the pension liabilities are transparent. Already the impact on the overall actuarial deficit has been huge. The government suggests that, prior to the reforms, the actuarial deficit of the DB system had been equivalent to 129% of GDP. Now the deficit is equivalent to just over 80% of GDP. The savings (i.e. the difference between the deficit prior to the reform and currently) within the IMSS is equal to a little over 17% of GDP, while the savings within the ISSSTE amount to nearly 23% of GDP.

“Mexico is, therefore, well advanced in a shift from an unfunded DB pension system to a fully funded DC system, where the pension liabilities are transparent. Already the impact on the overall actuarial deficit has been huge.”

The OECD also considers that the new system has been a success. After just 17 years of operation, the assets in the system that support the pension benefits were equivalent to just over 14% of GDP at the end of 2014. By this measure, Mexico is a mid-ranking country relative to others in the OECD. The Administradoras de Fondos para el Retiro (AFOREs – private pension fund managers) have collectively achieved annual investment returns of 12.5%, or 6.2% in real terms. The OECD also believes that CONSAR has also operated according to best practices of OECD countries.

Nevertheless, the OECD has identified several aspects which can be improved:

The transition from DB to DC needs to be made fairer. A worker who joined the IMSS or ISSSTE DB system just before individual DC accounts were introduced is entitled to a much larger pension if he/she chooses the old DB formula than another worker with a similar work history and savings record who joined just afterwards, and who is therefore compelled to receive benefits according to the new DC formula. The OECD sees this as unfair, and likely to cause opposition to the new DC system. The OECD’s suggested solution is to pro-rata the retirement benefits between the DB and the DC formula according to the length of the contribution period prior to the introduction of the DC system.

There is a need for higher contributions. The current contribution rate of 6.5% is sufficient to support a pension of just over 26% of final income before retirement for the average worker. The OECD suggests a gradual increase in the contribution rate to 13%-18% over 40 years: this would result in a 75%-90% likelihood of enough money to provide the average worker with a pension equivalent to 50% of final salary.

The old-age safety net should be improved. As is the case with other OECD countries, Mexico has a non-contributory old-age social pension for individuals who, for whatever reason, have not been able to accumulate enough rights or assets. The OECD argues that the Pensión para Adultos Mayores (PAM – the non-contributory old-age pension) should be increased in order to reduce the incidence of poverty in old age.

The government should harmonise the rules for all pension plans. At the moment, the entitlements of future retirees differ depending on whether they are affiliated with the IMSS, the ISSSTE, or with special pension plans run by universities, state-owned oil company PEMEX, municipalities, and state governments. The OECD argues that the ultimate goal should be a truly national system with the same benefits for all Mexicans.

The OECD also notes that some financial challenges remain. Because of the length of time taken to move from the DB basis to the DC basis, and the lack of reform of some pension schemes, the OECD expects that the government may face significant fiscal pressures from the mid-2030s. Particular DB pension funds are not accounting properly for future improvements in mortality, which means that they may be underestimating their actuarial liabilities. In addition, the Pensión Mínima Garantizada (PMG – the minimum guaranteed pension) is quite high relative to the contributions likely to be paid in the qualifying period, and this means that, for low wage workers especially, there is little incentive to contribute for longer than the qualifying period.

> "The OECD argues that the investment limits that apply to AFOREs' investment in equities and overseas assets prevents proper portfolio diversification. Further, while fees charged by the AFOREs have fallen over the last decade, they remain high by international standards."

The OECD also advocates changes to the rules governing AFOREs and providers of annuities. The investment restrictions that are applied to the funds offered by AFOREs to people who are saving for retirement on a DC basis mean that the workers have too little choice and are over-exposed to domestic fixed income assets. The OECD argues that the investment limits that apply to AFOREs' investment in equities and overseas assets prevents proper portfolio diversification. Further, while fees charged by the AFOREs have fallen over the last decade, they remain high by international standards. Life insurance companies are only allowed to offer one annuity product, the traditional immediate life annuity. In addition, they have to provide annuities through a ring-fenced subsidiary. They cannot diversify the risks across other business that they are underwriting, and, as a result, the cost of annuities is increased and the pensions that they can pay is reduced.

