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# Bearish outlook for Latin America

**The annual meetings of the IMF and World Bank – held this year in Lima – heard some fairly downbeat assessments of the world economy and of Latin America and the Caribbean's role within it.**

The IMF prepares its world economic outlook (WEO) twice a year, in April and in October. The October 2015 outlook has turned out to be one of the most bearish in recent years. The fund is predicting global GDP growth of 3.1%, down from its April prediction of 3.3%, and the lowest growth rate of the last six years. This, it says, is explained by lower commodity prices, lower growth in China, and a "persistently modest" recovery in the world's most developed economies. For emerging and developing economies 2015 is expected to be the fifth consecutive year of slowing growth. The BRIC economies (Brazil, Russia, India, China) are no longer looking like the engine of global growth they once were. As a group they are set to grow a comparatively modest 4.0%: Brazil and Russia are in the throes of recession leaving India and China to do the heavy lifting. While the IMF has kept its China growth predictions unchanged on April (GDP growth of 6.8% this year, easing to 6.3% in 2016) it says that the negative impact of China's slowdown on the world economy looks like being greater than it had originally estimated. The WEO report stresses the transmission mechanism through lower commodity prices. On a year-on-year basis oil prices have fallen 46%, metals are down 22%, and food prices have tumbled 17%. The commodities slump is expected to last at least another two years.

All this is clearly bad news for Latin America and the Caribbean, the region of the world that is likely to perform least well this year, according to the IMF. The region suffers because of the China-dependence of its commodity exporters; because it is exposed to the effects of monetary tightening in the US; and because it is also exposed to a reversal of investment flows, as capital seeks a return to safety by flowing back to the US, Europe, and Japan. As a result the IMF predicts that Latin America and the Caribbean will be in recession this year, with GDP contracting by 0.3%. By contrast, developing Asia will grow 6.5%, sub-Saharan Africa will grow 3.8%, emerging Europe will expand 3.0%, and the Middle East and North Africa will advance by 2.5%. Within the Latin American region the IMF sees recession in Venezuela (-10%), Brazil (-3.0%) and Ecuador (-0.6%), coupled with slower growth in the Pacific Alliance countries (Chile, Mexico, Colombia and Peru). On the plus side, however, the WEO report suggests global growth will gain momentum next year (+3.6%) and in 2017 (+3.8%), and that this will help pull Latin America back into positive growth territory (+0.8% in 2016).

Speaking at a press conference in Lima, IMF managing director Christine Lagarde argued that Latin American countries that have undertaken structural economic reforms are best placed to weather the downturn. She singled out Mexico, Colombia, Chile, and Peru for praise on this count, but described Brazil and Venezuela as examples of economies that have become stagnant and are now in "negative territory". London-based publication *The Economist* has argued that Brazil's and Venezuela's difficulties are based on the fact that both governments continued spending heavily after the commodity boom had begun to subside. Using the IMF numbers, it points out that if these two countries are excluded from the count, the rest of Latin America and the Caribbean will grow this year at an average rate of 2.6%.

The UN's Economic Commission for Latin America and the Caribbean (Eclac) is broadly in step with the IMF, although some of its individual country forecasts diverge slightly. Eclac also says regional GDP will contract by 0.3% this year – largely because of the recession in Brazil – and will recover with a modest 0.7% growth rate in 2016. This forecast, published at the beginning of October, represents a worsening assessment: as recently as July Eclac had been predicting 0.5% growth for the region this year. Eclac attributed the switch to weaker domestic demand, slower economic growth among the developed economies, and a slowdown in big emerging economies such as China. The depreciation of Latin American currencies against the US dollar, weak commodity prices, and financial market volatility also added to uncertainty. Eclac now sees Brazilian GDP dropping 2.8% this year (against a predicted fall of 1.5% in its July outlook). Mexico, the region's second largest economy after Brazil, is now expected to grow 2.2% (accelerating to 2.5% in 2016), while Argentina will expand by 1.6% in both 2015 and 2016. Venezuela will see a GDP contraction of 6.7% this year, Eclac says.

"How can governments best deal with this combination of global headwinds and domestic problems? One suggestion in Lima came from Chilean finance minister Rodrigo Valdés..."

The best-performing economies across the region this year will be Panama (GDP up by 5.8%) and the Dominican Republic (+5.6%). Cuba will grow by 4.0%. In South America the best performers will be Bolivia (+4.4%), Paraguay (+3.3%) and Colombia (+2.9%). Peru will grow by 2.7%, Uruguay by 2.4%, and Chile by 2.1%. Eclac says that in response to the economic slowdown, countries should make extra efforts to reverse the fall in investment, as a key step to achieving long term sustainable economic growth.

How can governments best deal with this combination of global headwinds and domestic problems? One suggestion in Lima came from Chilean finance minister Rodrigo Valdés. He said that commodity exporters need to adapt to the "new normal" of slow growth and that efforts to artificially accelerate growth back up to levels achieved at the height of the commodity boom would be counter productive. Instead, they should focus on reforms to boost productivity and develop human capital. "This will be a period of slow growth: we shouldn't promise what we can't deliver" he warned.

One interesting view of the region's economic fortunes has come from World Bank chief economist Augusto de la Torre, who says the continent is being cut in two. "Central America, Mexico, and the Caribbean are tracking the US recovery, and South America is suffering from the Chinese slowdown. It is a regional parting of ways. The US is pushing up and China is pulling down" he said. De la Torre said he was somewhat more pessimistic about the 2016 outlook for the region, relative to the official projections. He believed it might be another zero growth or negative year given that, apart from Chile, the recession had not yet bottomed out in a number of countries.

> “Latin America has become stagnant in a world economy that isn’t growing. We are not exceptional any more, our problems are similar to the problems of the rest of the world, that didn’t happen in the past.”
>
> *– José Juan Ruiz, chief economist at the Interamerican Development Bank*

**Low numbers: Eclac growth forecasts (% change in GDP)**

| Country | 2015 | 2016 |
|---|---|---|
| **South America:** | **-1.3** | **-0.1** |
| Argentina | 1.6 | 1.6 |
| Bolivia | 4.4 | 4.4 |
| Brazil | -2.8 | -1 |
| Chile | 2.1 | 2.5 |
| Colombia | 2.9 | 3.1 |
| Ecuador | 0.4 | 0.8 |
| Paraguay | 3.3 | 3.6 |
| Peru | 2.7 | 3.4 |
| Uruguay | 2.4 | 2.6 |
| Venezuela | -6.7 | -7 |
| **Central America & Mexico** | **2.6** | **2.9** |
| Costa Rica | 2.6 | 3.3 |
| Cuba | 4 | 4 |
| El Salvador | 2.2 | 2.3 |
| Guatemala | 3.8 | 4 |
| Haiti | 2 | 2.5 |
| Honduras | 3.4 | 3.3 |
| Mexico | 2.2 | 2.5 |
| Nicaragua | 4.3 | 4.5 |
| Panama | 5.8 | 6 |
| Dominican Republic | 5.6 | 5.2 |
| **Caribbean:** | **1.6** | **1.8** |
| Antigua and Barbuda | 2 | 3.4 |
| Bahamas | 2 | 2 |
| Barbados | 1.5 | 1.5 |
| Belize | 2.5 | 2.5 |
| Dominica | 1.9 | 2.2 |
| Grenada | 1.3 | 0.9 |
| Guyana | 4.5 | 4.5 |
| Jamaica | 1.1 | 1.6 |
| St Kitts and Nevis | 4.4 | 5.3 |
| St Vincent and the Grenadines | 2.2 | 2 |
| St Lucia | -0.2 | 0.5 |
| Suriname | 3 | 3 |
| Trinidad and Tobago | 1 | 1 |
| | | |
| **Latin America and Caribbean** | **-0.3** | **0.7** |

***Source:*** *Eclac*

However José Juan Ruiz, chief economist at the Interamerican Development Bank (IDB), who took part in a recent Brookings Institute debate with De la Torre, said there were grounds for optimism. Ruiz stressed the progress the region has made to reduce poverty and increase social inclusion. From his point of view the growth of the Latin American middle class and the consolidation of democracy has made some irreversible changes, ensuring that the local economies will not regress. “Latin America has become stagnant in a world economy that isn’t growing. We are not exceptional any more, our problems are similar to the problems of the rest of the world, that didn’t happen in the past”, he argued.

