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Peña Nieto at the two-year mark

Mexico's President Enrique Peña Nieto will mark two years in office this December – that's one third of his six-year term. The president's most significant economic achievement so far has been to secure congressional support for 11 major structural reforms. While it will take a few years for the results to feed through, international markets have been deeply impressed with the scale of the economic changes. Unlike other big Latin American economies, Mexico is now on its way to recovery. But these gains may be at risk because of the government's poor record on security.

On taking office in December 2012 Peña Nieto had two big problems. One was an underperforming, oil-dependent economy with deep structural imbalances. The other was a savage war with the country's drug gangs, escalated by his predecessor, which had cost around 70,000 deaths in the preceding six years. It is now evident that the new president decided to concentrate on the economic problem as priority one, envisaging that there could be slower, more gradual improvements in security – in effect relegating it to priority two. He may have also hoped that getting the economy right would help make the security problem more manageable.

In any case, Mexicans remain a little unclear as to how exactly government security policy has changed under the current administration. Officials say it is now more low-key and more intelligence-led; they also point to the creation of a small new police force, the National Gendarmerie. Critics counter that nothing has really changed; the latest massacres (including that of student teachers in the state of Guerrero), in their view, indicate an almost complete breakdown of law and order in certain parts of the country.

It is hard to underrate the significance of the structural reforms. President Peña Nieto tackled the fundamental problem of stagnating oil production and revenues by ending the seven-decade old oil, gas, and electricity generation monopoly. International oil companies will bid for exploration and production licences starting early next year, bringing in a flow of new inward investment. Petróleos Mexicanos (Pemex), the state oil company, will compete with them. As its obligation to fund the treasury with petro-dollars is eased back, it will be able to re-invest more. Meanwhile, to make up the shortfall, a fiscal reform has been approved to increase the contribution of non-oil taxes to the government budget. Reforms in the telecoms and broadcasting sectors are designed to reduce the power of oligopolies and promote competition (*see inside for more details*). Education reforms are designed to improve the skills of the work force. The overall aim is to achieve a more modern and competitive economy.

The optimists see signs that it is all beginning to work. At a time when Brazil, Argentina and Venezuela are all struggling with stagnation or recession, the Mexican economy is modestly gathering pace. After a slow start in 2013 the IMF predicts real annual GDP growth of 2.4% this year and 3.5% in 2015, due to "a stronger recovery in the US, an upturn in domestic construction activity, and the gradual dividends of the energy and telecoms reforms that are underway". The IMF has also said that the reforms will help Mexico achieve an annual GDP growth of 4% within five years - well above the average of the last decade. Despite complaints from the business sector, there is evidence that the fiscal reform is beginning to pay dividends – tax collection rose by 6.3% in January-August this year. There are some question marks on the horizon. For example, lower-than expected international oil prices next year could widen the budget deficit (currently predicted at around 3.6% of GDP) and force the government to take on more debt; but at 48% of GDP Mexican debt is considered manageable and well below that of the UK, Germany, Brazil and Argentina.

"Various analysts have highlighted how poor security threatens to undermine the economic reforms. "This is the most serious crisis Peña Nieto has faced", said political consultant Alfonso Zarate, adding, "the President's narrative in recent months has been all about the resources his structural reforms are going to bring the country. These tragic events are taking us back to the reality of widespread lawlessness.""

However, it now appears that the big threat to the structural reforms is not posed by external factors such as oil prices. The threat is internal, and can be summarised in two examples: Iguala (Guerrero state) and Tlatlaya (Estado de México). In late September in Iguala, 43 students were kidnapped: it is feared they were massacred by municipal police acting in collusion with a criminal gang, on the orders of a local mayor, and with the complicity of other state officials. Amid the outrage, the governor of Guerrero was forced to take a leave of absence. In Tlatlaya in June, 22 people died in what was described as an armed clash between the army and another drug gang. Subsequent investigations revealed that the army's account of events was untrue and that most were killed in extrajudicial executions. Both cases are considered emblematic of a breakdown in law and order, particularly at state level, for which President Peña Nieto is being held responsible. In late October, Mexico was shaken by a series of demonstrations around the country accusing the government of failing to protect its citizens.

Various analysts have highlighted how poor security threatens to undermine the economic reforms. "This is the most serious crisis Peña Nieto has faced", said political consultant Alfonso Zarate, adding, "the President's narrative in recent months has been all about the resources his structural reforms are going to bring the country. These tragic events are taking us back to the reality of widespread lawlessness." The central bank (Banxico) governor, Augustín Carstens, acknowledged that "there is no doubt that violence has been a negative factor" in the management of the Mexican economy. While arguing that things would eventually improve, Carstens noted that in a Banxico survey of analysts taken in early October, most had identified security issues as the top obstacle to economic expansion, followed by fiscal policy, weak domestic demand and international financial instability. The international press – which has a big impact on investor sentiment – has also begun to turn. *The Economist* – which has expressed enthusiasm for the structural reform programme, commented at the end of October, "Mr Peña has prioritised economic reform, and played down law and order, as the way to modernise Mexico, without admitting that both are equally important". While attempts have been made in the past to reduce corruption, improve the integrity of state institutions, professionalise the police, and reform the inefficient and slow-moving criminal justice system, the Peña Nieto administration may need to recognise that they have not succeeded. Initiating deep reforms in this area remains difficult and daunting, but the president will postpone them only at his own peril.

BRAZIL

Four-cornered struggle for the mobile market

Competition for Brazil's large mobile telephony market is heating up. In the latest moves, Telefónica of Spain, which operates the market-leading Vivo brand, beat off rival Telecom Italia to acquire GVT, a broadband operator. Heavily indebted Oi, in the process of merging with Portugal Telecom, has seen a change in its top leadership. Oi also ducked out of bidding in the latest 4G-spectrum auction, meaning that the government raised less revenue from the sale than it had hoped. Rumours of consolidation in the industry are rife.

Brazil's mobile telephony market is maturing, which means that profits are no longer as large or as easily obtained as they used to be. There are some signs of saturation. For example, there are about 280m mobile phone lines in service, in a country with a population of around 200m. Multiple phone ownership is prevalent in most of the developed economies and in many emerging markets, and does not necessarily mean lower profits. But the move to smart-phones, greater data usage and more technically advanced networks (such as 4G) is demanding greater investments from the operating companies. The question is whether consolidation is on the cards in an industry with four main players, and who might lead it.

"Oi is positioning itself for a consolidation of the market."

Analysts believe market leader Telefónica Vivo (majority-controlled by Telefónica of Spain) is in a strong position, with a 29% share of mobile subscribers. In September, Telefónica acquired broadband operator GVT from the French media and entertainment conglomerate Vivendi, in a cash and shares deal worth approximately EUR7.2bn (US$9.2bn). The acquisition positions Telefónica to offer its Brazilian customers more attractive 'bundles' of telecom, broadband and pay-tv services. The takeover still awaits regulatory approval. In a statement, Telefónica said that buying GVT allowed it to "enhance its positioning in one of its key markets and improve its growth profile and financial flexibility". In particular, it will allow Telefónica to challenge the broadband player NET, owned by Mexico-based América Móvil, the company controlled by billionaire Carlos Slim. In Brazil, América Móvil's mobile telephony brand, Claro, is number three by market share with 25%, but NET is number one in broadband, with a 49% share (rising to 69% in the city of São Paulo).

For a while it had looked as if Oi, number four in Brazilian mobile with a 19% market share, was lining up to mount a bid for the number three player, TIM, majority controlled by Telecom Italia, which has a 27% share. Oi is in the process of merging with Portugal Telecom, and has hired Brazilian investment bank BTG Pactual to advise it on mounting a bid for TIM. There are reports that a joint bid for TIM – in association with Claro – may be under consideration. There has also been speculation that TIM's assets might be broken up by one - or a combination - of the other players. But perhaps more than any of the others, Oi's profile has appeared to fluctuate between being a consolidator one moment, and being a weaker takeover target the next.

Oi emerged from the 1998 privatisation of Tele Norte Leste, Brazil's old state-owned fixed-line company. It is now the most heavily indebted operator (to the tune of US$19bn). Its merger with Portugal Telecom, initially seen as a sign of strength and debt reduction, became more problematic when it was revealed that the Portuguese company had some debt problems of its own (having lost money on loans to Espirito Santo International, a Lisbon-based company that subsequently defaulted). Then Oi announced it would not participate in the auction for Brazilian 4G frequencies at the end of September. An industry executive who chose to remain anonymous told *Reuters* news agency "Oi is positioning itself for a consolidation of the market". In the end, the other three companies bid an estimated BRL5.85bn (US$2.39bn) for 4G spectrums in the 700MHz band, less than the BRL8bn that the authorities had expected; one licence has remained uncontested.

In October Oi's chief executive, Zeinal Bava, who had moved across from Portugal Telecom in 2013, resigned. The new chief executive, Bayard Gontijo, has insisted that the merger with Portugal Telecom remains on track, adding that "We will play a key role in the consolidation of telecom industry in Brazil, we will reduce our debts and will sell certain assets in order to be prepared for this." But analysts remain to be convinced. According to UBS Securities, Bava's departure has left Oi "weaker and more vulnerable to a takeover".

MEXICO

Too many – and not enough

The Mexican media industry is on the verge of some important upheavals, triggered by the government's telecoms and broadcasting reforms on the one hand, and by the ongoing 'digital revolution' on the other. It is a complicated picture, but some analysts sum it up by saying that the country has too many newspapers that don't make much money and too few TV and telecoms operators that make too much money. Whether a more balanced media industry will emerge, with proper safeguards for freedom of expression, remains to be seen.

"The government led by President Enrique Peña Nieto has recognised that certain Mexican industries are oligopolies, dominated by small groups of players who can act in a cartel-like fashion, denying consumers the benefits of competition."