REGION

Corporate Radar

CMPC and SCA accused of running a cartel: Chile's economic prosecutions office (Fiscalía Nacional Económica) accused the powerful CMPC group (controlled by the Matte family) and Swedish-owned SCA of operating a price cartel in the country's paper products market for over 10 years. In a complaint filed with the competition tribunal (Tribunal de Defensa de la Libre Competencia – TDLC), the FNE said the two companies colluded on fixing quotas and prices on toilet paper, paper towels, paper serviettes, facial tissues, and cosmetic tissues. The two companies have combined sales in Chile of around US$400m per annum and control 90% of the market. CMPC owner Eliodoro Matte officially apologised to the public and the company's consumers for what he described as "these repudiable acts". President Michelle Bachelet said the matter was "very serious" and that she would submit a bill in congress raising the level of fines for market rigging. Apart from Chile, CMPC, which is also involved in forestry and cellulose, has operations in Argentina, Brazil, Colombia, Mexico, Peru, and Uruguay.

Petrobras announces further losses: State-owned oil company Petrobras announced net third quarter losses of BRL3.76bn (US$1.01bn) as a result of lower international oil prices, the depreciation of the real, and a deep

domestic recession. The loss was over three times larger than the market had been expecting, although smaller than in Q314, when the company was in the red by BRL5.34bn. Net revenue fell 6.9% to BRL82.2bn in Q315. But analysts noted that operating results improved, with Ebitda up by 82% to BRL15.5bn. Meanwhile the company was hit in early November by a stoppage by oil workers' union FUP that reduced output by around 115,000 barrels per day, or 5.5% of the total. On 11 November management offered a 9.5% salary increase, but the union, which is demanding an 18% rise, was reported to have rejected the offer and demanded a meeting with chief executive Aldemir Bendine.

LATAM denies IAG talks: Rumours of discussions on a strategic alliance or even a takeover bid by International Airlines Group (IAG – the alliance between British Airways and Iberia) for LATAM Airlines (the merger formed by LAN of Chile and TAM of Brazil) have been denied. The reports led to a 6% rise in LATAM share prices on 9 November. They were based on a discussion between IAG chief executive Willie Walsh and a group of analysts. According to press reports of the meeting Walsh had said IAG wanted to work more closely with LATAM and might even consider a takeover. However IAG later denied that this had been said, and LATAM issued a formal statement saying the company was "not in conversation with IAG on an ownership stake." Both companies are members of the Oneworld alliance and have code-sharing agreements.

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Pemex further in the red: Mexico's state oil company Pemex reported net losses of MXN167.57bn (US$9.921bn) in Q315 on the back of lower international oil prices, a fall in crude oil output, and a depreciating peso. The losses were more than double the MXN59.654bn loss in the comparable year-earlier period. Net revenues fell by 22.8% in the quarter to MXN313.77bn. Crude output fell by 5.5% to 2.266m barrels per day (bpd). The price of Mexican mix crude was down by 53.8% to US$41.75 a barrel.

SPECIAL FOCUS

HONDURAS

Banco Continental and the Rosenthals' empire: orderly liquidation, so far...

Recent actions by the US Treasury's Office of Foreign Assets Control (OFAC) and the Honduran government against three members of the wealthy and very prominent Rosenthal family have caused a massive scandal. The actions also appear to have caused cash flow problems for some of the family's businesses. However, the forced closure and liquidation of the Rosenthals' Banco Continental appears unlikely to cause problems for the Honduran banking system or for the economy as a whole.

On 7 October 2015, OFAC named Honduran magnate Jaime Rosenthal Oliva, along with his son Yani Rosenthal Hidalgo and his nephew Yankel Rosenthal Coello, as drug traffickers under the Foreign Narcotics Kingpin Act. As a result, all assets of the three Rosenthals that are under the jurisdiction of the US (or under the control of US persons) are frozen. US citizens are generally forbidden to do business with the Rosenthals. In addition, indictments charging the three (along with a fourth individual) with money laundering were unsealed by the Drug Enforcement Administration (DEA) and the US Attorney for the Southern District of New York. Yankel Rosenthal was arrested in Miami. The Rosenthals deny the charges.