## REGION

### What could possibly go wrong?

**Arguably, recessions are more interesting than booms. During a full-blooded economic boom, a rising tide lifts almost all ships: countries, industries, and companies, perhaps even some that don't deserve to, rise up. The issue during a boom is whether anyone will remember to invest some of the surplus wisely for leaner times in the future. During recessions however, there is a real risk of crisis – break points such as devaluations, payment defaults, or bankruptcies, all with serious political consequences. The issue during a recession is whether in the bad times the crisis can forge creative responses, new policies, innovations, diversification or better growth dynamics for the future. So what kind of recession is Latin America experiencing now?**

Implicit in many recent statements by Latin American government officials and analysts is the assumption that Latin America is in the midst of a soft or 'lite' recession: one where the slowdown is relatively moderate, where there will be no crisis, financial turbulence, or sudden discontinuities, and one where a recovery seems relatively close at hand. Certainly the IMF's latest forecasts can be seen as consistent with that view: it says Latin American GDP will contract by 0.3% this year, and recover by 0.8% in 2016: in other words, we are in a period of economic stagnation with prospects of moderately better times further down the road.

The 'recession lite' scenario can be challenged on various counts. First, this downturn is clearly not crisis-free, with Venezuela and Brazil leaping to mind as two clear exceptions to the orderly adjustment process said to be in progress across the rest of the continent. Venezuela combines a deep political crisis with the breakdown of an economic model almost entirely based on oil exports. With GDP set to fall by at least 6%-7% in both 2015 and again in 2016 this is no small issue. If oil prices remain low for the next two-three years, as many analysts predict, it is hard to see an early resolution to the crisis. While Brazil has much more market-friendly economic policies than Venezuela, there is no doubt that corruption and major fiscal mismanagement in that country have already created a deeper, longer recession than would otherwise have been the case. With a potential impeachment process against President Dilma Rousseff looming, there may well be a long-drawn out period of political uncertainty and economic policy drift. Brazil is Latin America's largest economy, so there is a real danger that it may contaminate or otherwise "drag down" its neighbours.

"While Brazil has much more market-friendly economic policies than Venezuela, there is no doubt that corruption and major fiscal mismanagement in that country have already created a deeper, longer recession than would otherwise have been the case."

In second place, 'surprises' cannot be ruled out. One example concerns levels of debt. As a result of a succession of payments crises experienced through the 1980s, 1990s, and early 2000s, followed by the good years of the commodity boom, most Latin American countries now have much lower levels of sovereign debt relative to GDP than they did in the past. Much of Brazil's public debt is now held in local currency rather than in US dollars, also reducing repayment risk. The conventional view therefore is that the chances of a default taking place in the current Latin American recession are low. But economist Carmen Reinhart has noted that there could be a problem of "hidden debt". In particular she says that lending by Chinese development banks to Latin America is not included in data gathered by the Bank for International Settlements (BIS), nor in World Bank databases. She cites data gathered by the Global Economic Governance Initiative which suggests that in 2009-2014 total Chinese lending to Venezuela was equivalent to 18% of that country's annual GDP, while Ecuador received loans equivalent to 10% of its GDP, as did Jamaica. Brazil received loans equivalent to a lower 1% of its GDP. Currency swap agreements, important for Brazil and Argentina, may also add debt that is not properly reported. Reinhart's conclusion is that if debts are being underestimated, "the magnitude of the ongoing reversal in capital flows that emerging economies are experiencing may be larger than is generally believed – potentially large enough to trigger a crisis."

In third place, there are other economies, apart from Brazil and Venezuela, which could face disorderly, rather than orderly adjustment. While some oil exporters like Mexico and Colombia can rely on floating exchange rates to allow them to diversify exports, adjust relative prices, and regain a competitive edge, Ecuador's room for manoeuvre is limited by the fact that it is a dollarized economy operating without its own national currency. This means that the impact of lower oil price has been severe, and the government has had to increase import tariffs and cut government spending in an attempt to maintain positive net dollar inflows. Local money supply has dropped by around one-quarter so far this year. Argentina too faces a difficult transition when a new government takes office in December, given scarce foreign currency reserves, a large fiscal deficit, and distortions caused by inflation and multiple exchange rates. So while Latin America as a whole is definitely in better economic shape than it was in the 1990s, it seems that this recession is certainly not "risk free".

## REGION

### Can Latin America export its way out of trouble?

**When commodity prices fall and the dollar strengthens against local currencies – broadly what is happening right now – there seems to be an obvious response: countries should try to reduce current account deficits by diversifying exports and seeking to sharpen their competitive edge. But this may be easier said than done.**

There doesn't seem to be an export-led recovery waiting just around the corner. According to a report published in October by the UN Economic Commission for Latin America and the Caribbean (Eclac) the region's exports will fall by 14% in 2015, the third consecutive year of contraction. Eclac says lower prices and demand for commodities have taken a toll: export value was down by 3.0% in 2013, and by a further 0.4% in 2014, before this year's expected double-digit percentage drop. And exports may fall again in 2016, simply because prospects for a global recovery in prices and volumes do not look good at the moment. To underline the significance of this situation, Eclac notes that regional export performance in the 2013-2015 triennium is expected to be the worst recorded in eight decades. Oil and commodity exporters will this year experience the sharpest drops in export earnings: 41% for Venezuela, 30% for Bolivia, and 29% for Colombia. Mexico and Central America will see contraction of only 4%, reflecting their more diversified and manufacturing-rich exports to the US.

"According to a report published in October by the UN Economic Commission for Latin America and the Caribbean (Eclac) the region's exports will fall by 14% in 2015, the third consecutive year of contraction."

Two factors make the current situation particularly difficult, the report argues. First, trends in the global economy are unfavourable to a recovery in trade. These include the Chinese slowdown, a reversal of capital flows out of emerging economies, expectations of monetary tightening, and a persistent fall in aggregate demand. Second, during the last boom many Latin American countries did not complete "pending tasks" such as investing in new technologies, in infrastructure, and in the improvement of production processes. Presenting the report Eclac executive secretary Alicia Bárcena said "The region is a crossroads: either it continues along the current path restricted by the global context, or it commits to a more active international insertion that favours industrial policy, diversification, trade facilitation and intraregional integration" she said.

"The region is a crossroads: either it continues along the current path restricted by the global context, or it commits to a more active international insertion that favours industrial policy, diversification, trade facilitation and intraregional integration."

*– Eclac executive secretary Alicia Bárcena*

**Exports take a battering, but Mexico suffers least (annual % variations)**

| | 2013 | 2014 | 2015 |
|---|---|---|---|
| Latin America | -0.2 | -2.7 | -13.8 |
| Caribbean | -1.7 | -3.8 | -17.5 |
| | | | |
| Argentina | 1.8 | -11.9 | -16.9 |
| Brazil | -0.2 | -7 | -15.1 |
| Bolivia | 3.6 | 5.2 | -29.5 |
| Chile | -1.7 | -1 | -16.8 |
| Colombia | -2.1 | -5.5 | -29.2 |
| Ecuador | 4.5 | 3.6 | -24.5 |
| Mexico | 2.5 | 4.5 | -4.1 |
| Peru | -9.6 | -7.8 | -16.3 |
| Venezuela | -8.6 | -16.8 | -40.6 |

***Source:*** *Eclac*

While many economists in the region agree in general terms with this approach, some note it takes considerable time for export diversification strategies to pay off. In Colombia, for example, think tank Fedesarrollo says the collapse in oil prices has widened the current account deficit to about 6.5% of GDP this year. The depreciation of the peso will help narrow that deficit, but it will do so first by reducing imports, and only second, and more slowly, by allowing export diversification and growth, much of which also depends on infrastructure investment to improve the country's inefficient logistics.

## BOLIVIA

### And this year's fastest-growing economy is...

**It is almost certain that Bolivia will be the fastest-growing South American economy in 2015. Its performance is defying stereotypes. The left-wing government is suspicious of the market economy, but it is nevertheless achieving a rate of growth that is the object of envy among its more capitalist neighbours. At the same tine, with a largely hydrocarbons-based export sector, Bolivia seems to be avoiding the chaos that low oil and gas prices are causing for the socialist government of Venezuela. Here we look at the reasons behind the country's success.**

There isn't an absolute consensus on how fast Bolivia will grow this year, but most analysts agree that it will be the fastest-growing economy in South America. In October Eclac predicted GDP growth of 4.4%, marginally down on its previous 4.5% projection. This puts Bolivian growth ahead of forecasts for Paraguay (3.3%) and for market-friendly Pacific Alliance countries like Colombia (2.9%) and Peru (2.7%). Its performance will be in sharp contrast to the recessions underway in Brazil and Venezuela, or the standstill in Argentina. Eclac says Bolivia will again grow at the same 4.4% rate in 2016. However, in its World Economic Outlook the IMF is a little less bullish for next year, forecasting Bolivian growth at a lower 3.5%. The authorities in La Paz meanwhile are more upbeat. Central bank president Marcelo Zabalaga has said "in 2016 we are going to grow at a rate similar to what we have recently experienced – 5% or more". In fact, according to World Bank data, in the nine years since President Evo Morales took office in 2006, annual GDP growth has averaged an impressive 5.1%.