The government led by President Enrique Peña Nieto has recognised that certain Mexican industries are oligopolies, dominated by small groups of players who can act in a cartel-like fashion, denying consumers the benefits of competition. In fact, in his first two years in office the president seems to have taken to heart an study by the Organisation for Economic Co-operation and Development (OECD) which suggested that 'dysfunctional' markets have been costing the country as much as 1.8% of GDP in missed growth opportunities. Many of his structural reforms seek to bring in greater competition. But it can be argued that his telecoms reforms, approved in principal by the federal congress in June 2013 (primary legislation) and then again in July 2014 (when the secondary or enabling legislation went through) are set to have an uneven impact on the media industry.

The reforms tackle telecommunications and broadcasting and empower a new regulator, Instituto Federal de Telecomunicaciones (Ifetel), to enforce corrective measures when one industry player is found to be "preponderant" – defined as having a market share of over 50%. Ifetel has come to exactly that conclusion having examined two very big players: Carlos Slim's mobile telephony company América Móvil and the Azcárraga family's *Televisa* TV operation, both of which control around 70% of their respective markets. The regulator has begun to enforce "asymmetric" corrective measures (such as forcing the two companies to allow smaller competitors to use their infrastructure at favourable rates). The legal process has some way yet to run, but some say the regulator is going to be tougher with Carlos Slim than with Emilio Azcárraga. Slim has accepted that he will have to divest part of América Móvil so as to reduce his overall market share. *Televisa*, by contrast, is not talking of divestment and is not being challenged in the very profitable pay-TV sector that it dominates, although it does face the prospect of more competition. Ifetel is auctioning licences for two new free-to-air national TV channels next year, and that will take the total number of players from the current two (*Televisa* and *TV Azteca*) to four.

The problem with this, say media specialists and academics, is that it does not tackle Mexico's longstanding history of political manipulation of the media. Miguel Alejandro Guerrero, a researcher at the Universidad Iberoamericana in Mexico City, says that almost all media – newspapers in the nineteenth century, radio in the 1920s, and TV in the 1950s, came into existence thanks to some form of political patronage. During the long period of one-party rule under the traditional Partido Revolucionario Institucional (PRI), newspapers survived not because of revenues from sales and commercial advertising, but because they were able to attract 'official' or government advertising – in effect a subsidy that came with political strings. Guerrero's research colleague Mireya Márquez Ramírez says that while the US and Europe saw the emergence of economically viable, editorially independent newspapers, in Mexico a succession of newspapers were set up by intellectuals from different factions of the PRI, each seeking (and getting) government-funded advertising to keep them afloat.

"According to research conducted in 2010 by Claudia García Rubio of the Universidad de Guadalajara, there were 279 newspapers published in the country that year, with very low combined circulation - just over 6m copies. The penetration rate as a proportion of the population was only 5.7%. García Rubio also found that Mexican newspapers have a short life cycle: their average age was 29 years."

"In the 1970s, Mexico City had more newspapers than Paris, and a lot fewer readers", says Guerrero. The end of the one-party state in 2000 and the advent of a more democratic system has not really changed things enough, she adds. Instead of seeking funding only from the PRI, now back in power, a Mexican newspaper now turns either to the PRI or to other parties in power at a state or municipal level. Political manipulation is particularly blatant at state level. Newspaper proprietors are often willing participants in the deal, credited with the saying 'anuncias o te pego' (roughly, 'advertise with me, or I will hit you [editorially]'). Newspapers also seek to benefit from (legal) party political advertising at election times, and from (nominally illegal) 'advertorial' deals, whereby a paper will agree to give prominence to a particular politician for a fee.

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Even more overtly than newspapers or radio, Mexican television developed as a child of the PRI's 'revolutionary family'. It was President Miguel Alemán (1946-1952) who set the rules for the development of the Mexican television system. The first television licence was awarded to Rómulo O'Farrill, a newspaper, radio and automobile industry entrepreneur, in 1949. Emilio Azcárraga Vidaureta, who had a chain of 13 radio stations, won his first television licence in 1951. The O'Farrill and Azcárraga families then joined forces with President Alemán's son (Miguel Alemán Velasco) in 1954 to create *Telesistema Mexicano*. Almost 20 years later, in 1973, this group merged with its main competitor – Monterrey-based *Televisión Independiente de México* (at the time the only other large TV network in the country) to create *Televisa*. *Televisa* has dominated the industry since then; Emilio Azcárraga Jean, grandson of the founder, currently leads it. It had virtually no competition until the early 1990s, when President Carlos Salinas de Gortari (1988-1994) decided to privatise a state TV network. To some extent this too was perceived as being kept 'within the family': the licence was won by Ricardo Salinas Pliego, a businessman with interests in the retail sector, who also happened to be a partner of the president's brother. Under commercial ownership, this chain developed into the *TV Azteca* network, which currently occupies the number two position in the country by market share.

As in the case of newspapers, Mexican television has tended to see itself as an ally of governments, not as an organisation subjecting them to independent scrutiny through its news coverage. The big difference, however, is that TV is mass market and very profitable, while newspapers are not. TV companies need governments to retain their licence and protect their market shares, not to make money. According to market analysts IBOPE, TV had a massive 97% penetration rate in 2012. Free-to-air TV remains the most effective advertising medium in the country, despite the rise of the internet (estimated by IBOPE to have a 48% penetration rate).

Although he has cast himself in the role of a reformist and moderniser, critics say President Peña Nieto himself remains indebted to *Televisa* and is therefore not likely to be too hostile to it. Elected governor of the Estado de México in 2006, the young and telegenic Peña Nieto hired *Televisa* to promote his public works programmes and to use some of its airtime to interview him. Peña Nieto's romance with the *Televisa* soap opera star Angela Rivera also received intensive coverage on the company's TV channels (as did their marriage in 2010). According to Javier Aparicio, a political scientist at the CIDE think-tank, in the first years of his term as governor "you would see Peña Nieto on the nightly news shows as well as on advertisements, promoting his achievements". The relationship did generate controversy. A 2008 law banned politicians and candidates from buying certain types of promotional advertising, and there were inconclusive claims that *Televisa* and Peña Nieto had sought to circumvent it. *Televisa* and *TV Azteca*'s initial reluctance to cover live presidential debates in the 2012 campaign also came in for severe criticism from political activists. None of this prevented Peña Nieto from winning the July 2012 election with a 6% margin over his left-wing opponent.

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Bearing this history in mind, critics say it remains to be seen whether the reforms will usher in more independent, economically viable and diverse media. Initial indications are that contenders for the two new TV licences include a mix of insiders and new players. In September, *Televisa* announced that a member of its board of governors, Germán Larrea, had presented his resignation following an alleged conflict of interest. Germán Larrea is often described as Mexico's second-richest businessman (after Carlos Slim), and is known locally as 'The King of Copper'. A very low-profile figure who does not like publicity, he controls the Grupo México mining, infrastructure and transport conglomerate. According to *Televisa* sources, Larrea had admitted that a company linked to him was preparing to bid in the planned Ifetel auction of concessions to run the two new free-to-air TV channels. Success would of course place him in direct competition not only with *Televisa* but also with *TV Azteca*. According to press reports, other potential groups bidding in the Ifetel auction are the Vázquez family (with interests in hotels and hospitals), Grupo Imagen, the company which now owns the *Excélsior* newspaper and has interests in radio networks and cable TV, Grupo MAC (another publisher with newspaper interests), Grupo Radio Centro (one of the main commercial radio networks) and the publishers of *El Financiero*. A decision on these concessions is now expected before the end of the first quarter of 2015. At Universidad Iberoamericana, Mireya Márquez-Ramírez says she is not very optimistic on the future of independent media in Mexico. However, she acknowledges that the rapid spread of social media is creating new opportunities for critical journalists, and that some of these ventures may find a way of becoming economically sustainable.

Another media analyst, Elena Scaramuzzi at Cullen International, underlines positive aspects of the new rules. "Mexico has a vibrant media industry," she says, adding that, "Mexico is a leading country in terms of content production, sales, exports and distribution, and I am convinced that the Mexican media industry will continue to prosper. Mexico's content production, however, has a broader base than the big global players. We should not forget the importance and role of local community broadcasters, a phenomenon observed not just in Mexico but all over Latin America. We should not forget that one of the aims of this reform is to stimulate, incentivise and to give more regulatory certainty to these smaller players, recognizing the fundamental social and cultural role they play at the local level."

No oomph in exports

The global economy is not giving Latin America and the Caribbean much help this year. But it is also true that the region is not doing very much to help itself. Exports have pretty much stopped dead in their tracks; the United Nations' Economic Commission for Latin America and the Caribbean (known by its Spanish /Portuguese acronym CEPAL) says this weak performance is storing up problems for the future.

The numbers are daunting. Back in 2011, with the global commodities boom in full swing, Latin American and Caribbean exports surged ahead by 23.5% over the course of the year, earning healthy dollar revenues and stimulating domestic consumption. But the export drive shuddered to a halt with annualised growth of only 1.6% in 2012, followed by a contraction of 0.2% in 2013. CEPAL says 2014 will be another year of stagnation. Exports fell by 0.3% in the first half of the year and CEPAL is predicting growth of only 0.8% for the year as a whole. Imports have also stopped dead over the last three years, and this year are predicted to contract by 0.6% across the region as a whole.

What is happening? According to CEPAL's October 2014 annual report, *Latin America and the Caribbean in the World Economy 2014*, the region is being hampered by slower growth in some of its key export markets, and by a fall in intra-regional trade. The global economy is less accommodating than it was. While in recent years global trade growth has exceeded GDP expansion significantly (by almost 2% in 2001-2007), this gap has narrowed sharply (to around 1% in 2011-2014).