OFAC strikes Banco Continental

The announcement is unusual in that OFAC also named Banco Continental SA, which the Rosenthals own. OFAC says that the bank "has served as an integral part of the Rosenthal money laundering operations and facilitated the laundering of narcotics proceeds for multiple Central American drug trafficking organisations". OFAC has never previously designated a bank under the Kingpin Act.

Other businesses which were named by OFAC include three holding companies in the British Virgin Islands (BVI), three investment companies in the US and Panama-based Grupo Continental, the parent company of the family's conglomerate. In addition to Banco Continental, the conglomerate includes Inversiones Continental, the Honduran subsidiary of Grupo Continental that holds the group's interest in financial services and other sectors, and Alimentos Continental, the conglomerate's agribusiness arm: both of these enterprises were also named specifically by OFAC.

"International law required the government of Honduras to seize control of and liquidate Banco Continental. The Honduran Comisión Nacional de Bancos y Seguros (CNBS – the financial sector regulator) took over Banco Continental on 12 October, arguing that the freezing of the bank's US assets reduced its capital adequacy ratio from 11.6% to 5.2%, or below the regulatory minimum of 6% and began the process of liquidation."

International law required the government of Honduras to seize control of and liquidate Banco Continental. The Honduran Comisión Nacional de Bancos y Seguros (CNBS – the financial sector regulator) took over Banco Continental on 12 October, arguing that the freezing of the bank's US assets reduced its capital adequacy ratio from 11.6% to 5.2%, or below the regulatory minimum of 6% (*see* Honduras: Crocodiles and Lions, in our sister publication Latin American Caribbean & Central America – November 2015) and began the process of liquidation. The CNBS also announced arrangements for the bank's 220,000 depositors to get access to their money. A depositor can withdraw sight and time deposits up to a limit of HL208,680 (US$9,485) through one of four other banks – Banco FICOHSA, Banco Atlántida, Banco del País and Banco Occidente, according to the letter of the alphabet with which the depositor's surname begins. As of 10 November, some HL1,440mn has been paid out to 59,051 depositors. Foreign currency deposits will be paid out in Honduran lempiras. People with deposits and loans will only receive the difference. The CNBS has yet to announce what will be the arrangements for people who have borrowed money from Banco Continental and who do not need immediate access to any money that they have deposited.

The (few) hard numbers

Because of the Rosenthals' political prominence (with Jaime Rosenthal having been vice president in the late 1980s, Yani Rosenthal having run unsuccessfully for president in 2012, and Yankel Rosenthal being president of the Marathon soccer club and having been Minister of Investment until June this year), the actions by OFAC and the CNBS seizure of Banco Continental have caused an enormous scandal.

And a note to the 2014 Annual Report of Banco Continental confirms that the breadth of the family's interests is, indeed, vast. Inversiones Continental, one of the Honduran companies that has been named by OFAC, owns 93.73% of Banco Continental, 86.63% of Seguros Continental, 99.99% of Arrendadora Continental, 89.56% of Almacenes de Depósito Continental and all of Continental Casa de Bolsa, the group's other financial services businesses.

Inversiones Continental is also a majority shareholder of Alimentos Continental (in agribusiness); Editorial Honduras, Sociedad Televisora

Nacional and Cable Color (in media); Inversiones Bicon (in cement); Promociones y Turismo and Aparthoteles Continental (in tourism); and Zonas Industrias Continental and Constructora Continental Delta (construction and real estate) among other companies.

Banco Continental itself has two associates, Banco de Occidente and Inversiones Bicon. As of the end of 2014, the investments in these companies were valued at HL638m (US$29m) and HL183m (US$8m) respectively.

Press reports suggest that the net wealth of the family amounted to nearly US$700m prior to the CNBS seizure of Banco Continental. In the absence of readily available data in relation to the assets, liabilities, and earnings of all the subsidiaries of the Panama-based Grupo Continental (i.e. Inversiones Continental and its holdings along with the investment companies in the US and the BVI), this figure is difficult to verify. By standards other than those of Honduras, the businesses are not particularly large. For instance, Seguros Continental, the insurance business which appears so far not to have been affected by the group's problems, had total assets and shareholders' funds of HL1,084m (US$49m) and HL571m (US$26m) at the end of 2013. During that year, it wrote net premiums of HL204m (US$9m) and made net profit of HL63m (just under US$3m).