"The simple explanation of Bolivia's success is that, like many of its neighbours, it took advantage of the commodity price boom to redistribute income and reduce poverty; but unlike some of them, it followed much more prudent fiscal and monetary policies and did more to boost investment and export diversification."

The simple explanation of Bolivia's success is that, like many of its neighbours, it took advantage of the commodity price boom to redistribute income and reduce poverty; but unlike some of them, it followed much more prudent fiscal and monetary policies and did more to boost investment and export diversification. As a result the economy is retaining greater momentum at a time when the commodities boom has ended and global headwinds have increased. Going forward, continued success is not guaranteed, of course, and lower prices for gas, the country's main export, will inevitably take a toll. Eclac predicts 2015 exports will be down by one-third on last year. President Morales has said that lower gas prices imply an export revenue shortfall of some US$3bn this year.

Economy minister Luis Alberto Arce insists that the government's economic model, which he describes as an alternative to 'neo-liberalism', has been the key to growth. He says it is based, first, on asserting national ownership and control of natural resources and, second, on "the active participation of the state, because we don't believe in the market economy". State intervention has helped redistribute income and reduce extreme poverty, the minister says. The third element according to Arce is the reinvestment of surplus income from commodity exports into productive diversification, such as into the construction of urea and liquid petroleum gas (LPG) plants. The minister says public sector investment is running at around 17% of GDP, compared to 7%-8% of GDP for private sector investment. In his view domestic private sector investment is "not very dynamic", but foreign private sector investment is much more so. He recognises the country's export dependence, but he notes that alongside hydrocarbons (12% of GDP) and mining (8%), manufacturing now accounts for 17% of GDP and agriculture 13%. The government, he says, is also investing in "roads, hospitals, bridges, schools, railways and infrastructure".

It is also evident that despite the anti-capitalist stance, Bolivia is pitching very hard for private sector investment. Bolivia was going ahead with an investment road show in New York in late October, and according to the minister is particularly interested in attracting large-scale foreign investment in hydroelectric plants, since the country wants to export electricity to its neighbours such as Chile and Peru. Also on the agenda is an agreement with German company K-UTEC AG Salt Technologies to develop a lithium carbonate processing plant in the Uyuni salt flat. More investment opportunities are likely to be discussed when President Morales visits Germany for talks with Chancellor Angela Merkel in November.

While foreign analysts may focus on Bolivia's outperformance relative to other Latin American economies, for a significant portion of the population what may matter more is the slowdown in growth relative to the boom years. According to Daniel Loza of opinion pollsters Ipsos, the proportion of the electorate that disapproves of the government's economic policies, while still a minority, has been growing. "In October of last year we had 27% of the population that disapproved, but in April of this year we had a 31% disapproval rating" he said. With a referendum due next year to decide whether Morales can stand for re-election again in 2020, the government wants to maintain a high growth rate for as long as possible.

How fast the Bolivian economy grows is also important because, under a decree introduced in 2013, above 4.5% growth triggers the payment of a second annual bonus payment to the country's employees. In October INE, the national statistics institute, confirmed that GDP growth in the 12 months to June 2015 had been 5.2%, and the economy ministry said that the second bonus was therefore payable. The private sector response has been unenthusiastic. Federico Diez de Medina, representing the business federation of Cochabamba, said that paying the bonus would force some employers to lay off staff or even close down their companies. Wilfredo Rojo of the Santa Cruz exporters' association said employers would pay the bonus but that it would cause them financial problems.

"According to the Paraguayan Central Bank's monthly economic activity indicator (known as Imaep) output in the first eight months of this year rose by 3.4%."

## PARAGUAY

### Not just soya

**Along with Bolivia, Paraguay is also set to be one of South America's more dynamic economies in 2015 and 2016, with predicted growth rates of 3.3% and 3.6%, according to Eclac. In part this is because, as a largely agricultural economy at a fairly early stage of development, high growth rates are relatively normal. In the 10 years to 2013 Paraguayan GDP growth averaged 4.9%. As an oil importer, Paraguay is also benefiting from an improvement in its terms of trade.**

According to the Paraguayan Central Bank's monthly economic activity indicator (known as Imaep) output in the first eight months of this year rose by 3.4%. Officials say this comparatively strong growth rate reflects recently increased agricultural production estimates, and a strong showing by sectors such as household services, financial services, public sector enterprises and hotels and restaurants. Paraguay is the world's fourth largest soya exporter and also ships other agricultural commodities such as cotton and tobacco. The government says the 2015/16 soya harvest could reach 10m tonnes, up from 8m in the 2014/15 season. But here too the authorities seeking to promote economic diversification. Jorge Moreno of construction industry association Cámara Paraguaya de la Construcción (Capaco) notes that at the midway point of 2015 various road building projects in the country had begun to gather pace. Jorge Pappalardo, vice president of the industrialists' association (Unión Industrial Paraguaya – UIP) described the local economy as showing "good dynamism".

Brazil's recession is widely seen as having a negative impact on Paraguay, its comparatively tiny neighbour (in terms of both population and market size). While the Brazilian shock waves are clearly a problem, there is also a sense in which the crisis next door creates some significant opportunities for Paraguay. Under the existing Ley de Maquila introduced in the 1990s, Paraguay offers attractive tax breaks to companies that import machinery and raw materials for processing by local labour, on condition that 90% of their output is directly re-exported. The law, modelled on Mexico's long-standing special regime for maquiladoras – assembly plants dotted along its northern frontier with the US – exempts companies from all major local taxes, apart from a 1% levy on exports.

Operating in Paraguay has therefore become increasingly attractive for Brazilian companies that are seeking to escape from their high domestic production costs and taxation liabilities. Apart from the tax breaks, they benefit from lower wage and energy costs. For industrial customers, electricity tariffs in Paraguay are roughly half their level in Brazil. The Itaipú hydroelectric complex, built decades ago in partnership with Brazil, remains the second largest of its kind in the world (after the Three Gorges complex on the Yangtze River in China), and the cheap energy it produces is a major asset for Paraguay. Over 40 Brazilian companies are reported to be carrying out assembly operations in Paraguay in industries such as textiles, auto parts, toys and plastics. Sarah Saldaña of Brazil's lobby group Confederação Nacional da Industria (CNI), which recently organised a mission to Paraguay for a total of 79 Brazilian companies, says the intention is not to have them close down their operations in Brazil but to "make them stronger and more competitive and to get them more involved in international production chains". She says Paraguayan maquiladora exports, most of which are produced by Brazilian companies, rose by 52% last year to reach US$260mn.

"Gustavo Leite, Paraguay's economy minister, points out that despite Brazil's economic slowdown, last year Paraguay's exports to Brazil actually rose by 18%."

Gustavo Leite, Paraguay's economy minister, points out that despite Brazil's economic slowdown, last year Paraguay's exports to Brazil actually rose by 18%. In more general terms, asked to explain Paraguay's comparatively strong growth rate in the face of its neighbours' difficulties, he said "it is a prize we have won for having a healthy economy based on renewable and non-extractive resources". Leite stresses the attractions of cheap hydroelectric energy, a labour force that is "eager to learn" and has high productivity and low absenteeism, and a geographic location alongside "a neighbouring giant with competitiveness problems". Finance minister Santiago Peña has also commented "we are pushing to diversify beyond agriculture".

In terms of macroeconomic policy the government of President Horacio Cartes is market-friendly and pro-business: there is for example a flat 10% tax rate. In June US ratings agency Standard & Poor's put Paraguay's BB rating on a positive outlook, saying that the country was displaying "increasing resilience" to the difficulties of its neighbours. Recognising the increased global headwinds – lower global commodity prices and the poor showing of trade partners Brazil and Argentina – earlier this year the Paraguayan Central Bank cut its key interest rate by one percentage point to 5.75%. Central Bank president Carlos Fernández Valdovinos has commented that this countercyclical measure is intended to keep the economy moving without risking a rise in inflation (the current inflation target rate is 4.5%). In October Fernández said "With the 100 basis points that we have already cut, we have given enough stimulus to demand and, for the moment, bigger cuts are not needed anymore". He added, "We can't pretend to grow at the same speed having Brazil contracting".