South American exporters in particular are losing out because of sluggish demand for their goods in the European Union (EU). The Mercosur block, dominated by Brazil and Argentina (and also comprising Paraguay, Uruguay and latterly Venezuela), will see exports fall by 2.3% this year. Mexico and Central America, which are more focused on selling to the better-performing US economy, are doing better – they can expect a 4.9% increase in exports this year.

And despite the rhetoric about regional integration, trade between Latin American and Caribbean countries remains low. CEPAL calculates that last year only 19% of total trade was intra-regional, compared to 50% in the Asia Pacific and 59% within the EU. Intra-regional trade within the Caribbean Community (CARICOM, comprising 15 members and five associate members) does not even reach 15% of total exports.

The big message of the report is that the region remains too reliant on commodity exports and is too fragmented – in fact, the opposite of the much talked-about regional economic integration. CEPAL stresses the growing role of multinational value chains, and the way Latin America appears to be missing out on this important opportunity to build more diversified and resilient economies. It identifies three main global value chains in the world - North America, Europe, and Asia - and comments that "with the exception of Mexico, the region is not an important provider of non-commodities intermediate goods to these chains, nor does it carry much weight as an importer of intermediate goods originated in these world regions". Low participation in these value chains reduces the region's ability to achieve 'inclusive trade', defined as a pattern of imports and exports that "favour growth and productivity, reduces structural heterogeneity, improves the well-being of the majority (employment and salaries), and reduces inequality".

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THE PRESIDENTIAL INBOX (1)

Bolivia

On 12 October President Evo Morales won a resounding election victory, taking 61% of the vote to secure a third term in office, starting in January 2015 and running to January 2020. Most analysts agree that the country's exceptionally strong economic performance was a key factor underpinning the popularity of this left-wing but pragmatic leader, a representative of the traditionally impoverished Aymara indigenous community (which makes up about two-thirds of Bolivia's 10m-strong population). The Morales government now has to beware of complacency and start planning for the day the country's natural gas boom may come to an end.

While Morales is a close political ally of his fellow left-wing leaders in Argentina and Venezuela, the small Bolivian economy seems to be functioning in an entirely different league. Both Argentina and Venezuela will experience recession in 2014, along with rampant inflation (over 60% in the case of Venezuela, according to the IMF). By contrast, Bolivia will see real annual GDP growth of 5.2% and inflation of not more than 6% this year (also on IMF forecasts). The country's recent performance doesn't look like a flash in the pan, either. Morales and his economy minister, Luis Arce, have achieved 5%-plus economic growth every year since they came to office in January 2006, delivering the longest, most consistent period of economic expansion experienced by Bolivia in the last three and a half decades. Arce, a Marxist, is sometimes described as a 'closet liberal'. Certainly he has balanced the budget more years than not and Jeffrey Webber, a Canadian analyst of the Bolivian economy, was recently moved to comment that "inflation rates have been clamped at levels that would keep Milton Friedman resting peacefully in his grave".

"At many different levels Bolivia's performance has been impressive..."

At many different levels Bolivia's performance has been impressive. Foreign currency reserves stood at US$15.4bn in October, equivalent to just over 48% of GDP (comparatively speaking, one of the highest levels in the world). Per capita GDP has doubled, according to IMF data. The proportion of the population living in conditions of extreme poverty has been reduced from 38% to 18%, a result the World Bank this year described as "extraordinary". In July, UNESCO said Bolivia had freed itself of illiteracy (the proportion of Bolivians who cannot read or write has been brought down to under 5% of the population). Income inequality has been sharply reduced. This was achieved in part by major increases in the real purchasing power of the minimum wage – up 87.7% in 2005-2014. Social spending (on health, education and pensions among other things) has also grown significantly, although it has lagged behind overall economic growth – as a result it has fallen as a proportion of GDP, from 12.4% in 2005 to 11.5% in 2012. Public sector investment has also grown, with funds going into the construction of roads, schools and hospitals. And despite the government's leftist credentials, Foreign Direct Investment (FDI) has kept on coming. At 5.9% of GDP in 2013, it was ahead of Peru's 4.9% and Brazil's 3.0% in the same year.

One of the keys to the government's success was the 2006 nationalisation of the hydrocarbons industry, in particular the natural gas sector. While presented to domestic and international opinion as a body blow delivered against exploitative international companies, the move was carefully balanced. Operating companies such as Petrobras, Total and Repsol lost ownership of the gas deposits but were kept on as service providers, keeping their expertise in the country and delivering their output to the state-owned hydrocarbons company, Yacimientos Petrolíferos Fiscales Bolivianos (YPFB). While revenue shares were adjusted in Bolivia's favour, at a later stage these companies were offered new tax and other incentives to boost output. The move coincided with rising gas demand from Bolivia's energy-hungry neighbours Brazil and Argentina. As a result, Bolivia's gas export earnings have rocketed from around US$1bn in 2005 to US$6.1bn in 2013. Bernardo Fernández, of the Universidad Católica Boliviana, notes: "When Evo Morales came to power, no-one was expecting this bonanza. These have been a very prosperous eight years, and there'll be a couple more before the fiscal situation starts to deteriorate".

This then, is the key issue for the third Morales term in office: how to prepare the country for a potential "post gas-boom" economy. On current calculations, Bolivia's main gas fields, which account for 57% of exports and 45% of government revenue, are likely to begin to decline in 2017. The government is stepping up exploration: YPFB is to spend US$300m searching for new gas fields, and Russia's Rosneft is expected to join Gazprom to operate in the country. But critics on both the Right and the Left say not enough is being done to diversify the economy beyond the extractivist economic model. César Arias of Fitch Ratings says the next four years may not be as good to Bolivia as the last. Eric Farnsworth, of the Washington-based Council of the Americas (usually highly critical of nationalist governments), notes, "there is a huge competitiveness issue that's going to take years for the Bolivians to get their arms around." Writing for *Los Andes*, Peruvian journalist Eder Pérez Fuentes also had the competitiveness issue in mind when he listed two big challenges for the government: first to make good a deficit in education spending and quality of delivery; and second to develop an industrialisation policy, particularly focusing on the potential of adding value in the iron ore and lithium sectors.

THE PRESIDENTIAL INBOX (2)

Uruguay

Uruguay's general elections were held on 26 October, with a second round ballot due on 30 November and the new administration due to take office on 15 March 2015. After ten years of economically successful centre-left rule, the new president might be forgiven for thinking that economic policy is a non-issue. Our suggestion: don't take the economy for granted, worry about inflation, and watch out for the impatient middle classes.

Uruguay can be presented as a model case for the benefits of moderate left-wing economic policy. After ten years of rule under the leftist Frente Amplio coalition, it has the highest per capita GDP in Latin America (US$16,232, placing it ahead of Chile with US$14,911). Uruguay has enjoyed investment-grade credit ratings from Moody's and Standard & Poor's (S&P) since 2012. According to the IMF, real annual GDP growth will be 2.8% both this year and next – slower than the average of nearly 6% achieved over the last decade, but still impressive given that its two large neighbours, Argentina and Brazil, are currently struggling with recession. Mario Bergara, economy minister in the outgoing government led by President José Mujica, says "Uruguay will continue to grow, albeit at a decelerated rate, but faster than Brazil and Argentina. The country is also decoupling in terms of the main transmission channels – we don't have much financial connection with Brazil and most of our exports are commodities, so it wouldn't be hard to re-orientate exports if Brazilian demand falls – which we haven't yet seen". Exports have been diversified, with China now the biggest market.

"Uruguay can be presented as a model case for the benefits of moderate left-wing economic policy. After ten years of rule under the leftist Frente Amplio coalition, it has the highest per capita GDP in Latin America (US$16,232, placing it ahead of Chile with US$14,911). Uruguay has enjoyed investment-grade credit ratings from Moody's and Standard & Poor's (S&P) since 2012."

During the last ten years Uruguay also has been successfully redistributing income. Poverty has been reduced from 40% to 11% of the population. Unemployment has also been dramatically cut from 22% in 2005 to a forecasted 6.9% in 2015 (IMF data). So perhaps it is not surprising that the economy appears to be a non-issue. In a pre-electoral survey by pollsters Factum, economic issues hardly registered at all as voter concerns. The electorate seemed most worried by crime and security (42%), education (15%), drugs (13%) and domestic violence (11%). To add to the apparent irrelevance of economic issues, most international analysts could find few fundamental economic policy differences between the candidates. In a research note, investment bank JP Morgan-Chase commented, "we do not expect significant changes in the framework of current policy".

Yet it would be foolhardy for an incoming president to believe in "the death of economics", for a various reasons. For a start, there remain a number of outstanding macroeconomic issues. One of these is that inflation is still too high: at 9.1% it remains outside the central bank's 3%-7% range. While clearly manageable, Uruguay is running both fiscal and current account deficits. (Bergara says he is relaxed about the current account deficit of around 5% of GDP because it reflects strong foreign investment inflows.) A second and more fundamental reason for caution is that Uruguay could, like Brazil before it, become a victim of its own success. As a result of a decade of growth and redistribution, many people have joined the middle class. While this is seen as positive for living standards and development, this 'new middle class' can be more politically demanding, particularly in terms of the value for money it expects to get from its taxes. Middle-class discontent was a major factor in the demonstrations and unrest that swept through Brazil last year. A similar upheaval is not necessarily on the cards in Uruguay, but the new president will need to pay close attention to the middle-class mood. At the end of the day, demands for better security, more effective policing and higher quality education all have major economic effects: the money needs to be found from somewhere to fund these improvements. A final point to bear in mind: the new president may have to deal with a crisis in the Brazil and Argentina-dominated trading bloc Mercosur, which recently has been more of a hindrance than a help to Uruguay's export diversification efforts.