Chart 1: Banco Continental SA Balance sheet as at 31 December 2014

(All figures in millions of Honduran lempiras)

Agribusiness loans	1,660	Capital items	1,692
Industrial loans	1,051		
Housing loans	2,339	Sight deposits	1,859
Service sector loans	898	Savings deposits	2,182
Commerce loans	715	Term and other deposits	2,808
All other loans [1]	1,022	**Total deposits [5]**	**6,849**
Total loans [2]	**7,685**		
		Industrial sector loan program funding	1,181
Investments in associates [3]	851	Middle class home loan program funding	1,106
		Other loans	353
Investment properties	43	Creditors and other liabilities	367
Notes and bonds issued by the central bank	718		
Other securities	614		
Cash and bank deposits [4]	1,297		
Property, furniture etc.	340		
TOTAL ASSETS	**11,548**	**TOTAL LIABILITIES AND CAPITAL ITEMS**	**11,548**

1 Includes HL273mn to 17 different municipal councils

2. Of which HL5,869mn were backed by mortgages over borrowers' assets

3. Predominantly Banco de Occidente (HL638mn) and Inversiones Bicon (HL183mn)

4. Including HL696mn with the central bank and HL361mn with foreign banks

5. Includes HL1,209mn in deposits from related parties. Loans to/claims against related parties amounted to HL121mn. Loans/guarantees through credit cards amounted to HL172mn

Source: *Banco Continental SA Annual Report for 2014*

At the end of 2014, Banco Continental itself had total assets of HL11,548m (US$525m) and shareholders' funds of HL1,692m (US$77m) **[1]**. Total loans to customers amounted to HL7,685m (US$349m), while total deposits amounted to HL6,849m (US$311m). Over three quarters of the loans were secured by mortgages. The bank's balance sheet was expanded by loans through official programmes to promote lending to the industrial sector of HL1,181m (US$54m) and to promote home loans of HL1,106m (US$50m). Assuming that Banco Continental has grown broadly in line with the rest of the commercial banking sector (which includes 17 institutions) through the first eight months of 2015, loans and deposits should have risen by around 4%-5% since the beginning of this year. The bank's loan portfolio was widely spread over different sectors of the Honduran economy and included HL273m (US$12m) in loans to 17 different municipal councils. Pre-tax and post-tax profits in 2014 amounted to HL66m (US$3m) and HL43m (US$2m) respectively. The bottom line was boosted by the bank's share of its associates' profits of HL88m (US4m).

However, all this needs to be considered in the context of the entire commercial banking system **[2]**. As at the end of 2014, Banco Continental apparently accounted for about 3.7% of customer deposits and a very similar percentage of loans to customers, according to data from the central bank. Banco Continental did account for a higher percentage – about 6.8% – of total bank lending to local governments. As noted, though, local governments represented a very small part of its loan book. Collectively, the Honduran banks are strong, with claims on the central bank amounting to around one third of total deposits. The central bank's numbers also suggest that the government is effectively funding its non-financial state owned enterprises through the commercial banking system.

Chart 2: Honduras' Commercial Banking System

Selected metrics (all figures in millions of Honduran lempiras)

	Dec-14	Aug-15	Variation
Total deposits	185,052	194,557	5.1%
Loans to households etc.	100,694	105,255	4.5%
Loans to other non-financial companies	103,512	109,053	5.4%
Claims on the central bank	65,010	72,327	11.3%
Net claims on the central government	-9,412	-10,663	13.3%
Claims on public non-financial businesses	8,441	9,043	7.1%
Claims on local governments	4,025	3,598	-10.6%

Source: *Banco Central de Honduras*

So, how important is Banco Continental, really?

Banco Continental's accounts for 2014 give the overall impression of a small and politically well-connected institution with a strong balance sheet and fairly low profitability (with return on equity of about 8% in 2014 if the associates' profits are included) which, because of the prominence of the Rosenthals, has been seen as being much more important than it really is. In the event that the bank were to encounter financial problems – which does not appear to be the case currently – it could easily be absorbed by another Honduran bank.