## TRINIDAD & TOBAGO

### Restoring confidence and rebuilding trust...but not yet in a sustainable way

**The (new) government of Trinidad & Tobago's Budget for the September 2016 fiscal year envisages a reduction in the budget deficit from 4.2% of GDP to 1.8% of GDP. However, this assumes that successful implementation of new measures to boost government revenues, and one-off items (including asset sales), raise amounts equivalent to 3.2% of GDP and 8.2% of GDP respectively.**

The title of the Budget Statement delivered on 5 October 2015 by Trinidad & Tobago's Finance Minister Colm Imbert – *Restoring confidence and rebuilding trust: Let us do this together* – identifies one of the key challenges facing the new People's National Movement (PNM) government. There is a widespread lack of faith in the country's institutions. The World Economic Forum's *Global Competitiveness Report 2015-2016* assessed Trinidad & Tobago's institutions as being the 108th best of those of the140 countries considered. The country's overall competitiveness ranking is 89.

Some of the underlying details are worrying. Aspects for which Trinidad & Tobago has particularly unfavourable rankings include: diversion of public funds (124); public trust in politicians (128); favouritism in decisions of government officials (137); wastefulness of public spending (112); business costs of crime and violence (136); organised crime (117); the reliability of the police service (116); and the ethical behaviour of firms (125).

> "In early May 2015, the CBTT publicly challenged the decision by Moody's Investor Services to downgrade the sovereign rating of Trinidad & Tobago from Baa1 to Baa2 and to change the outlook from stable to negative."

The budget seeks to restore confidence and trust at a time when economic conditions have become more difficult. According to the Central Bank of Trinidad & Tobago (CBTT), the domestic economy shrank by nearly 2% in 1H15. The energy sector contracted by about 3.5% thanks mainly to continued shortfalls in the output of natural gas. The non-energy sector shrank by about 1%, thanks to weakness in construction, distribution and manufacturing. At the end of September 2015, when the CBTT announced the seventh consecutive 25 basis point hike in the repo rate (to 4.50%), the central bank noted that early indicators suggest that the economy remained sluggish through 3Q15. The Budget Statement noted that total energy exports in the year to September 2015 have been estimated at US$7.5bn, down from an annual average of US$12.7bn over the preceding four years **[1]**.

In early May 2015, the CBTT publicly challenged the decision by Moody's Investor Services to downgrade the sovereign rating of Trinidad & Tobago from Baa1 to Baa2 and to change the outlook from stable to negative. Moody's decision had been driven by three considerations. One was 'persistent fiscal deficits and challenging prospects for fiscal reforms'. The second was the slippage in oil prices and the limited diversification of Trinidad & Tobago's economy outside the energy sector. The third was the allegedly 'weak macroeconomic policy framework and inadequate provision of vital macro-economic data (given the deficiencies of the Central Statistical Office).

Several of the numbers included in the Budget Statement support Moody's concerns. Largely because of the weakness in energy exports, the trade surplus contracted from US$4.6bn in 2014 to US$1.7bn in 2015. Thanks to capital outflows, overall foreign exchange reserves slipped over the year to the end of

| Chart 1: Trinidad & Tobago's economy and budget |
|---|
| *Selected statistics for September 2015 fiscal year* |
| Total energy exports of US7.5bn, down from annual average of US$12.7bn in 2010-14 |
| Trade balance down from US$4.6bn in 2014 to US$1.7bn in 2015 |
| Reduction in official foreign reserve of US$720mn |
| Government revenues from petroleum down by TT$8.0bn |
| Government expenditures cut by only TT$3.0bn |
| Fiscal deficit of TT$7.0bn (4.2% of GDP) vs budgeted TT$4.3bn or 2.7% of GDP |
| The deficit does not include arrears of state agencies (HDC, UDeCOTT, NIDCO, EFCL and EMBD*). |
| Pre-election negotiations with unions resulted in TT$5.0bn of salary arrears in the public sector |
| Lower energy volumes and prices meant that collections from the oil companies were TT$13bn, $TT8bn below budget |
| Current spending was TT$3.1bn lower than budgeted, thanks to lower retail fuel subsidies. |
| Social sector programme spending maintained in spite of lower revenues |
| Capital spending exceeded budget by TT$225mn, due mainly to accelerated expenditure in the final quarter of the fiscal year. |
| Government overdraft with Central Bank of Trinidad & Tobago at TT$8.5bn or 98% of legal limit at one point in September. |
| |
| *Housing Development Corp., Urban Development Corp., Natinoal Infrastructure Development Company, Education |
| Facilities Company Limited and Estate Management and Business Development Company. |
| |
| ***Source:*** *Government of the Republic of Trinidad & Tobago, Budget Statement 2016, of 5 October 2015* |

September 2015 by US$720mn. Government revenues from petroleum fell by TT$8.0bn (US$1.3bn) relative to original estimates. However, the previous government of the People's Partnership (PP) coalition only cut its expenditures by TT$3.0bn. As a result of this, the fiscal deficit ballooned to TT$7.0bn (or 4.2% of GDP), rather than the TT$4.3bn (2.7% of GDP that had been budgeted.

Other details pointed to some shortcoming in governance by the previous government. The deficit figures cited above do not include the arrears of six state agencies – which the new administration were still trying to quantify at the time of the Budget Statement. Further, negotiations prior to the election between the previous government and the trade unions representing public sector workers resulted in a liability of the government for about TT$5bn in salary arrears. In spite of collections from oil companies being more than one third lower than the level budgeted, the previous government maintained spending on its social programmes.

Over the nine months to the end of June 2015, the previous government's actual capital expenditure was behind the budgeted allocations, due to delays in implementation. However, by the end of September, total capital spending was ahead of budget by TT$225m. This meant that the September 2015 fiscal year was the first for several years in which the budgeted capital expenditure had actually been achieved. The implication is that, following the announcement in June of the date for the election, the previous government had accelerated public works for the sake of political expediency. One result of this was that the government's overdraft with the CBTT rose to TT$8.5bn, or 98% of the legal limit at one point shortly after the election, which was held on 7 September 2015.

And the public sector debt ratios have been moving in the wrong direction. In September 2010, net public sector debt was equal to 32.2% of GDP. By September 2014, the ratio had increased to 40.2% of GDP. As of September 2015, it is estimated to be 46.3% of GDP.

| Chart 2: Highlights of Budget for September 2016 year |
|---|
| Aim to reduce the budget deficit from TT$7.0bn (or 4.2% of GDP) to TT$2.8bn (1.8% of GDP) |
| Measures to boost revenues should raise extra TT$5.2bn (3.2% of GDP) |
| One off items (including asset sales) should raise an additional TT$18.6bn (11.4% of GDP)* |
| Total spending (including TT$5.0bn in salary arrears) of TT$63.0bn - versus revised estimate of TT$61.8bn in 2015. |
| Current revenues of TT$41.6bn, or TT$18.7bn less than the original estimates for 2015. |
| Total revenues of TT$60.3bn, including oil revenues of TT$5.5bn. |
| Capital expenditure through Public Sector Investment Program of TT$7.0bn, or 14.2% lower relative to 2015. |
| |
| *This includes: one-off dividends etc. from National Gas Company, Trinidad Generation Unlimited, and CLICO and the Initial Public Offering (IPO of Trinidad & Tobago NGL). These items should raise TT$13.4bn. It also includes: a new tax regime for the gaming industry the introduction of a property tax regime increases to the Green Fund and Business Levies beginnings of reform to the fuel subsidy VAT system reform (including a reduction in the rate from 15% to 12.5%, but a widening in the base) and increased tax collection efficiency. These items should boost revenues by TT$5.2bn. |
| |
| NB Forecasts assume oil price of US$45/bbl, Henry Hub gas price of US$2.75 per mmBtu and Indonsia gas price of US$8.00 per mmBtu. |
| |
| ***Source:*** *Government of the Republic of Trinidad & Tobago, Budget Statement 2016, of 5 October 2015* |

With this background, the new government is emphasising fiscal discipline in its budget for the September 2016 fiscal year **[2]**. The aim is to reduce the budget deficit from the estimated 4.2% of GDP in 2015 to 1.8% of GDP – or from TT$7.0bn to TT$2.8bn. In part, this will be achieved by way of a reduction in capital expenditure through the Public Sector Investment Programme (ie spending out of current revenue as opposed to through the Infrastructure Development Fund) of around 14.2% to TT$7.0bn. The new government will continue with the public mass transit system which is due to be financed by the Inter-American Development Bank (IDB).

Overall spending in the current year is expected to be TT$63.0bn, or slightly more than the TT$61.8bn which is expected to be the final result for the September 2015 year. However, this amount includes the TT$5.0bn in back pay for public sector workers that was agreed as a result of the negotiations between the previous government and the relevant unions. Excluding that item, overall spending is being reduced by TT$3.8bn.

The new government anticipates that current revenues will be TT$41.6bn, which is a lot less than the latest estimates for the September 2015 fiscal year – of TT$49.8bn – let alone the original estimates for 2015 of TT$60.5bn. The government is looking to raise TT$18.6bn – which is equivalent to 11.4% of GDP – from one-off items.