> "Middle-class discontent was a major factor in the demonstrations and unrest that swept through Brazil last year. A similar upheaval is not necessarily on the cards in Uruguay, but the new president will need to pay close attention to the middle-class mood."

THE PRESIDENTIAL INBOX (3)

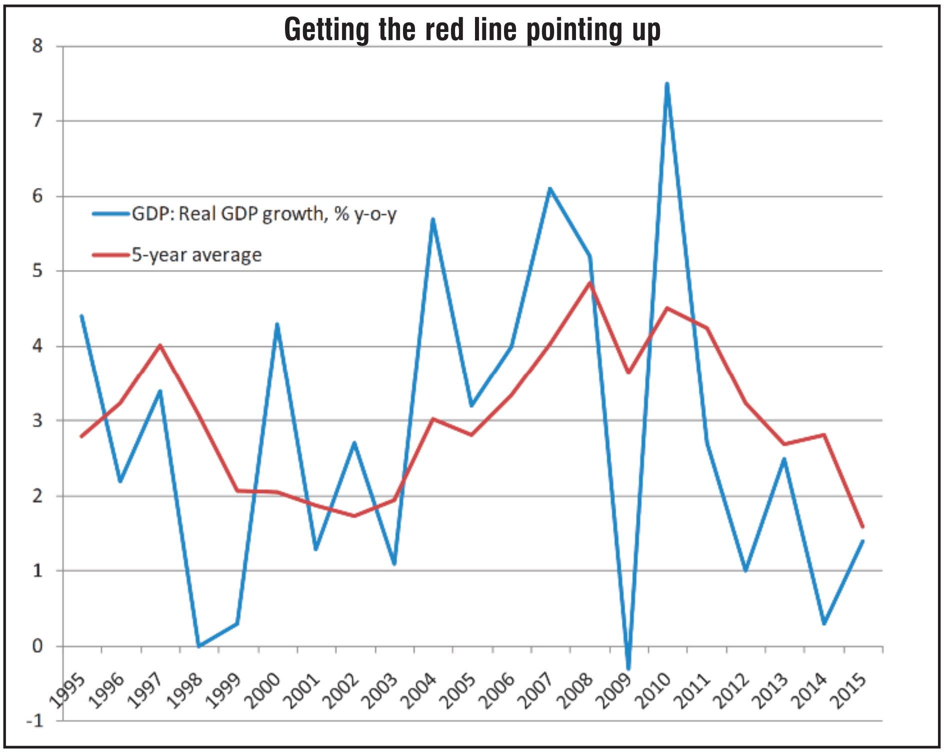
Brazil

Incumbent Dilma Rousseff of the ruling left-wing Partido dos Trabalhadores (PT) won the second round of the Brazilian presidential race on 26 October. Stripping away the claims and counter-claims of a bitterly fought election campaign, how serious are the economic problems she must now face?

The daunting news for the re-elected president of Latin America's largest economy is that there will be no quick solutions to Brazil's economic malaise. Since 2008, the medium term economic growth rate (i.e. the average GDP growth over the preceding five years) has been trending down, from 4.8% to an estimated 2.8% this year. In the four years of Rousseff's presidency (2011-2014 inclusive), real annual GDP growth has averaged only 1.6% (assuming the IMF's latest estimate of just 0.3% for this year is correct). A key issue is whether this is a demand-side or a supply-side problem. If it is a demand-side problem, the solution is relatively easy: using some combination of fiscal, monetary and trade measures the new government simply needs to boost demand to get the economy growing again.

Not so simple, says Neil Shearing of Capital Economics. He argues that the Brazilian problem is almost entirely on the supply side. In earlier years (such as 2003-2011) high, demand-led growth was possible because extra labour could be easily recruited. Now however, Brazil remains a near full-employment economy. The problem, as he puts it, is that "Brazil's productivity performance has been nothing short of abysmal". In 2003-2012, output per worker has grown at only 1.5% per year, the lowest of any major emerging market with the exception of Mexico. So it follows that any attempt to boost growth by stimulating domestic demand could backfire, leading to overheating and higher inflation.

Low productivity is in turn linked to a series of structural problems. The cost of operating in the country - known as the 'Custo Brasil' (Brazil cost) - is high for a series or reasons. One is over-regulation of the economy: with a complex tax system it takes the average Brazilian company 2,600 hours a year to file its tax returns (compared to a Latin American average of 367 hours). Investment rates have been too low. In fact, investment has averaged 18% of GDP over the last decade, also the lowest rate among emerging markets. Infrastructure needs are huge, particularly in transport. Shipping a container from Brazil is four times more costly than shipping it from China. Linked to this problem is an insufficient domestic savings rate, which Shearer attributes in part to an over-generous pensions system, which in effect reduces the incentive to save for retirement.



"Rousseff, elected at the head of an eight-party coalition and facing a stronger opposition in both the federal congress and at the state government level, will have to negotiate deals."

Part of the problem is that it will be difficult to steer the structural reforms that many have long agreed are necessary through the Brazilian political system. Rousseff, elected at the head of an eight-party coalition and facing a stronger opposition in both the federal congress and at the state government level, will have to negotiate deals. Reducing pensions is not popular. There are constitutional constraints limiting the president's ability to reallocate government-spending budgets. Successful reforms will yield only a medium to long-term political dividend, and on the short term are more likely to be a political liability. Perhaps the real motivator, however, is that the political cost of inertia is likely to be much greater than the cost of change.

Rousseff won 51.6% of the valid votes; her opponent, Aécio Neves of the centre-right Partido da Social Democracia Brasileira (PSDB), won 48.4%; a difference of 3.4m votes. In her victory speech, Rousseff denied that the closeness of the result showed that Brazil was a divided nation. She also spoke of her desire to fulfil her campaign promise of "change" by instigating political reform via a plebiscite.

Guido Mantega, Rousseff's widely distrusted finance minister, will step down at the end of the year. His successor will give a good indication of whether there is likely to be any substantive change in the government's economic policies, but Rousseff has given no sign that there will be any. One of the names circulating as a possible replacement is Aloízio Mercadante, the current cabinet chief. However, Rousseff was widely believed to have directed economic policy during her first mandate and there seems little reason to believe she will not do the same in her second.

Social risks threaten moving into 2015

Argentina's economy has been in recession for much of 2014 and will likely remain so for some time. The country's financial situation, although challenging, is such that the various actors can continue to 'muddle through', avoiding a major crisis. However, the likely deterioration of the labour market could produce some social upheaval in the run up to the general election in October next year.

Although the identities of the senior officials have changed over time, the administration led by President Cristina Fernández has followed a consistent and unorthodox economic policy. Domestic demand (and the needs of political stakeholders) have been supported by easy fiscal policy. According to the latest IMF's latest (October) World Economic Outlook (WEO), the overall budget deficit has risen from around 2.8% of GDP in 2013 to 4.5% in 2014. To a significant extent, government spending (which by developed country standards is quite low at about 36% of GDP) has been monetised. This has been the root cause of high inflation (of 18% year-on-year in August, on official data). The competitiveness of Argentina's exporters has been protected by a controlled slide in the value of the local currency peso relative to the US dollar.

This policy has been maintained in face of periodic volatility in global financial markets, occasional episodes of panic about falls in foreign reserves at the central bank and bad publicity surrounding litigation with 'hold out' sovereign bond creditors in New York.

The authorities now face a new challenge: a fairly brutal recession. IMF forecasts indicate that Argentina's economy is likely to shrink by 1.7% this year and by 1.5% in 2015. According to Cabinet Chief Jorge Capitanich, the government itself is looking for real annual GDP growth of 0.5% this year and 2.8% in 2015.

“The authorities now face a new challenge: a fairly brutal recession. The IMF forecasts indicate that Argentina's economy is likely to shrink by 1.7% this year and by 1.5% in 2015.”

Argentina - Selected economic and financial metrics	
Official exchange rate USD/ARS, 16 October 2014	8.54
Dólar Blue exchange rate, 16 October 2014	14.73
Industrial Monthly Estimate, YTD vs pcp, August 2014	-2.30%
Cumulative exports, Q214 & Q314 vs pcp	-10%
Cumulative imports, Q214 & Q314 vs pcp	-10%
Average monthly trade surplus, Jun-Aug 2014	US$1,027mn
Construction Activity **[1]**, YTD vs pcp, August 2014	-2.30%
Public Services **[2]** YTD vs pcp, August 2014	4.60%
Unemployment rate, 2Q14	7.50%
Underemployment rate, 2Q14	9.40%
Year-on-Year M3 growth, September 2014	21%
Year-on-Year growth in private sector credit, September 2014	21%
1-month wholesale deposit rate (BADLAR), September 2014 **[3]**	20.3%
1-month retail deposit rate, September 2014	18.4%
Foreign reserves at BCRA, end September 2014	US$27,866mn

Notes
1. Synthetic Indicator of Construction Activity
2. Synthetic Indicator of Public Services
3. BADLAR has fallen by 660bp over the last five months

Sources: *INDEC, BCRA, Dolarblue.net*

“The various actors in Argentina's economy and financial system probably can continue to muddle through for another year without a financial crisis. But with the approach of the general (and presidential) elections in October 2015, rising unemployment could result in demonstrations and general unrest.”

The figures in the **chart**, most of which come from official Argentine sources suggest that the IMF forecasts (and those of many private sector economists) are closer to the mark. Thanks to the softness of the global economy and, in particular, the recession in neighbouring Brazil, cumulative exports over the six months to the end of September were 10% lower than in the previous corresponding period. Construction activity and overall industrial production in the first eight months of the year were both down 2.3% over the corresponding period of 2013: this highlights the softness of domestic demand, which has contributed to a sharp fall in imports.