All this raises the question of the financial situation of the other companies that are owned by Inversiones Continental. At the end of 2014, related parties (but not Banco Occidental) had deposits with Banco Continental of HL1,209m (US$55m). In other words, group companies accounted for a little under one fifth of total deposits. Loans to and claims against related parties amounted to HL121m (US$6m) while loans through credit cards used by group employees amounted to a further HL172m (US$8m). This means that group companies and related parties accounted for just 4% of Banco Continental's lending. Although significant amounts of money may have been channelled between Banco Continental and the other group companies in either direction through off-balance sheet vehicles, it seems that most of the group companies have been generating cash, and that much of that cash has been deposited with the bank.

The lurid reports of how crocodiles and lions at the Rosenthals' 30-hectare ranch have not been fed for over a month (*see* '[Honduras: Crocodiles and Lions]'), together with the temporary closure of Tiempo, one of the group's newspapers, at the end of October, suggest that some group companies have indeed been hit hard by the inability to withdraw deposits. However, the sheer number and diversity of the group's other businesses – from which there have not been reports of financial distress – suggest that they are the exceptions rather than the rule.

"The scandal will continue to generate much comment – and particularly when further details become public if (as appears likely) one or more of the Rosenthals face trial."

It is also significant that payments to depositors who have wanted to extract their money from Banco Continental have only involved about one fifth of total deposits and around one quarter of the depositors. The implication is that most of the depositors are happy to leave their money with the bank even as the regulator undertakes an orderly liquidation. Meanwhile, it appears that the bank has been able to absorb the freezing of about HL800m (US$36m) in deposits with US banks and/or other assets that are under the control of the US authorities.

The scandal will continue to generate much comment – and particularly when further details become public if (as appears likely) one or more of the Rosenthals face trial. However, Banco Continental has been able to withstand the freezing of its assets in the US, and, so far, the vast majority of the various businesses of Inversiones Continental have been able to cope with the freezing of their deposits with the bank. The liquidation appears to be progressing in an orderly fashion. Given the small size of Banco Continental within the overall Honduran commercial banking sector and the financial strength of the sector as a whole, it seems unlikely that the liquidation will have an adverse and lasting impact on Honduras' economy.

HONDURAS

Meeting – and beating – expectations

Thanks in part to an improvement in terms of trade and in part to growth in remittances from expatriates, Honduras' economy expanded by 0.6% in Q215 and by 3.0% relative to the same quarter of 2014. This is in the context of a general improvement in the country's ranking in the World Economic Forum's latest *Global Competitiveness Report*.

In mid-September 2015, the International Monetary Fund (IMF) completed its first review in terms of the Stand-By Arrangement and Stand-By Credit Facility that had been arranged for Honduras in December 2014. As a result, the government of Honduras has access to IMF funding of around US$63.8m, should it need it.

The IMF's First Deputy Managing Director remarked favourably on the commitment of the Honduran government to implementing reforms agreed with the IMF, at a time when the economy has been benefiting from an improvement in the terms of trade and strong remittances from expatriates.

"For 2015, the authorities have strengthened fiscal and monetary targets, taking advantage of the more favourable external environment to reduce the deficit of the central government and state electricity company ENEE at a faster pace than originally envisaged. This will add to the credibility of fiscal adjustment and enhance confidence. The authorities also plan to continue changing the composition of public expenditure to create room for higher and better-targeted social spending to support the reduction of the high levels of poverty."

The government had made significant progress with strengthening ENEE's financial position prior to the end of 2014. Thanks to tighter control of costs and a 12% lift in power tariffs, the government had managed to reduce ENEE's deficit by around 0.5% of GDP, improve operating margins and reduce the stock of arrears. Over the course of 2015, the government will reduce the number of personnel at ENEE by about 40%.

"The IMF is looking for real GDP growth to accelerate from 3.1% in 2014 to 3.5% this year to 3.6% in 2016 and 3.8% in 2018. Overall GDP in 2015 should be US$19.94bn."

The government has completed a census of public servants and is looking to reduce its own wages bill. Savings will be used to expand *Vida Mejor*, the flagship social programme, from 270,000 families living in extreme poverty to 300,000 over the course of 2015. The IMF notes that there is scope to increase social spending if tax revenues are greater than have been expected. The government has provided poor families with subsidies to protect them from the increases in electricity tariffs.