Some TT$13.4bn is expected to come from a capital repayment from Trinidad Generation Unlimited; dividends from the National Gas Company; a partial repayment by insurance-based conglomerate CLICO in relation to the support provided by the government since that company found itself in difficulties following the global financial crisis; and proceeds from the Initial Public Offering (IPO) of Trinidad & Tobago NGL Limited.

Another TT$5.2bn is due to be derived from a number of modifications to the overall tax system. Some TT$1.2bn should come from changes which include: a new tax for the gaming industry; increases to the Green Fund and Business Levies; the introduction of a new property tax system; increased efficiency in the collection of tax; and a reduction of the fuel subsidy (which keeps the retail prices of gasoline and diesel at artificially low levels).

However, by far the most important change involves Trinidad & Tobago's Value Added Tax (VAT) system. The new government proposes to broaden the base, and to make collection more rigorous but, at the same time, to lower the overall VAT rate from 15.0% to 12.5%. The new measures (which will also include an increase in the threshold for VAT registration from TT$360,000 to TT$500,000) will take place from the beginning of 2016. They are expected to boost overall VAT revenues by TT$4.0bn.

In part because of the political cycle, the previous government had not been able to adjust its budget to a deteriorating economic environment. This contributed to perceptions of increasing financial risk which, in turn, caused Moody's to lower the sovereign rating and the outlook in the middle of the year. Execution of fiscal policy did not help perceptions of Trinidad & Tobago's institutions.

> "The budget identifies many of the problems that face the country and the government. However, the government will need to continue to work – as it suggests, in collaboration with labour and business interests – to rebuild trust and confidence in the economy and the institutions of Trinidad & Tobago."

With its budget for the year to September 2016, the new government is relying on a number of one-off measures to move towards fiscal balance. However, the simple arithmetic – involving measures equivalent to 11.4% of GDP to reduce the budget deficit from 4.2% of GDP to 1.8% of GDP – suggests that the deficit will likely blow out again in the September 2017 fiscal year unless there is a dramatic improvement in the overall performance of the economy.

Such an improvement appears to be very unlikely. Using what appear to be reasonable assumptions for energy prices, the government expects that Trinidad & Tobago's economy will grow by no more than 1.0%-1.4% annually over the medium term.

Therefore, the government has not found a fiscal policy that is truly sustainable. It has, perhaps, bought itself some time in which to reach agreement with its supporters and other key stakeholders in relation to hard decisions that will need to be made. A key date will be the end of March 2016. By that time, it will be a lot clearer whether the projections of revenue from the various one-off measures are realistic.

Further, it should also be clearer what is the financial position of the National Insurance Board of Trinidad & Tobago (NIBTT – the central institution of the country's social security system). Following the completed, but not yet published, Ninth Actuarial Review, the government will be looking to increase the maximum insurable income levels and to boost the contribution rates from 12% to 13.2%.

The budget identifies many of the problems that face the country and the government. However, the government will need to continue to work – as it suggests, in collaboration with labour and business interests – to rebuild trust and confidence in the economy and the institutions of Trinidad & Tobago.

## VENEZUELA

### A bloated budget

**Venezuela's latest annual budget suggests that the finance ministry has run out of ideas other than to keep on printing money.**

The finance minister, Brigadier General Rodolfo Marco Torres, in mid October submitted to the unicameral national assembly a 2016 budget plan worth BF1.55trn, which at the official exchange rate of BF6.3/US$ amounts to US$247bn, more than twice the US$117.7bn proposal sent down this time last year (itself over a third higher than its predecessor). "This budget will allow us to return to the path of economic growth", Torres declared. Yet the budget's sole nod to realism – an oil price forecast of US$40/barrel – totally belies that declaration.

"There will be no catastrophe or collapse here...Look, oil could fall to US$40 dollars and I would guarantee the people all their social rights, their rights to education, to health, to food, to life."

*– Nicolás Maduro in October 2014 promises that the oil price shock will not affect the social tenets of the Bolivarian Revolution.*

Venezuela is entrenched in recession and without an oil price recovery back towards the US$80-US$90 mark (at minimum), it is set to remain firmly in the doldrums next year. Perhaps the best that can be said is that the 2016 plan certainly promises to be inflationary – albeit the last thing most Venezuelans need right now is more inflation. The national assembly, dominated by the ruling Partido Unido Socialista de Venezuela (PSUV) under the tight control of the house president Diosdado Cabello, is unlikely to object to the new plan – if anything PSUV deputies seeking re-election in mid-term legislative elections on 6 December will inflate it even more.

Inflation was 68.5% in 2014 and Venezuela's central bank (BCV) has not released inflation data since February, when it confirmed the 2014 result. The government has barred the publication of most macroeconomic data on the grounds of the 'economic war' it claims is being waged against it a shadowy group of international right-wing extremists; and the budget presented by Torres contained no growth, inflation or exchange rate forecasts. However, appearing on state TV on 20 October as the budget went to congress, President Nicolás Maduro forecast that inflation this year would be 85%, falling to 60% in 2016.

Local private economists, along with the likes of the International Monetary Fund (IMF) and the World Bank, put inflation in triple digits already; the IMF now projects average inflation of 159.1% in 2015 and 204% in 2016.

According to the local workers advocacy group, Centro de Documentación y Análisis para los Trabajadores (Cenda), in August alone food prices rose by 22.2% month-on-month over July. Cenda calculates that the minimum wage covers just a week's grocery shopping. In a similar vein, a BCV source recently told the local daily *El Nacional* that headline inflation in September was 16.9% month-on-month and 179.5% year-on-year, the highest since March 1989 (when monthly inflation was reported as 21.7%). The source put accumulated year-to-date inflation at 142%, translating into monthly inflation of about 16%, on average, in the first nine months of 2015.

Having dubbed inflation "induced, criminal and speculative", Maduro also announced the extension of the Law of Fair Prices (Ley de Precios Justos) to "all prices and all products" and promised tougher penalties for price-gougers and any retailers using the black market as a price guide. Maduro complained that the law, which sets maximum profit levels of 30%, had "not been applied" and warned that the government was going to "turn the screws". To this end, he announced a new 'national fair prices command' to be led by the vice president, Jorge Arreaza, the food minister, Carlos Osorio, the industry and trade minister, José David Cabello, the president of the Superintendencia Nacional para la Defensa de los Derechos Socioeconómicos (Sundde), César Ferrer, and the head of the Bolivarian National Guard (GNB), Néstor Reverol Torres.

The president was unclear as to why the Fair Prices Law had not been applied properly thus far, but he said that the Sundde needed to "reanimate, renenergise", and gave the new 'fair prices command' 30 days to establish new maxims for fair profits and fair prices throughout the economy. In its first decision, the new command announced that importers would be subject to a new maximum profit ceiling of 20%, below the 30% ceiling applicable to national producers. Luis Vicente León, head of the local market research firm Datánalisis, said he expected the government to implement "aggressive distribution strategies" in the run up to the 6 December ballot, as it sought to shore up support in core low-income neighbourhoods.

"The president was unclear as to why the Fair Prices Law had not been applied properly thus far, but he said that the Sundde needed to "reanimate, renenergise", and gave the new 'fair prices command' 30 days to establish new maxims for fair profits and fair prices throughout the economy."

Maduro also extended an earlier 30% increase in national minimum wage, effective as of 1 November, to public sector workers and the armed forces. The minimum wage has now been increased four times this year (it is usually twice) and, with the legislative elections imminent, the latest comes well in advance of the usual year-end increase, typically given in early December, ahead of the Christmas period. The latest increase takes the minimum wage to BF9,648/month.

Combined with a concurrent increase in food tickets, Maduro boasted that Venezuelan workers would have a total combined minimum salary of BF16,399 a month, which at the main fixed exchange rate is an impressive-sounding US$2,600, one of the highest in the region. Yet at the free-floating Simadi exchange rate, which trades at about BF200/US$1, it amounts to US$81. And at the black market rate, of roughly BF800/US$1, it is just US$20 a month, equivalent to the average wage in Cuba.

### Non-credible forecasts

Presenting the budget last year, Finance Minister Torres had forecast real annual GDP growth of 3% for 2015, with inflation of 25%-30%. However, having contracted by 4% in 2014, Venezuela is in "deep recession" and will register a GDP result of -10% this year and -6% next year, according to the IMF's latest World Economic Outlook, released on 6 October. The Fund's inflation forecasts are equally eye-watering. It projects average inflation of 159.1% in 2015 and 204% in 2016.