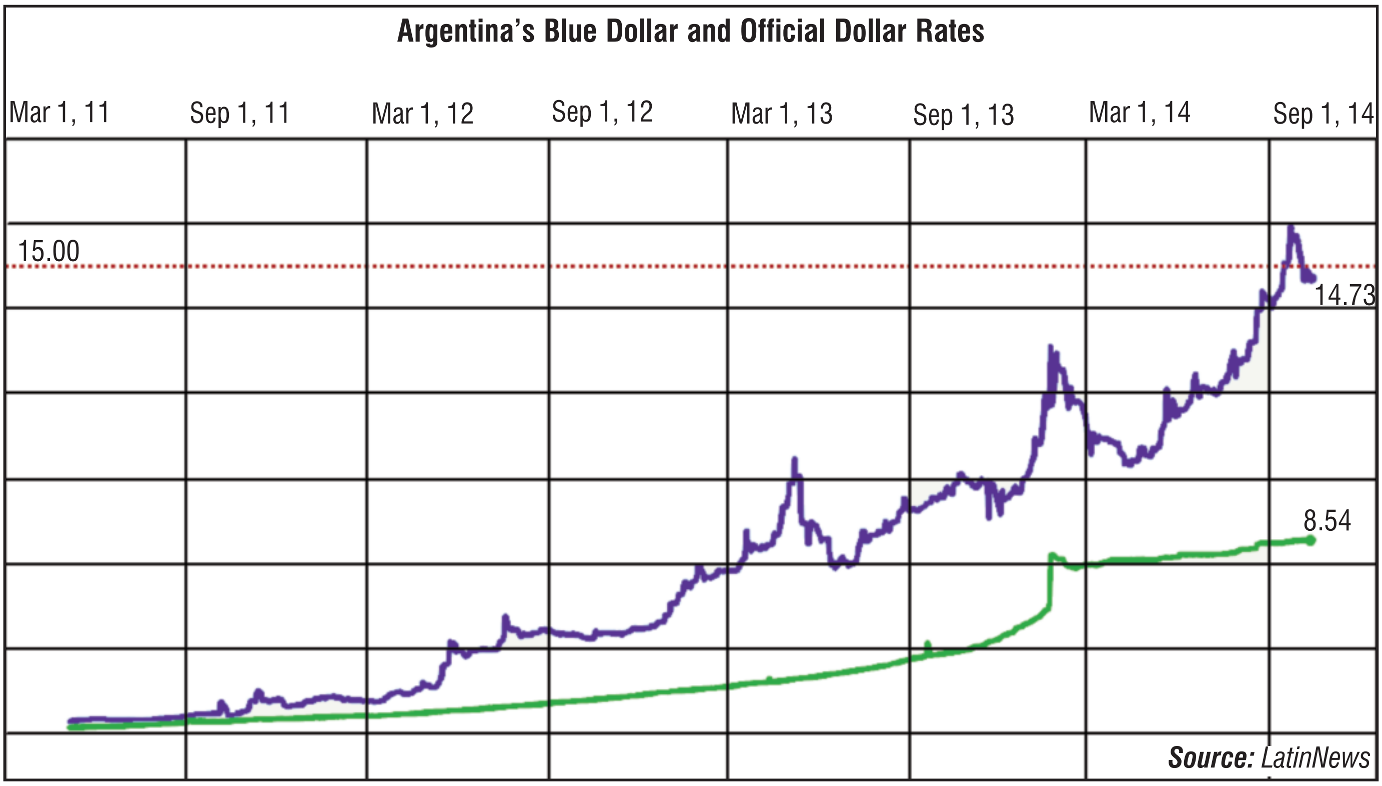
In financial markets, the most worrying development has been the weakening of the dólar blue (i.e. black market) peso rate to over ARS15/US$. At a time that the official rate has been at ARS8.5/US$ or so, this represents a record premium. However, the premium needs to be considered in the context of the technical default by the Argentine government at the end of July and the renewed aversion on the part of investors towards emerging markets risk in general, and towards Brazil in particular.

Further, we would attribute the record premium to the rigour with which the government controls the movement of US dollars into and out of Argentina. In essence, the main factor determining the dólar blue rate is the scarcity of US dollars within Argentina, rather than a sharp deterioration in financial conditions. Both M3 and credit to the private sector grew by 21% in the year to September, or (very) broadly in line with inflation. Over the five months to September, the one-month BADLAR rate for wholesale deposits has fallen by 660 basis points to 20.3%. The one-month retail deposit rate has also dropped over that period, and stood at 18.4%. Foreign currency reserves at the central bank amounted to a little under US$28bn at the end of September, or about the same as they had been at the end of March.

Shortly after his appointment as central bank president in early October, Alejandro Vanoli told local banks to lift the interest rates that they pay depositors to 87% of the yield on LEBAC Treasury Notes - meaning that the banks will have to pay annual interest rates of at least 26-27%. He also said that there would be no devaluation: nor would there be any changes to the ways in which Argentines can legally acquire US dollars. These measures should underpin financial stability. They also recognise that, at ARS8.50/US$, the peso is not clearly overvalued. Argentina has been running a trade surplus of around US$1bn per month in the recent past. Even the IMF, whose forecasts are significantly more pessimistic than those of the government, is looking for a current account deficit of less than 1% of GDP in 2014 as a whole. Following Vanoli's announcement, the dólar blue rate rallied to ARS14.7/US$ or so.

One of the main risks facing the government is rising unemployment. According to official data, the unemployment and the underemployment rates in Q314 were, respectively, 7.5% and 9.4%. Various surveys have shown that a majority of large private sector employers have been laying off staff or leaving vacancies unfilled. The situation would be worse but for the expansion of activity in the public sector. In the first eight months of this year, the main indicator of public sector activity reported by the national statistics institute (INDEC) was up 4.6% year-on-year over the corresponding year-earlier period.

The various actors in Argentina's economy and financial system probably can continue to muddle through for another year without a financial crisis. But with the approach of the general (and presidential) elections in October 2015, rising unemployment could result in demonstrations and general unrest. Much also hinges on expectations for the direction of economic policy in Brazil in President Dilma Rousseff's second term which, in turn, will have an impact on the labour market in Argentina.



JAMAICA

So far, so good...

In recent months Jamaica's government has made considerable progress, with a broadly based program of fiscal (and other) reforms. This success has been recognised by the International Monetary Fund (IMF). Nevertheless, significant risks remain.

In mid-October, the IMF held a high level conference, 'Unlocking Growth in the Caribbean', in partnership with the government of Jamaica, at Montego Bay on 23-24 October. This follows a similar conference held in the Bahamas last year, involving regional prime ministers, finance ministers and central bank governors, as well as officials from the IMF, the World Bank, the Inter American Development Bank (IADB) and the Caribbean Development Bank. The latest conference follows a number of statements from the IMF praising the government of Jamaica for its progress with a broad economic reform program. On 24 September, the IMF announced a further disbursement under Jamaica's Extended Fund Facility (EFF) of around US$69bn. The Fund noted that the program was progressing as it should. "Jamaica's economic performance under the [government's and the central bank's] economic program supported by the EFF has remained strong. All quantitative performance criteria for end-June 2014, as well as the continuous quantitative program targets and benchmarks, were met".

The **chart**, which summarises the projections for Jamaica included in the IMF's latest (October 2014) World Economic Outlook, shows how the economy is perceived. Traditionally, the principal problem has been a high level of government debt. At about US$21bn, this is equivalent to around 140% of GDP. Having increased revenues and cut spending, the government is now running a primary (i.e. before debt service) surplus of around 7% of GDP. The overall budget is in balance. Debt is expected to fall to just over 100% of GDP by 2019.

Jamaica's economy - as the IMF sees it									
	Units	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Gross domestic product, constant prices	% change	-0.47	0.20	1.05	1.78	2.23	2.45	2.65	2.70
Gross domestic product, current prices	US$ bn	14.78	14.20	13.92	14.19	14.57	15.19	15.96	16.77
Gross domestic product per capita, current prices	US$	5,339	5,100	4,974	5,043	5,151	5,341	5,579	5,831
Inflation, average consumer prices	% change	6.90	9.35	8.79	7.95	7.65	7.25	6.75	6.25
Volume of imports of goods and services	% change	4.82	8.01	7.49	9.18	9.70	7.59	6.09	5.46
Volume of Imports of goods	% change	4.41	6.63	7.88	10.12	10.03	6.56	5.59	5.18
Volume of exports of goods and services	% change	7.25	8.89	11.66	12.44	12.69	8.51	6.71	5.53
Volume of exports of goods	% change	11.44	3.91	12.72	15.81	15.05	10.49	11.34	8.18
Unemployment rate	% workforce	13.93	15.28	15.28	15.28	15.28	15.28	15.28	15.28
Population	mn	2.77	2.78	2.80	2.81	2.83	2.84	2.86	2.88
General government revenue	% GDP	25.72	27.20	26.79	26.08	26.13	26.31	26.37	26.45
General government total expenditure	% GDP	29.79	27.08	27.52	26.37	25.31	25.26	24.88	24.58
General government net lending/borrowing	% GDP	-4.08	0.12	-0.73	-0.28	0.82	1.06	1.49	1.87
General government primary net lending/borrowing	JAD bn	72.33	111.66	121.28	131.90	145.25	149.03	163.39	178.29
General government primary net lending/borrowing	% GDP	5.40	7.65	7.59	7.50	7.50	7.00	7.00	7.00
General government gross debt	JAD bn	1,964	2,068	2,235	2,312	2,430	2,490	2,540	2,567
General government gross debt	% GDP	146.51	141.64	139.94	131.45	125.49	116.96	108.84	100.77
Total investment	% GDP	19.85	20.14	18.47	16.84	15.60	14.09	12.97	12.04
Gross national savings	% GDP	8.54	9.79	11.03	11.20	11.19	10.36	9.33	8.93
Current account balance	US$ bn	-1.93	-1.57	-1.16	-0.93	-0.82	-0.79	-0.77	-0.75
Current account balance	% GDP	-13.04	-11.05	-8.31	-6.55	-5.65	-5.18	-4.81	-4.45

NB. Estimates of government finances start from 2014 of all other metrics, from 2013.