The IMF is looking for real GDP growth to accelerate from 3.1% in 2014 to 3.5% this year to 3.6% in 2016 and 3.8% in 2018. Overall GDP in 2015 should be US$19.94bn. The government's primary deficit (i.e. before interest payments) is expected to slip from 3.8% of GDP in 2014 to 1.3% this year. The overall deficit is projected to fall from 4.3% of GDP to 2.5%. Central government gross debt is expected to rise from 45.7% of GDP in 2014 to 48.4% this year.

According to Banco Central de Honduras (BCH – the central bank), real GDP rose by 0.6% in the June quarter, and by 3.0% relative to the second quarter of 2014. The growth was broadly based, with an expansion in activity in the telecommunications sector (by 1.2% relative to the March quarter of 2015); retailing, hotels and restaurants (up 1.1%); financial services (up 0.6%); and construction (up 1.5% thanks to both public works and spending on residential housing in Tegucigalpa and San Pedro Sula). There were smaller rises in activity in manufacturing (up 0.3%) and agriculture (0.1%).

In terms of expenditure, growth in the second quarter was driven by exports of goods and services (which rose by 1.8% relative to the March quarter) and domestic consumption spending (which increased by 0.6%). However, investment fell by 4.2%.

There were some significant changes in Honduras' balance of trade through the first half of 2015. Thanks to the fall in the global price of energy, imports of fuel and power were US$721m, or US$345m less than they had been in the first six months of 2014. The deficit in trade in goods increased by US$235m to US$2,546m thanks mainly to higher imports of raw materials for industry and consumer goods. Remittances in the first half of 2015 amounted to US$1,823m, or 10.3% more than in the previous corresponding period.

The BCH is looking for inflation this year of between 3.75% and 5.75%, or about 75 basis points lower than its target (of 4.50%-5.50%). The central bank cut its key policy rate by 25 basis points on each of 9 February, 23 March, and 6 July. The rate currently stands at 6.25%.

In April 2015, the IMF had assessed the BCH's monetary policy as being "broadly appropriate", bearing in mind the inflation target and the central bank's desire to allow the lempira to depreciate relative to the US dollar by around 5% over the course of 2015. Over the year to June 2015, broad money (M3) and deposits from the non-bank public both rose by 13.7%. Bank lending to the private sector rose by 9.2%

"Crime and violence was identified by the companies that the WEF surveyed as being the most problematic factor for doing business in Honduras."

Honduras' financially strong and conservatively managed banking sector is one of the country's competitive advantages. In the latest (2015-2016) *Global Competitiveness Report* of the World Economic Forum (WEF), the country is ranked 38th (out of the 140 assessed globally) for its financial market development. Honduras' competitiveness is also boosted by its business sophistication (54/140) and innovation (54/140).

Honduras' overall competitiveness ranking was 88/140 – a marked improvement relative to 2014-2015 (when the country was ranked 100/144) and 2013-2014 (111/148) if not 2012-2013 (90/144). However, the overall score for competitiveness has been increasing over time. Ironically, the WEF's methodology means that the competitiveness ranking is held back by Honduras' macro-economic situation. This is because of the size of the budget deficit relative to GDP (100/140), the low savings rate (103/140), and the overall credit rating of the government (112/140).

Crime and violence was identified by the companies that the WEF surveyed as being the most problematic factor for doing business in Honduras. Out of the 140 countries surveyed in the latest report, Honduras is ranked 133rd for business costs of crime and violence, 134th for organised crime, and 114th for the reliability of the police service. In spite of the progress made by the government to control its expenditure, the country is ranked 124th for wastefulness of government spending.

REGIONAL MARKETS REVIEW

REGION

A snapshot of the (very varied) levels of financial development in Latin America and the Caribbean

The region as a whole would benefit from further development of financial institutions and markets. However, the gains, in terms of economic growth, would likely be less for Brazil and Chile, where financial institutions and markets are most developed, than in other countries.

[6] IMF, Regional *Economic Outlook – Western Hemisphere: Adjusting Under Pressure*, October 2015

In its latest Regional Economic Outlook of the Western Hemisphere, the IMF devoted a chapter to an examination of the financial development of Latin America and the Caribbean[6].

In assessing the financial development of each country considered, the IMF constructed a Financial Development Index, which has two core components: Institutions and Markets. Both components take into account access, depth and efficiency.