Meanwhile, the current account deficit is projected at 3% of GDP this year, improving to 1.9% of GDP next year as oil prices begin to recover slowly and imports are held at minimal levels. This is in a country accustomed to running sizeable current account surpluses, however.

And finally, private analysts put the fiscal deficit at about 17% of GDP this year. Torres told the national assembly that the 2016 budget included indebtedness of BF195.2bn, which at the official FX rate is a not-inconsiderable US$30bn.

In a recent note to clients, Barclays Bank forecast an annual GDP contraction of 9.1% for Venezuela this year, making the point that accumulated inflation

“While Torres may lack all credibility on the budget front, the Venezuelan government continues to meet its external debt commitments, now routinely drawing on its scarce central bank foreign reserves (previously, the treasury typically made these payments by drawing down US dollars from its external accounts, rather than buying currency at the time of payment).”

over the 2014-2016 period could exceed 1,000%. With international oil prices set for only a moderate recovery in 2016, the recession will not abate until 2017. The US Energy Information Administration now expects West Texas Intermediate (WTI), the reference oil barrel for Venezuela, to average just US$53.57 per barrel (/b) in 2016, citing “significant uncertainties as the oil market moves towards balance”. Among these it specifically notes the re-entry onto global markets of Iranian oil, which will further weigh on prices.

### Debt payment – a priority

While Torres may lack all credibility on the budget front, the Venezuelan government continues to meet its external debt commitments, now routinely drawing on its scarce central bank foreign reserves (previously, the treasury typically made these payments by drawing down US dollars from its external accounts, rather than buying currency at the time of payment). According to the finance minster, at year-end 2014 Venezuela's debt was 68% domestic and 32% international. With almost a third of debt held outside the country, there are clear motives to avoid default.

Torres insisted that the government had ready the US$3.5bn needed to make payments due in late October, including a US$1.41bn amortization on a 2015 Petrobono bond and US$2.05bn payment on a 2017 bond held by the state oil company Petróleos de Venezuela (Pdvsa). According to estimates by *Bloomberg*, Venezuela has some US$5.6bn in interest and foreign-debt bond principal due in the final quarter of this year, with an additional US$10.8bn falling due in 2016. Torres said that by year-end, the country will have made US$13bn in debt payments. As of 27 October, central bank reserves were just US$15.1bn.

## REGIONAL BUSINESS REVIEW

## REGION

## Pacific Alliance countries in TPP deal

**Long running and sometimes secretive talks on a Trans Pacific Partnership (TPP) trade deal involving 12 countries culminated in agreement in principle on 6 October, although there will now be a long period of discussion at national legislative level before any formal treaty is approved. Three Latin American countries – Mexico, Chile, and Peru, who along with Colombia also happen to be members of the Pacific Alliance group – have been directly involved. For them, and for the region more widely, TPP could have far reaching consequences.**

TPP has been described as world's single largest free trade deal, with the 12 Pacific Rim countries involved representing a population of over 800m people and some 40% of global GDP. The big players in the group include the US and Japan, along with a number of Asian economies (including Australia, Malaysia and Vietnam) and a trio from Latin America: Mexico, Peru, and Chile. China is not a participant. TPP has been viewed with suspicion by much of the political left and by nationalist Latin American governments, in part because it is seen as a US-led initiative and in part because a number of clauses of the overall deal have been negotiated in secret – although, shortly after the negotiating teams had finalised the deal, the US administration said that it hoped to release the full text within a month.

The main outlines of the complex deal are that it provides for reductions in trade tariffs, not only on physical goods, but also for trade in services. It also covers a range of intellectual property and patent matters. One of the last sticking points was over the treatment pharmaceutical patents, and the timescale of patent protection before generic production of specific medicines can begin.

A key issue for the Latin American participants, who have already built up a network of bilateral free trade agreements (FTAs), is that it generalises import tariff cuts to all 12 participants, meaning that they widen their preferential access to a bigger range of Pacific Rim markets. Peru, to give one example, will gain access to the Australian market, a country with which it has not yet signed an FTA. Mexico only has an existing FTA with Japan, so in one fell swoop it will gain preferential access to markets in Australia, New Zealand, Brunei, Malaysia, Singapore, and Vietnam. Also important is that TPP allows the accumulation of local content rules – meaning that tariff reductions apply not just to goods produced in individual member countries, but also to those created by production chains spread out across various countries. Peruvian trade minister Magali Silva said the overall effect "is like having the 12 countries acting like a factory".

"Critically important for Mexico is that TPP in effect means the renegotiation of some aspects of its two-decades-old North American Free Trade Agreement (Nafta) with the US and Canada, who are both also TPP members. That may involve some dilution of existing benefits."

But there are some downsides. Critically important for Mexico is that TPP in effect means the renegotiation of some aspects of its two-decades-old North American Free Trade Agreement (Nafta) with the US and Canada, who are both also TPP members. That may involve some dilution of existing benefits. It has been reported that Nafta's 55% local content rule for automobiles will be replaced by a TPP 45% local content requirement (not as bad as the 30% which had apparently first been proposed by Japan). As a result Mexico may face increased competition in the US market from auto components produced by the Japan-centred value-added production chain. On balance Mexican negotiators believe the benefits outweigh the potential risks. "The Trans-Pacific Partnership will translate into greater opportunities for investment and well-paid jobs for Mexicans", President Enrique Peña Nieto said. There is also an asymmetry in that Colombia, the fourth member of the Pacific Alliance group, is not a TPP member. However, the other three Alliance countries have said Colombia may apply for TPP membership in the near future.

## REGION

### Corporate Radar

**Liverpool invests in Williams-Sonoma:** Liverpool, the Mexican chain of department stores, has said it will invest over MXN1bn (US$60.2mn) to open 13 retail outlets selling articles for the home under the Williams-Sonoma brand from the US. The new stores will begin to open in the last quarter of 2015, initially in Mexico City, but later in other localities. "The idea is not necessarily to have a fixed number of openings, but to work on the basis of the good locations that we can find and the opportunities that come up in the cities that we are interested in, so that we open as many stores as the market permits", said Liverpool executive Alejandro Mallet. Earlier Liverpool, which operates around 100 department stories in Mexico selling clothing, domestic appliances, and furniture, said it was also planning to open a new shopping centre and between 15 and 18 new retail outlets before the end of 2016.

**GM sees no early end to Brazil troubles:** Chuck Stevens, the financial director of US automobile company General Motors Co., said Brazil's macro-economic problems were likely to continue for some time, but that the company had "huge upside leverage once the macro situation changes". Stevens pointed out that GM's sales in Brazil improved on a year-on-year basis in October. Presenting GM's third quarter results, he said the company was aiming to get its European operations back into profit in 2016, for the first time since 1999. Analysts noted that GM achieved record third quarter operating profits of US$3.1bn, based on strong performance in the US and good performance in China, but offset by "dismal conditions" for the company in Russia and Brazil. GM's Q315 losses in South America widened to US$217mn, up from US$32mn in the year-earlier period.

**US prosecutors investigate PdVSA:** The US authorities have launched a major investigation into PdVSA, Venezuela's state-owned oil company, on suspicion that it has been involved in bribery schemes, black market currency operations, and laundering drug money, according to a report by the *Wall Street Journal*. The newspaper said that Rafael Ramírez, the former PdVSA president who is now Venezuelan ambassador to the US, was involved in bribery payments. It said an unnamed Spanish construction company seeking a US$1.5bn contract with PdVSA in 2006 had been asked to pay a US$150mn bribe to land the contract. While the *Wall Street Journal* said US federal prosecutors from New York, Washington, Missouri and Texas had met to coordinate the investigation and share evidence from the various different PdVSA probes, the newspaper also noted that no formal charges had yet been made public. The paper said that Ramírez had run PdVSA like a "family firm" amassing personal wealth and relying on his cousin, mother-in-law, wife, and brother in law, all of whom occupied key positions. It also said the US Treasury's Financial Crimes Enforcement Network (known as FinCEN) has alleged that Andorra-based Banca Privada d'Andorra (BPA) has helped launder US$4bn of Venezuelan money, around half of which has been "siphoned off" from PdVSA. As a result of FinCEN's claim, the Andorran and Spanish authorities have placed BPA and its Spanish subsidiary, Banco Madrid, under intervention, and they are investigating the nature of suspicious transactions. BPA's controlling shareholders, Ramón and Higini Cierco, have started legal action against FinCEN to get it to reverse its findings: they say the bank had reported alleged money-laundering incidents in a timely manner.

> "The US authorities have launched a major investigation into PdVSA, Venezuela's state-owned oil company, on suspicion that it has been involved in bribery schemes, black market currency operations, and laundering drug money, according to a report by the *Wall Street Journal*."