Source: *International Monetary Fund, World Economic Outlook Database, October 2014*

Benefiting from (very) low yields on US Treasuries and other developed world government bonds, the reasonably strong appetite for emerging markets debt, and widespread recognition of the achievements made, the government raised US$800m from international markets in July 2014. The coupon interest rate was just 7.625%. As the IMF emphasised in its fifth review under the EFF (published on 10 September), the bond issue boosted gross foreign exchange reserves to US$2.7bn. This is more than enough to cover the maturities falling due on government bonds over the next year or so.

Thanks to a recovery in tourism receipts, an increase in production of fruit and vegetables (which had been hit by drought) and growth in mining production, growth in exports is expected to accelerate from 9% in 2013 to 12% or so this year and 15% in 2015. This should underpin gradual growth (of 1%-2% per annum) in the economy. Meanwhile, inflation is expected to fall below 9% and to continue trending down. This is important, because inflation has long been higher in Jamaica than in its major trading partners, eroding competitiveness. Looking forward, the current account deficit is expected to fall from 11% of GDP in 2013 to about 8% this year and a little over 4% in 2019. Domestic demand has, however, remained fairly weak. Credit to the private sector rose by 6.3% over the year to June - a slow rate in the context of an economy that has been expanding by around 10% in nominal terms. Inter-bank interest rates have been 3-4% - or negative in real terms: this is another indication that there has not been strong demand for funds from households and businesses.

The reform program is multi-faceted. In June 2014, Jamaica's parliament passed the Banking Services Act, which strengthens the ability of the Bank of Jamaica to operate as prudential regulator of the financial system. The tax base is being broadened through changes to the General Consumption Tax (GCT) and through the reduction in sector- and firm- specific tax incentives. The Tax Collection and Tax Penalty Acts have been changed in order to promote revenue collection. Pilot schemes for new automated customs and tax systems have been put in place. Administrative measures have been adopted to tighten control of government expenditures.

A modernisation of the public sector should reduce the wage bill from about 10% of GDP in 2014/15 to 9% in 2015/16. Since mid-2013, the government has ceased providing financial support to Clarendon Alumina Production (CAP), the vehicle through which it holds its 50% in the JAMALCO alumina joint venture (with Alcoa): previously, financial support from the government to CAP had amounted to over 0.5% of GDP in some years. Measures are underway to boost liquidity in the government bond market.

Nevertheless, risks and challenges remain. Most obviously, the IMF does not foresee a reduction in the unemployment rate. At about 15%, this is high by virtually all standards. The rate is even higher among young people and women.

Although it is falling, the current account deficit is of sufficient size that any legal/administrative changes that can be made to promote inwards investment will be useful. In its latest Global Competitiveness Report 2014-2015, published in September, the World Economic Forum noted that inefficient government bureaucracy is, by a small margin, second only to crime/theft as the issue that the business sector sees as the biggest problem in Jamaica currently.

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For its part, the IMF flags a number of more specific potential problems, such as revenue shortfalls, the inability of the government to cut its wages bill as much at it plans, deteriorating performance by state-owned enterprises or a disruption to Jamaica's access to external finance (including funds from Venezuela through the PetroCaribe system). "Furthermore, investor confidence remains frail and reform fatigue could set in if ongoing painful reforms and real wage compression do not result in more rapid job creation and income growth", it ends.

The People's National Party (PNP) government led by Prime Minister Portia Simpson Miller has been applauded by the IMF for its establishment of an Economic Program Oversight Committee (EPOC). EPOC is an 'inclusive', if private sector business dominated, body that observes the government's progress with the reform program from the outside. As recently as 7 October, the EPOC reiterated its support for the achievements made to now.

Of course, the EPOC's views are not the only views that matter. The PNP government is now at the mid-point of its five-year term. Success on the reform front relies on further cuts to a bloated public sector payroll. Many Jamaican voters are unlikely to see any benefit from the government's financial reform program for some time.

The political challenges to further reforms are a lot higher than they have been over the last two years or so. For instance, we would be concerned about clear resistance from public servants to the payroll cuts (in the form of industrial disputes). We would also be concerned any clear deterioration in the law and order situation. For now, though, we share the IMF's optimism that the government's financial position, and the economy in general, are moving in the right direction.

SURINAME

Fiscal slippage and other challenges

Softness in the prices of gold, oil and alumina have hurt Suriname's budget. A lack of spending discipline has done a lot more damage. With elections due in 2015, the government has little appetite for hard decisions. However, a major financial crisis appears unlikely.

At first glance, Suriname's US$5.27bn economy looks to be in good shape, as **chart 1** indicates. According to latest (October 2014) IMF forecasts, real annual GDP growth should slow to a little under 3.3% this year, before rising to 3.8% in 2015 and 4%-5% over the subsequent four years to 2019. Thanks in part to the (more or less) fixed exchange rate (SRD1: US$0.30 since a 20% devaluation in January 2011); inflation is running at around 2%. The unemployment rate has risen from 8.5% to about 8.9% over recent years, but is not expected to increase further. Government gross debt is low, at around 33% of GDP.

Chart 1: Suriname's Economy - as the IMF sees it

	2012	2013	2014	2015	2016	2017	2018	2019
Gross domestic product, constant prices, % change	4.80	4.10	3.26	3.78	4.23	4.57	4.97	4.43
Gross domestic product, current prices, US$bn	4.83	5.04	5.27	5.65	6.04	6.49	7.00	7.52
Gross domestic product per capita, current prices, US	8,910	9,206	9,539	10,131	10,733	11,427	12,223	13,021
Inflation, average consumer prices, % change	5.01	1.92	2.59	3.48	3.09	3.05	3.03	3.01
Volume of imports of goods and services, % change	19.34	5.67	-6.50	7.20	0.91	6.06	5.87	5.31
Volume of Imports of goods, % change	22.74	9.80	-3.22	6.25	-0.19	6.70	6.53	5.84
Volume of exports of goods and services, % change	9.42	0.84	-1.31	2.73	0.59	14.72	4.87	4.75
Volume of exports of goods, % change	11.09	-0.05	-2.05	2.93	0.52	15.86	5.19	5.07
Unemployment rate, % workforce	8.50	8.50	8.93	8.93	8.93	8.93	8.93	8.93
Population, mn	0.54	0.55	0.55	0.56	0.56	0.57	0.57	0.58
General government revenue, % GDP	25.93	23.82	24.61	25.03	24.44	23.77	23.95	24.00
General government total expenditure, % GDP	29.91	30.62	28.10	27.97	27.31	26.40	26.25	26.24
General government net lending/borrowing, % GDP	-3.98	-6.80	-3.49	-2.94	-2.87	-2.63	-2.31	-2.25
General government primary net lending/borrowing, % GDP	-2.98	-5.41	-2.54	-1.94	-1.82	-1.40	-1.13	-1.10
General government gross debt, % GDP	22.24	29.77	33.47	36.14	39.78	39.67	39.08	38.64
Current account balance, US$bn	0.16	-0.20	-0.19	-0.21	-0.17	0.03	0.05	0.10
Current account balance, % GDP	3.40	-3.93	-3.59	-3.70	-2.79	0.53	0.74	1.27

Note: Forecasts begin after 2011 for GDP, unemployment and current account balance as % of GDP. Forecasts begin after 2012 for public finances and population; after 2013 for trade and inflation.

Source: *International Monetary Fund, World Economic Outlook Database, October 2014*

For this reason, there is not much difference between the government's primary (i.e. before interest payments) and overall budget deficits, of 2.5% and 3.5% of GDP respectively. The IMF is also looking for the current account to move from a deficit of 3.6% of GDP in 2014 to a surplus of 1.3% by 2019.

In the report following its latest Article IV Consultation with the local authorities, the IMF noted that the banking system was strong in terms of its profitability, liquidity and levels of capital. Overall supervision of the banking system by the Centrale Bank van Suriname (CBVS) has been strengthened by the passage of a new banking law in 2011 and the implementation of more rigorous regulations through 2013. Through much of 2013, credit growth to the private sector was in excess of 15% year-on-year: however, the stock of lending to the private sector amounted to only 26% of GDP. As yet, though, there is no specific law governing the insurance sector.

However, some recent trends are concerning. Exports fell from over 60% of GDP in 2011 to 50% in 2013, reversing a trend that had been in place since 2008. In 2013, challenges included the fall in the price of gold, which typically accounts for just over 60% of total exports. Revenues from sale of alumina (about 10% of exports) have been constrained by the persistent weakness in aluminium prices. Prices of oil (another 10% of exports) have also been slipping.

"The slippage in the price of gold has caused Canada's Iamgold to postpone an expansion by of its Rosebel Gold Mine, while the international major Newmont Mining likewise has placed under review its investment program for its local mines."