The IMF found that, across the region as a whole, access to financial institutions had expanded substantially between 2004 and 2003. Partly for this reason, most countries in Latin America and the Caribbean are assessed more favourably for Institutions than for Markets. However, the countries of the region generally lag behind other emerging markets (but not low income countries) in terms of overall financial development.

Of course, there is considerable variation between the countries. **[1]** For the 123 countries globally for which the IMF gathers data, the Financial Development Index varies from zero to one, which is the Index for the country with the highest level of overall financial development. The average Financial Development Index for the G7 countries is about 0.6. For Brazil and Chile, the Index is a little less than 0.5. The Index is between 0.3 and 0.4 for each of Panama, Mexico, Colombia and Peru. At the other extreme, the Index is a little over 0.1 for Nicaragua.

Chart 1: Selected Financial Development Index components, 2013: Top three countries and bottom two

Institutions	**Top Three**			**Bottom Two**	
Access					
Bank branches per 100,000 adults	Brazil 118.6	Bahamas 74.4	Chile 67.3	Paraguay 19.8	Nicaragua 11.9
ATMs per 100,000 adults	Peru 88.4	Brazil 47.7	Chile 17.2	Nicaragua 7.6	Jamaica 6.1
Depth					
Domestic bank deposits / GDP %	Barbados 113.8	Panama 78.7	Bahamas 72.1	Dom. Rep. 22.7	Costa Rica 22.5
Insurance company assets /GDP %	Barbados 26.9	Trinidad & T. 26.7	Chile 20.2	Ecuador 1.6	Dom. Rep. 1.5
Domestic credit to private sector / GDP %	Chile 105.9	Brazil 80.6	Bahamas 77.4	Venezuela 25.3	Argentina 15.8
Efficiency					
Interest rate spread %	Venezuela 1.4	Argentina 2.3	Mexico 2.9	Peru 14.1	Brazil 14.1
Markets					
Access					
Measure of issuers of debt	Chile 117.7	Barbados 106.4	Colombia 70.8	Uruguay 0.4	Nicaragua 0.0
Depth					
Outstanding international public debt securities / GDP %	Bahamas 65.2	Barbados 36.2	Jamaica 31.3	Nicaragua 2.2	Bolivia 2.1
Debt securities of non-financial sector by local firms / GDP %	Dom. Rep. 10.1	Jamaica 10.1	Paraguay 8.2	Bahamas 3.5	Panama 3.2
Efficiency					
Stockmarket turnover ratio*	Argentina 6.5	Dom. Rep 6.5	Jamaica 6.5	Bahamas 2.2	Panama 1.6

*value traded/ stock market capitalisation

Source: *IMF*

The IMF highlighted the positive relationship between financial development and growth. However, Brazil and Chile are nearest the 'optimum' level of development beyond which the marginal impact on growth from any further development is negative. Conversely, further financial development

in the Dominican Republic, Paraguay, or Honduras could have an increasing – and positive – impact on growth.

The IMF suggests that the fundamental elements of a well-functioning financial system include: strong property rights; an efficient legal system; low corruption; sufficient financial information; and sound prudential regulation and supervision.

It argues that countries that fare poorly in terms of the depth and efficiency of financial institutions (e.g. the Dominican Republic, Jamaica and Peru) could look to improving the rules defining property rights and collateral, as well as strengthening credit reporting systems.

Stronger legal and regulatory frameworks, together with the use of standardised and simple instruments, could help countries in the region with underdeveloped bond markets such as Costa Rica and Uruguay.

Conversely, countries with underdeveloped stock markets could benefit from policies that increase demand for and supply of equities – such as pension reforms, financial liberalisation, improved corporate governance and changes to tax systems.

PERU

Avoiding the stock exchange downgrade

Since August the Bolsa de Valores de Lima (BVL) has been battling to avoid being downgraded from "emerging" to "frontier" market status by MSCI (Morgan Stanley Capital International), the US-based publisher of stock exchange and other financial indices. While the outcome is still uncertain, it now looks as if the BVL has a fairly robust plan to enable it to stay in the club of its choice.