**Tough times for Codelco:** Chilean state-owned copper company Codelco faces a couple of difficult years as it seeks to weather low international prices by further cutting its costs and rationalising its operations, said its chairman Óscar Landerretche on a visit to London in October. But he said the company was unlikely to reduce its long-term US$25bn investment programme or to cut back production – moves that some in the industry had been hoping for, to boost depressed copper prices. Landerretche said Codelco would instead push ahead with its annual target of producing between 1.6m and 1.7m tonnes of copper in 2015 and 2016. He added that Codelco expects copper prices to fluctuate between US$2.00 and US$2.50/lb over the next few years, levels at which it can still operate profitably. Only if prices fell below US2.00 /lb would it consider trimming production. According to state copper commission Cochilco, international copper prices averaged US$2.57/lb in the year to mid-October, a fall of 17.4% on the US$3.11 registered in the comparable year-earlier period.

**Vale reports Q315 loss:** Brazilian mining giant Vale SA reported a US$2.12bn third quarter loss, attributed to low international iron ore prices and the weak Brazilian real. The loss came despite record production levels: the company churned out 88.2mn tonnes of iron ore during the quarter. It also produced 71,600 tonnes of nickel and 2.05mn tonnes of coal. But greater production volumes were not enough to offset low prices. In four of the last five quarters Vale has reported an overall loss. In Q315 net revenues were US$6.51bn and Ebitda was US$1.88bn. Iron ore prices are now only about a quarter of the US$200 a tonne recorded at the peak of the commodities boom in 2011. The company's finances were also hit by the depreciation of the real, which fell by 28% against the US dollar during the quarter. Vale is meanwhile pushing on with its key investment project, a new iron ore mine in the Amazon known as project S11D. Chief financial officer Luciano Siani said the project is now 75% complete. When finalised S11D is expected to add 90mn tonnes of iron ore to Vale's annual output at competitive cost. While the project is seen as critical for the future of the company, in the short term it has been putting pressure on cash flow.

**BMV edges past Bovespa:** 21 October was a potentially very significant day for Latin American capital markets, which have been under the weather recently. According to consultancy Economática, on that day the total market capitalisation of the Mexican stock market (Bolsa Mexicana de Valores – BMV) rose to US$478.8bn, for the first time edging past the market cap of the Sao Paulo exchange (Bolsa de Valores, Mercadorias & Futuros de São Paulo – Bovespa), which was US$471.6bn. The explanation lies in the negative impact on share prices that comes from Brazil's extended political crisis and recession. On 21 October the Bovespa index had dropped 2%, bringing the market cap to its lowest point since 2005, a decade earlier. The peak of the last Bovespa bull cycle was April 2011 when its market cap stood at US$1.53trn, about three times its current level. The BMV hasn't exactly been moving in the opposite direction: it too has fallen, but at a much slower rate than the Bovespa. The current BMV market cap is down by 23.5% on the August 2014 high point of US$625.7bn. Brazil's steeper decline reflects not only the general fall in local currency share prices, but also the sharp depreciation of the real against the US dollar. It is not being suggested that the BMV will outperform the Bovespa in the long-term: Brazil has the larger economy and when it eventually recovers from the current recession the Bovespa can be expected to once more move up ahead of the BMV in terms of the total market cap. But the current short term reversal of roles is a sign of the times, as far as the relative health of the two main Latin American economies is concerned.

"21 October was a potentially very significant day for Latin American capital markets, which have been under the weather recently."

## REGIONAL COMPETITIVENESS

### REGION

## A mixed scorecard

**Once again, the *Global Competitiveness Report 2015-2016* of the World Economic Forum (WEF) highlights the diversity of the economies of Latin America and the Caribbean. This year sees strong improvements in the relative positions of Colombia and Mexico, as well as Uruguay and (from a much lower level) Honduras. Conversely, there was a sharp deterioration in the relative position of Brazil.**

The latest edition of the World Economic Forum's *Global Competitiveness Report* assessed 140 countries globally. As usual, most of the economies in Latin America and the Caribbean received overall ratings that placed them around the middle in terms of rankings: some 12 countries within the region were ranked between 50 and 100. Only Chile, at 35th place overall, was ranked more highly. Argentina was ranked at 106th. Six countries – Nicaragua, Bolivia, Paraguay, Guyana, Venezuela and Haiti – were ranked between 108th and 134th.

Several countries achieved strong improvements in their relative positions. For example, Colombia's ranking improved from 66 out of the 136 countries assessed both this year and last year to 61/140. The WEF noted that this was mainly due to an improvement in the development of the country's financial markets (for which the ranking jumped 45 places to 25th. Colombia has benefited from a fairly large national market (36th globally) and good macro-economic results. Most other aspects considered were fairly stable. The country's rating is held back by basic requirements such as public institutions (125th), corruption (126th) and security (134th) remaining serious challenges.

"As ever, the results highlight the weakness of institutions in many of the countries: in the larger ones, though, this problem is offset by the scale of national markets, efficiency in labour markets, efficiency of goods markets and/or the quality of higher education and training."

Improvement in the efficiency of Mexico's financial markets (up 17 places to 46th) contributed to that country's rise in the rankings. Like Colombia, Mexico benefits from a large national market (11th) and is held back by deficiencies in basic requirements. Trust in pubic institutions (115th) is low and corruption is seen by businesses as being the biggest problem. Other countries whose rankings improved included Uruguay (up seven places at 73rd) and, from a fairly low level, Honduras (up 12 places at 88th).

One of the most important changes was the deterioration in Brazil's ranking (down 18 places to 75th). This was due to the macro-economic environment (117th), which includes deteriorating terms of trade, weakness in demand and stubbornly high inflation. Corruption scandals have hurt trust in public institutions (down 18 places to 122nd) and private institutions (down 38 to 109th). Brazil's overall ranking would have been worse this year but for the very large size of the national market (7th), the comparatively high level of technological readiness (54th) and business sophistication (56th). Other countries whose relative positions slipped markedly included Bolivia (down 12 places to 117th) and El Salvador (down 11 places to 95th).

As ever, the results highlight the weakness of institutions in many of the countries: in the larger ones, though, this problem is offset by the scale of national markets, efficiency in labour markets, efficiency of goods markets and/or the quality of higher education and training. A good example of this is Argentina, which is rated 106th overall, but which is ranked 27th for the size of its national market and 39th for the quality of higher education. Problem areas include property rights (133rd), ethics and corruption (137th), and the quality of infrastructure (122nd). Countries that stand out for good rankings for business sophistication and innovation – in global as well as regional terms – include Panama (44th) and Costa Rica (38th). Honduras stands out as a country whose ranking for business sophistication and innovation (53rd) is considerably better than its overall ranking (88th).

## REGION

### (Mostly) holding their own against stiffer competition

**The 18th semi-annual Global Financial Centres Index (GFCI 18) published by consultants Z-Yen in September 2015 found that the relative positions of several of the centres in Latin America and the Caribbean had changed significantly over the preceding six months. In particular – the rankings of São Paulo and Rio de Janeiro improved, while that of Mexico City fell.**

From the point of view of the financial professionals surveyed in GFCI 18, the global financial services industry has become stronger over the six months since March 2015, when GFCI 17 was published. In the latest survey, ratings (out of 1,000) were published for each of 84 centres globally. Ratings fell for only 10 of these centres. In only three centres – Gibraltar, Riyadh and St Petersburg – did the ratings fall by more than 10 points.

“From the point of view of the financial professionals surveyed in GFCI 18, the global financial services industry has become stronger over the six months since March 2015, when GFCI 17 was published.”

This is consistent with long-term trends, in which overall ratings have risen, and the differences between the various regions around the world have fallen. In GFCI 18, the average rating for the top five centres in each of North America, Western Europe and the Asia-Pacific is about 725. The weighted average rating of the top five centres in Central and Eastern Europe is about 650. The corresponding figures for both Middle East/Africa and Latin America and the Caribbean are both slightly higher than this, at around 700 and 670 respectively.

Eight centres in Latin America and the Caribbean have GFCI ratings. Five of those – Bermuda, the British Virgin Islands (BVI), Panama and the Bahamas – are international finance centres (IFCs) in that the organisations which operate within them focus mainly on clients that are based elsewhere. The other three – São Paulo, Rio de Janeiro and Mexico City – are centres where most of the organisations’ focus is on (very substantial) opportunities in the domestic market.

In global terms, most of the region’s financial centres are middle ranked. São Paulo, with 672 points in GFCI 18, is the highest ranked, at 31st overall. Panama, with 638 points, is 52nd ranked. Mexico City (616 points and 69th position overall) and the Bahamas (606 points and 75th position) are fairly lowly ranked relative to other centres around the world.