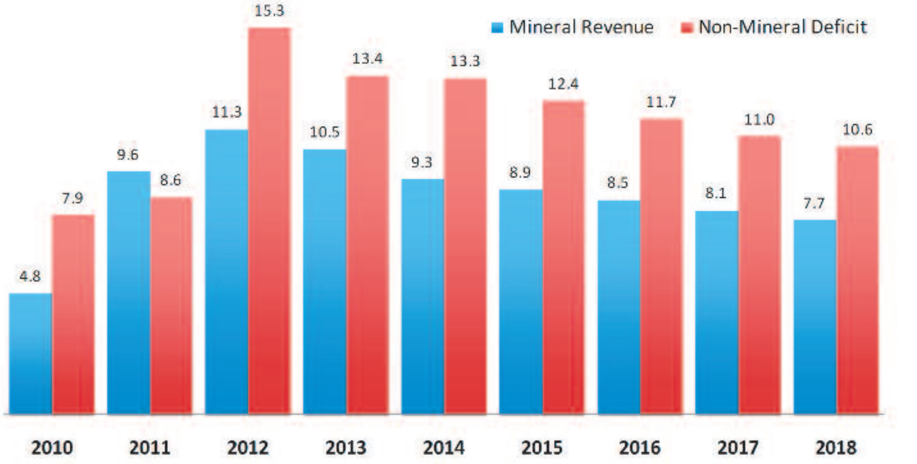
The slippage in the price of gold has caused Canada's Iamgold to postpone an expansion of its Rosebel Gold Mine, while the international major Newmont Mining likewise has placed under review its investment program for its local mines. In May 2014, the government shelved plans to raise US$500m by way of a sovereign bond. The issue was meant for the purchase of government equity interests in each of the latter two projects, ahead of plans to boost production after 2015. As of September 2014, it appeared that the government was considering raising US$200m or so through a loan, in order to fund its investment in Newmont's Merian gold project.

The sovereign bond also would have raised money for the state owned energy company, Staatsolie Maatschappij Suriname NV (Staatsoli). At the end of March 2014, Staatsolie raised US$275m on its own account through a five-year loan from a consortium of regional and international banks. The money will go towards US$1.85bn in capital expenditure planned for 2014-18. Staatsolie is looking to commission a new refinery prior to the end of 2014, and is progressing with an ethanol project in Wageningen, about 200km west of Paramaribo. At current rates of production, Suriname's oil reserves should last another 15 years - although this could be extended if Staatsolie's exploration efforts are successful.

More crucially, the softness in mineral prices is likely to have an impact on public finances. The budget deficit has two key components: revenues received by the government in relation to the production of minerals (i.e. gold, alumina and oil/related products); and the non-mineral deficit (i.e. the excess of spending over revenues from all other sources). As **chart 2** shows, mineral related revenues fell quite sharply as a percentage of GDP in 2013, and are expected by the IMF to continue to decline through the forecast period.

The government has not adjusted its overall spending to recognise the downturn in revenues from the extractive industries. The non-mineral deficit soared from 8.6% of GDP in 2011 to 15.3% in 2012. The IMF expects the deficit to exceed 13% in 2014. In a working paper published in July 2014, Fund economists Daniel Kanda and Mario Mansilla observed that "overall, a medium term non-mineral fiscal deficit target in the neighbourhood of 5.25% of GDP, while ambitious, appears appropriate".

Chart 2: Key elements of budget deficit in Suriname (% GDP)



***Source:** IMF*

'Fiscal slippage' was a major theme of the IMF's report following its Article IV consultation. Spending on subsidies and transfers jumped by 1.5% of GDP in 2012, "led by pension, childcare, and disability benefit increases". Spending on goods and services (including, perhaps, mis-classified capital expenditure) rose by 2.25% of GDP. The statistical discrepancy (essentially unclassified spending) increased by 1.25%.

"In discussions with the [IMF], the government acknowledged that fiscal consolidation was needed. The government has indicated that it is at least considering the introduction of a Value Added Tax (VAT) and a review of electricity subsidies, estimated at around 2% of GDP. These subsidies largely benefit Suriname's higher income urban population."

In its discussions with the Fund, the government acknowledged that fiscal consolidation was needed. The government has indicated that it is at least considering the introduction of a Value Added Tax (VAT) and a review of electricity subsidies, estimated at around 2% of GDP. These subsidies largely benefit Suriname's higher income urban population.

In 2013, the government introduced a new health care system. Health insurance is compulsory for everyone aged between 16 and 59. However, citizens younger than 16 or older than 60 are entitled to basic healthcare that is free at the point of delivery. The new system is being administered by Self Reliance, one of the four indigenous insurance companies, to whom the government pays a premium.

With total assets of SRD850m at the end of 2013, the largest (by far) of the local insurance companies is Assuria. In mid-2014, the managing director of Assuria noted that the preparation time for the new health care system had been very short, and questioned whether it would be financially sustainable. He also noted that the government is planning to introduce a new General Pension Plan. According to the IMF, this will be funded largely on a pay-as-you-go (PAYG) basis. More worryingly, the government has rejected the legislation making its way through the National Assembly to establish a Sovereign Wealth Fund (SWF). Over time, the SWF would have grown so as to provide the government with a fiscal buffer in the event of a sharp downturn in revenues from the country's minerals sectors.

Over the nine months to the end of September 2014, the official reserve assets held by the CBVS slipped from around US$775m to US$662m, but remain ample in the context of the overall economy and imports. This indicates that a currency crisis is unlikely and that the authorities should be able to maintain the local currency SRD at the present level - which the IMF considered as "somewhat on the strong side". As noted, the overall level of government sector debt is also low: the risks of a financial crisis also appear to be low.

Nevertheless, it is difficult to avoid the conclusion that the government's appetite for tough decisions in relation to the fiscal slippage is minimal, and will remain so prior to the elections due next year. By the end of 2015 though, it should become a lot clearer whether the government has the stomach for the fiscal reforms that are clearly needed. Should the price of gold fall sharply over the coming year from the current level of US$1,250 or so, the pressures for change will become even more intense.

Winning the state healthcare contract had a transformative impact on Self Reliance's business. Total premiums written jumped from SRD111m in 2012 to SRD250m in 2013. Of the premiums written in the later year, healthcare insurance accounted for SRD198m. Self reliance also provided motor insurance (premiums of SRD24m in 2013), fire insurance (SRD14m), travel & accident insurance (SRD4m) and other non-life insurance products (SRD9m). The company's assets jumped from SRD141m at the end of 2012 to SRD260m at the end of 2013.

"For oil producers, the boom is over. The price of oil is now in downtrend. The WTI price, for instance, dropped below US$100/d in the middle of August, finishing the month at around US$96/b. During much of September, it tracked sideways in a band of US$90-93/b. However, it fell to the lower limit of the band at the end of that month."

COMMODITIES REVIEW

OIL

Venezuela gets a sharp shock

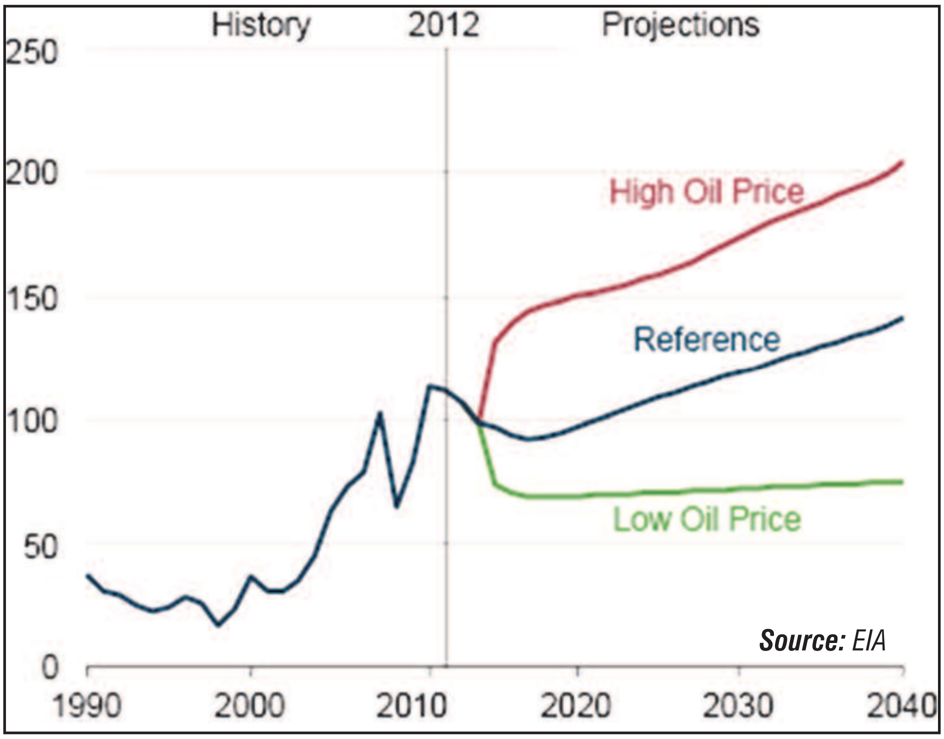
As of the last weekend in October, the price of West Texas Intermediate (WTI), the reference price for Latin American oil, had fallen to around US$82 per barrel (/b).

For 13 years to 2008, the price of oil was on a very strong uptrend, with global prices roughly quadrupling to well over US$100/b. As the world emerged from the global financial crisis, crude prices regained this level in 2011-13.

For oil producers, however, the boom is over. The price of oil is now ona downward trend. The WTI price, for instance, dropped below US$100/d in the middle of August, finishing the month at around US$96/b. For most of September, it tracked sideways in a band of US$90-93/b. However, it fell to the lower limit of the band at the end of the month.

Over the following four weeks, the price continued to fall, with the result that WTI was at a new low of US$82/b as of the last weekend of October. Without going into a detailed analysis of the dynamics of the global oil market, we note that the latest (10 October 2014) Monthly Oil Market Report published by the Organization of the Petroleum Exporting Countries (OPEC), of which Venezuela and Ecuador are the only Latin American members, highlighted the recent "bearish sentiment", softness in global demand (thanks in part to the stagnation in the Euro zone), "ample" supply and the general strength of the US dollar (which makes raw materials less costly for importers).