Since the end of the global mining boom, the BVL has seen both prices and trading volumes fall. The market capitalisation of its listed companies has slumped from US$102.6bn in 2012 to US$59.8bn at the end of September; the value of monthly share transactions fell from US$508.5m to US$129.5m in the same period. IGBVL, the general share price index, was up by 13.4% in 2012 but has plummeted every year since then, down by 26.2% in 2013, down by a further 11.4% in 2014, and down again by 31% in the first nine months of this year. On 6 November the IGBVL stood at 3,192, a year-to-date fall of 38.3%.

In August MSCI said it was considering a downgrade because the BVL was in danger of dropping below a series of pre-established liquidity and trading volume criteria required for emerging market status. In particular it said only three stocks on the BVL met MSCI emerging market "investability criteria". Any exchange with less than three stocks making the grade faces an immediate downgrade. The BVL and the Peruvian government were extremely concerned. BVL president Christian Laub said a downgrade of the exchange could trigger a capital outflow of between US$1.5bn and US$5bn. Suggestions by some analysts that Peru might be better off in the "frontier" market club were dismissed by the local investment community. Laub, along with Peruvian finance minister Alonso Segura and various others, travelled to New York to make their case to MSCI, ahead of an end-September deadline for an initial decision on the matter.

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The trip was relatively successful. What the Peruvian delegation took to New York for MSCI to consider was a package of capital market reforms designed to boost the liquidity of the Lima exchange. The package includes the elimination of capital gains tax on share dealings (effective from January 2016) and a whole set of technical changes to reduce transaction charges and boost volume, including the introduction of short-selling, computer-based trading, and a strengthening and expansion of market-making activities by brokers and funds. In response to the criticism that too few financial products are traded on the exchange, the authorities also said they were looking at introducing derivatives and US-style REITs (real estate investment trusts), following Mexico's example, where they have been introduced and are known as *fideicomisos de inversión y bienes raíces* (Fibras).

MSCI responded by saying it would keep the BVL in its emerging markets category pending further assessment of its performance over a period running up to June 2016. This was shorter than the Peruvians had wanted (they had asked for a 30-month assessment period), and MSCI warned that "failure by the Peruvian authorities and the stock exchange to reverse the declining trend in liquidity…may lead to MSCI's decision to reclassify the MSCI Peru Index to Frontier Markets in June 2016". It also warned that a shift to "frontier market" would be automatically triggered at any point in time if the bourse lost any of its three emerging-market-grade securities, the minimum needed to remain in that category. These look like tough requirements, but Laub has pointed out that what BVL needs to demonstrate in its trial is not a full turn around but just the beginnings of a change in the negative trend.

The BVL is working on a plan to boost the number of MSCI "investable" stocks. At the moment three stocks, Southern Copper (mining), Buenaventura (mining), and Credicorp (finance/banking) are in the MSCI Peru Standard Index (the criteria for this includes having a minimum market cap of US$1.34bn). A fourth, Ferreycorp (construction), is currently the sole Peruvian company listed on the MSCI Peru Small Cap index. The key issue is maintaining at least three in the Standard Index: MSCI has already said it is considering transferring Southern to its US index and will make a decision on that in May 2016. Therefore, if nothing else is done and Southern is removed from the MSCI Peru Standard Index at that point, the BVL will be automatically downgraded to frontier status. To avoid this Laub says he has an action plan which includes adding two stocks, Intercorp (banking) and Alicorp (consumption/retail) to the Standard index, and a further seven to the Small Cap index: InRetail (consumption/retail), Edelnor (energy), Graña y Montero (construction), Pacasmayo (construction), Unacem (construction), Milpo (mining), and Volcan (mining). The idea is that some of these small cap stocks may eventually graduate for inclusion in the Standard Index. Laub says: "Some years ago we had eleven companies in the MSCI Peru indices. Now we have only four, but we can get the number back up again. We're going to have to show the world's investors what we are doing."

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LATIN AMERICAN ECONOMY & BUSINESS is published monthly (12 issues a year) by **Latin American Newsletters**, Intelligence Research Ltd., Hamilton House, Fourth Floor, Mabledon Place, Bloomsbury, London, WC1H 9BB, Tel: +44 (0)203 695 2790 Email: subs@latinnews.com or visit our website at: **http://www.latinnews.com**. Subscription rates will be sent on request. Overseas subscription sent by airmail. **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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