Mexico City was the only financial centre in the region whose rating fell from March to September (by 7 points to 616). As that the ratings for the vast majority of other centres – both globally as well as in Latin America and the Caribbean – were rising during this period, this meant that Mexico City slipped 13 places in the rankings. By contrast, very strong rises in ratings and rankings were achieved by São Paulo (up 28 points and 12 places), the Cayman Islands (up 18 points and five places) and Rio de Janeiro (up 28 points and 12 places). São Paulo was particularly well regarded by survey respondents in North America and Western Europe, while the Cayman Islands’ overall rating was held back by the assessments of respondents in Western Europe. Rio de Janeiro’s rating was helped by the assessments of respondents in the Asia Pacific and Latin America and the Caribbean, but suppressed by the views of respondents in Western Europe.

The region is home to four Associate Centres – which have not received a sufficient number of assessments over the previous two years to be awarded a GFCI rating. These centres are Buenos Aires, Trinidad & Tobago, Santiago and Barbados.

In GFCI 18, only two of the centres in the region had sufficient assessments from elsewhere to be considered transnational. These were the BVI and the Cayman Islands. Both are classified as being 'transnational specialist' centres – which means that they are seen as having depth in their respective fields (such as offshore company and fund domiciliation and offshore banking and specialist captive insurance respectively). In GFCI 17, the Cayman Islands had been classified as being a 'transnational contender' – or not quite a specialist centre if undoubtedly one with good connections to over half of the other centres worldwide.

Mexico City and São Paulo were the only two centres in the region to be classified as 'established players'. This means that they are home to a diversity of financial services organisations and activities and have depth in many areas. However, they are familiar to relatively few financial services professionals who are based elsewhere. All the other centres in the region are classified as being 'Local Specialists' – in that they have depth in particular fields, but are not particularly well known elsewhere in the world.

"Bermuda stands out as a centre that is very long established as an IFC, and one that has unquestioned strength in offshore catastrophe reinsurance, captive insurance and other aspects of insurance."

Aside from the near-universal rise in ratings (both within the region and globally), a number of conclusions can be drawn. One is that the fortunes of Brazil's financial services sector appear to have diverged from those of the economy. Even as policymakers wrestle with stubbornly high inflation, weak economic growth and unresolved structural problems, global perceptions of Brazil's banks and other financial services organisations have improved significantly. This suggests that the strengths of the Brazilian financial sector – its access to capital, scale, franchises, sophistication and links to the rest of the world – are serving it well.

The decline in the ranking of Mexico City is as much a function of the rises in ratings elsewhere as it is due to the small drop in that centre's rating through mid-2015. Mexico's geographic position and membership of NAFTA means that, to a greater extent than other centres in the region, organisations in Mexico City are in competition with peers in the US Relative to GFCI 17 of March, none of the US centres experienced a fall in ratings and Los Angeles secured enough ratings to be awarded a GFCI rating (650 points and 49th rank and a classification as 'a transnational and diversified centre').

Bermuda stands out as a centre that is very long established as an IFC, and one that has unquestioned strength in offshore catastrophe reinsurance, captive insurance and other aspects of insurance. However, it is classified as a 'local specialist'. This may be because many of the survey respondents are physically based in a fairly small number of global insurance centres such as London.

The falls in the rankings of the BVI, Panama and the Bahamas since March 2015 are probably not significant. In all cases, the ratings rose. However, the ratings of similarly ranked – but not necessarily competing or comparable – centres rose more.

Had it received a sufficient number of assessments, Santiago's rating would have placed it as the highest ranked centre in the region. Its rating of 676 is broadly similar to those of Vienna, Beijing or Abu Dhabi. Conversely, Buenos Aires' rating of 568 would have placed it at around 80th rank (behind Madrid and Cyprus) had that centre received enough assessments. In spite of the challenges arising from heterodox economic policies, Argentina's financial sector has significant strengths.

### What is the GFCI?

The Global Financial Centres Index (GFCI) was created in 2005 and was first published by Z-Yen in March 2007. The survey covers 98 centres around the world, of which 84 currently have a GFCI rating.

Each centre's rating out of 1,000 is based on two kinds of data.

Z-Yen considers 105 'instrumental' factors, which combine to make a financial centre competitive. These are grouped into five broad areas – business environment, financial sector development, infrastructure, human capital and reputational/ general factors. The data for each of these comes from a variety of sources.

Z-Yen also uses responses completed by financial services professionals over the preceding two years (in the case of GFCI 18, 3,194 responses with 28,676 assessments of centres received over the 24 months to the end of June 2015)

Normally, GFCI ratings are awarded to centres that have received at least 200 assessments from other centres over the previous two years. Older assessments are assigned less weighting than more recent assessments. A centre is removed from the list of rated centres if, over a rolling two-year period, it has received fewer than 100 assessments: in this situation, it is regarded as an Associate Centre until such time that the number of assessments rises again.

In classifying the centres, Z-Yen assesses three aspects. One is *connectivity*: if 70% or more of the weighted assessments of a particular centre come from other centres, that centre is considered to be 'global'. If over 55% of the assessments come from other centres, that centre is considered to be 'transnational'. Another aspect is *diversity*. This is the variety of financial sectors that flourish in a particular centre. Diversity is regarded positively. The third aspect is *specialty* in relation to each of five areas: investment management, banking, insurance, professional services, and government/regulatory. Specialty is measured by the difference of the GFCI rating for each of the areas relative to the overall GFCI rating. Diversity and specialty are analogous to depth and breadth of financial services.

## METALS

### Down, and not recovering any time soon

"Thanks mainly to the softness in Chinese industrial production, demand for iron ore, steel and base metals is likely to remain weak for at least the next year or so."

**Thanks mainly to the softness in Chinese industrial production, demand for iron ore, steel and base metals is likely to remain weak for at least the next year or so. In the meantime, lower energy prices have significantly reduced the costs of mining, smelting and refining metals. This means that marginally profitable operations can continue to supply products for longer. Over the long-term, increased exploration in developing countries should also boost supply of metals.**

The subtitle for the latest (October 2015) *World Economic Outlook* published by the International Monetary Fund (IMF) was '*Adjusting to Lower Commodity Prices*'. In essence, a downwards revision to economic growth forecasts – relative to those of July and April this year – has been associated with falls in the prices of most metals, energy and food. In its *World Economic Outlook*, the IMF devoted a Special Feature to metals, and asked the question: what next?

The question is relevant to a number of Latin American economies. Brazil is one of the largest exporters of metals. In 2014, net metal exports accounted for 4.64% of GDP for Guyana and 4.75% for Bolivia. The figure was even higher for Peru, at 6.23% of GDP, and for Chile at 15.00%.

The IMF argues that a key factor determining the trajectory of metals prices is industrial production in China. As recently as 2002, cross-border trade in metals was dominated by supply from Canada (especially) and Russia to the US and, to a lesser extent, from Australia to Japan. In its dealings with the five largest exporters of metals (Australia, Brazil, Canada, Chile and Russia), China was an important customer, but broadly similar in size to South Korea.

In 2014, the picture was very different. Australian exports of metals to China alone amounted to over US$52bn – or over three times Australian exports to Japan and South Korea combined. Similarly, exports of metals from Chile (over US$15bn) and Brazil (nearly US$13bn) dwarfed those countries' exports to Germany, Japan, Korea and the United States. In 2002, Japanese metal imports had been over twice those of China. In 2014, Chinese metal imports were nearly five times as large as those of Japan. In 2014, China accounted for nearly 60% of global iron ore consumption and about half of copper consumption. The corresponding figures were over 45% for aluminium and nickel.

> "The IMF notes that there is 'considerable uncertainty' in relation to the timeframe for and the extent of the economic slowdown in China."

The IMF notes that there is 'considerable uncertainty' in relation to the timeframe for and the extent of the economic slowdown in China. From a basic regression analysis that relates Chinese industrial production to the IMF's own metal price index (with both variables expressed as logarithms), it appears that 60% of the movement in metal prices can be explained by variations in industrial production in China. This analysis suggests that, in the short-term, metal prices may have further to fall.

However, the IMF argues that supply of metal is likely to hold up over the coming years. This is in spite of the fall in metal prices by about one half from their peak in early 2011. It is also in spite of a sharp curtailment in investment by ten of the largest mining companies worldwide – from about US$500bn in 2012 to US$400bn in 2014. Citing research work by consulting firm SNL Metals & Mining, the IMF observed that during cyclical downturns in the recent past the price of copper has fallen to the ninth decile of high cost producers (if not further). The implication is that metal prices will have to fall further if high cost suppliers are to curtail unprofitable output. In the meantime, the costs of mining, smelting and refining metals have fallen thanks to the global slump in energy prices.

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