Extrapolation of oil price movements from a few weeks is often unwise. Nevertheless, we note that the recent movement in the oil price is far closer to the trajectory projected by the US Energy Information Administration (EIA) in the Low Oil Price scenario envisaged in its recent (9 September) *International Energy Outlook* than it is to the one for its Reference Oil Price scenario (base case); let alone the High Oil Price scenario, as the **chart** shows.



"In just six weeks, the price of Venezuelan oil, which trades at a discount of about US$5/b to WTI, has dropped by 16% – from US$92.6/b on 5 September to US$77.7/b in the week of 13-17 October. Things are moving quickly in the wrong direction for the country, but the government is sticking to its line that everything is fine."

For most countries in Latin America and the Caribbean, the slippage in the oil price will have impacts to which they can adjust. The details vary from case to case and depend on numerous factors, including: the extent to which prices stay at current levels (or fall further); the balance of trade in energy; effective prices at which energy is procured via the contracts currently in place; and the extent to which retail/industrial prices for energy are subsidised.

However, the developments of the last four weeks are – unequivocally – bad news for Venezuela's state oil company, Petróleos de Venezuela (Pdvsa), and by extension, the left-wing government led by President Nicolás Maduro.

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Presenting the 2015 budget on 21 October, Finance Minister Rodolfo Marco Torres said the treasury was prepared for "whatever scenario that presents itself with the price of oil". That scenario, to even the most casual observer, is one of a big oil shock that Venezuela – despite the government's protestations – is ill equipped to absorb. This could be a new era for Venezuela, which after a decade and a half of 21st Century Socialism still relies on the 'devil's excrement' for 97% of the country's export earnings and 40%-45% of fiscal income. President Maduro might have insisted on national TV that the country can live with oil at US$40/b, but right now much of the evidence suggests otherwise. Some private economists put the breakeven price for Venezuela at US$121/b.

In this current scenario, the latest budget assumptions look ambitious. The US$117.7bn plan, up 35% in annual terms, uses the main official exchange rate of BF6.3/US$1 and is based on an oil price forecast of US$60/b in 2015, unchanged on the 2014 budget. The left-wing government for years has used an artificially low oil price assumption so that it then can spend the 'windfall' generated by above-budget oil income at its discretion (and without accountability to the legislature).

However, the Venezuelan oil basket is trading perilously close to the 2015 budget figure. Bank of America analyst Francisco Rodríguez has calculated that a drop in international crude prices to US$80/b (or roughly US$75/b for the Venezuelan basket) would reduce Venezuela's oil export revenues by about US$10bn in 2015, from an estimated US$75bn in 2014, a fall of 14%. And with global supplies set to outstrip demand in the near (and medium) term, the future price direction is pointing firmly down. Tellingly, Maduro in mid October called for an emergency OPEC meeting, a request yet to be accepted as OPEC's dominant member – Saudi Arabia – can live with oil at a slightly lower price for now.

Torres forecast real annual GDP growth of 3% next year, which might technically be possible, depending on the depth of this year's recession (some estimates go as low as -4.5%), but will not mean a 'recovery' in any sense for the vast majority of Venezuelans. Likewise, he pencilled in inflation of 25%-30% (the IMF projects average inflation of 63% next year), even as he admitted that the budget deficit this year is 17% of GDP. The only way around that is to devalue and/or monetise it by printing reams of local currency Bolívares. Either option means inflation. There was no mention of devaluation, but it seems almost inevitable. Neither was there any mention of a reduction in the country's lavish fuel price subsidies (amounting to US$12bn-US$15bn a year, on official estimates) – but again, some sort of recalibration seems unavoidable.

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Markets remain sceptical

Meanwhile yields on Venezuelan bonds hit a five-year high of 17.87% in mid October, as investors demanded ever more of a risk return to hold the sovereign. And the country's five-year credit-default swaps, already the highest in the world, hit a five-year high of 19.89 percentage points the day of the budget presentation, according to newswire *Bloomberg*, implying a 75% chance of default within five years. Venezuela has US$17.6bn in debt service due on bonds in the next three years: US$5.9bn in 2015; US$4.7bn in 2016; and US$7bn in 2017.

Torres repeated that Venezuela has full capacity to service its external debt. Pdvsa has US$3.0bn in bond payments due in late October (and has the liquid reserves to pay). Unusually, Venezuela paid US$1.6bn on 8 October to service its Global 2014 bond by drawing from its (already-scarce) central bank (BCV) foreign reserves. Normally, the treasury makes these payments by drawing down US dollars from its external accounts, rather than purchasing foreign currency at the time of payment. The amortisation left the BCV's liquid reserves at an estimated US$300m – or just two days of import cover.

In our last edition, we looked into the possibility – being touted by some economists since June – that the country could/or should default. We identified three signs to watch out for indicative of an imminent default. The first would be an increase in the velocity of money in the country, a monetary alarm bell indicating that households and businesses have lost faith and see a collapse as inevitable. The second sign was fiscal – a sharp drop in the price of oil, dramatically affecting prospects for Pdvsa and the government; and the third was political – widespread social unrest, most likely over rampant inflation and the continued shortages of basic goods, and a gradual withdrawal of public support for the government's (ostensibly) inclusive Socialist agenda.

While Venezuela's overall debt is low – at 51% of GDP (though some analysts put it at a higher 70% to account for off-budget financing from China) –that does not automatically mean that it is solvent. In fact, Venezuela is facing a US dollar liquidity crisis of major proportions – obliging the heretofore high-spending government to hoard scarce dollars – which forces the bulk of a very difficult adjustment onto the local population, in the form of a severe cutback in imports (to which the country is addicted) and rampant inflation, as the central bank prints local currency Bolívares in a bid to monetise its debt.

Our analyst Andrew Hutchings presciently noted, "…a 10% fall in the global price of oil would have serious implications". Ominously, in just six weeks, the price of Venezuelan oil has dropped 16%.

It is likely that Pdvsa, the government – and the Venezuelan people – will continue to 'muddle through' to year end, coping with unstable monetary policies, very high inflation, a chronic shortage of consumer goods and pressure from international markets concerned about the risk of a financial crisis.

However the risk of a social explosion in Venezuela will increase in line with the fall in the price of oil. If such unrest were to involve the Pdvsa workforce, an all-out financial crisis would become far more likely. Ahead of the mid-term legislative elections due in late 2015, the government typically will increase spending to boost the economy. But an unfunded spending increase makes it all the more probable that Venezuela descends into a true hyperinflationary spiral.

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POSTSCRIPT

COLOMBIA

Colombia takes the crown in WB's business environment report

Colombia is the easiest country in which to do business in Latin America according to the World Bank's latest (2015) Doing Business Report.

Released on 29 October, the report analyses regulations that apply to businesses during their life cycle, including start-up and operations, trading across borders, paying taxes and resolving insolvency. The ease of doing business rankings, covering 10 topics and cover 189 economies, now also include a new 'distance to frontier' score. This new aggregate shows how close each economy is to global best practices in business regulation. A higher score indicates a more efficient business environment and stronger legal institutions. Other methodology changes this year mean that the WB backdated its 2014 scores, meaning that they are not strictly comparable.

Colombia was ranked at a decent no. 34 of the 189 countries in the global ranking, making it the best in Latin America. The WB in a press release noted that "Colombia has implemented the largest number of regulatory reforms in the region since 2005, with 29 in total. For example, in 2013/14, Colombia facilitated access to credit through a new law improving its secured transactions system."

Following closely on Colombia's heels was Peru (ranked at 35, but a smidgen ahead of Colombia in the aggregate distance to frontier score, with 72.1 to Colombia's 72.3), then Mexico (39), Chile (41), and Puerto Rico (47). These were followed by the likes of Panama (52), Jamaica (which leapt up the table to 58 from a backdated 85 last year), Guatemala (73), Trinidad & Tobago (79), Uruguay (82), Costa Rica (83), and the Dominican Republic (84).

Brazil, the region's main economy, was well down at 120 on the ease of business rank, but its distance to frontier score was better at 58. Argentina was also well down at 124, with Venezuela ranked the worst place to do business in Latin America - and almost in the world - at 182 of the 189.

The WB makes the point that top five ranked economies in Latin America "are now among the best performers globally in several areas measured by the report. For example, ten years ago, a Peruvian entrepreneur would have had to spend more than 33 days to register a property transfer. Now it would take her only 6.5 days, less time than in the United States (15 days) or Austria (20.5 days)", it notes.

Singapore tops the global ease of doing business ranking for 2015, along with New Zealand, Hong Kong, China, Denmark, South Korea, Norway, the US, the UK, Finland and Australia.

It also points out that "local entrepreneurs in Latin America saw an improvement in the business environment in the past year as the pace of reforms to improve business regulations remained strong. Half the economies in the region implemented at least one such reform in 2013/14".

Augusto Lopez-Claros, Director, Global Indicators Group, Development Economics, World Bank Group, noted that "Some Latin American economies have been improving their business environment for almost a decade, reaching levels in many cases on par with global best practices….Accelerating and expanding this process would help close the gap with global top performers and boost competitiveness".

FDI

According to the UN Economic Commission for Latin America and the Caribbean (Eclac), Foreign Direct Investment (FDI) in Latin America and the Caribbean was stable in 2013, but only thanks to one major transaction (the US$13.2bn purchase of Modelo, a Mexican beer maker, by a European firm). Total inflows were valued at US$188bn, a year on year increase of 6% in nominal terms. Eclac said that conditions remained conducive to FDI in the region, and transnational corporations made slightly higher profits than in 2012. FDI outflows were much more volatile and, after a large increase in 2012, they dropped by 30% to US$32.6bn in 2013.

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