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Trump targets Carlos Slim

The US presidential campaign has involved Mexico more than any previous contest, largely because of Republican candidate Donald Trump's controversial policies on building a border wall and promising to deport illegal Mexican immigrants. In a surprise mid-October turn, Trump introduced a new *coup de theatre*: he was, he claimed, the victim of a conspiracy between Hilary Clinton (his Democratic Party opponent), the *New York Times*, and Carlos Slim, the Mexican billionaire of Lebanese descent.

Trump's campaign suffered a setback on 12 October, when the *New York Times* published a story quoting two women who alleged that the candidate had touched them inappropriately. Trump angrily denied the allegations (later followed by several others) as "fabrications", and rapidly put together a counter-attack. This was that the *New York Times* is partly owned by Carlos Slim; that Carlos Slim has made donations to the Clinton foundation; and that, therefore, there is a Slim-Clinton conspiracy to discredit him. As he put it, the Times reporters who wrote the story were not journalists but "corporate lobbyists for Carlos Slim and for Hillary Clinton". Trump went on to warn against "letting foreign corporations and their CEOs decide the outcome [of the election]… you just can't do this."

Through his lawyers, the Republican candidate said that the article was libellous and demanded that it be withdrawn, and that the paper issue an apology. But this was rapidly rebuffed, with the paper's lawyers standing by the story and stating that "nothing in our article has had the slightest effect on the reputation that Mr. Trump, through his own words and actions, has already created for himself". The Times publisher, Arthur Sulzberger, acknowledged that Carlos Slim holds a 17% stake in the newspaper, but insisted that Slim "fully respects boundaries regarding the independence of our journalism" and "never sought to influence what we report". Arturo Elías, a spokesman for Slim, denied any anti-Trump conspiracy, stating, "of course we aren't interfering in the US election. We never get involved in politics in Mexico, much less in the United States" and clarifying Slim's attitude to Trump: "He doesn't know him. He's never met him in any way. He doesn't know anything about his personal life and to be honest, he doesn't care about his personal life."

Some Mexicans might disagree with the assertion that Slim has no involvement in Mexican politics – his flagship telecoms company, América Móvil, for example, has lobbied the authorities to protect its interests over the introduction of new industry competition regulations. It is clear, however, that Slim, regularly listed as one of the world's richest men (and significantly more wealthy than Trump) prefers to take a lower profile, and has intervened less in local politics than other wealthy Mexican families (such as the Azcárraga family, which through its *Televisa* TV empire has been very supportive of the

current ruling party). Slim could arguably end up paying a price for this disengagement, since earlier this month, the Mexican telecoms regulator, Instituto Federal de Telecomunicaciones (IFETEL), announced a new anti-trust probe into fixed-line public telephone services that is expected to focus on Telmex, a company owned by América Móvil.

It is also clear that Slim has no love for Trump. He has, as stated, made donations to the Clinton Foundation (somewhere between US$250,000 and US$500,000, according to the *Wall Street Journal*). Slim's US-based Ora TV network, which had been planning a joint venture with Trump in 2015, cancelled the project when the US businessman first began making his anti-Mexican comments, accusing the country of sending rapists, crime and drugs to the US. Some believe that if Trump loses the US election race he is planning to launch a new conservative 'Trump TV network' to combat what he sees as a liberal US media conspiracy. If that happens, it is not inconceivable that Slim and Trump might be squaring off again in the near future, in another business (rather than a political) battle.

REGIONAL ECONOMY REVIEW

MEXICO

Mexico prioritises currency over growth

Although Mexico's monetary authorities have taken pains to emphasise that they are not targeting a particular exchange rate, periods of sharp peso depreciation have been followed by a hike in domestic interest rates over the course of 2016 – most recently at the end of September. Yet with inflation remaining low and GDP growth weakening, critics allege that monetary policy tightening at this stage will further impede the pace of growth. The central bank (Banxico) will hope that by acting pre-emptively, inflation expectations will remain anchored at current low levels, but the reality is that higher interest rates will have little impact on supply-side price pressures.

Banxico's decision to raise the benchmark interest rate by 50 basis points (bps) on 29 September, the third time this year following identical rises in February and June, reinforces the extent to which the central bank is prioritising exchange-rate concerns over economic growth. It had long been believed that Mexico's monetary policy authorities would seek to raise interest rates in line with the tightening cycle in the US – its main trading partner – but while the US Federal Reserve (the Fed) has put the brakes on the tepid pace of rate hikes there, the Mexican authorities have surged ahead with repeated hikes.

Higher rates jeopardise already-weak growth

Monetary policy tightening appears somewhat at odds with recent inflation and GDP growth data, which reveal that consumer prices remain contained and the pace of growth is slowing.

The last monthly data prior to Banxico's interest rate announcement showed that consumer price inflation stood at 2.7% in August, broadly in line with levels of 2.5%-2.9% recorded earlier in the year. Following the announcement, the September reading showed a marginally stronger 3%, but this remains well within Banxico's 2%-4% official target range. The latest information published by Banxico on medium-term inflation expectations – a key driver of monetary policy decisions – showed that expectations remain well-anchored, at 3.2% at the end of 2016, 3.4% at the end of 2017 and an annual average of 3.3% over the following 5-8 years.

Real annual GDP growth has also been disappointing, slowing from 2.5% year-on-year in the first quarter of 2016 to 1.5% in the second quarter. Higher

interest rates tend to hit private consumption directly, but this component of growth is already weak, expanding by just 1.9% in the second quarter (significantly slower than rates of over 3% in 2015). Underlining the negative outlook, on 4 October the International Monetary Fund (IMF) downgraded its forecast for Mexico's GDP growth, from 2.5% to 2.1%. The Fund is slightly more bullish about 2017 prospects, anticipating a marginal rebound to 2.3%, but the overall pace of domestic growth is not particularly dynamic.

Currency concerns

Instead, Banxico's decision to continue raising interest rates is likely to have been driven by currency considerations. In the week prior to the rate hike, the Mexican peso had approached the psychologically-important barrier of Ps20:US$1, driven mainly by market concerns about the possibility that the Republican candidate Donald Trump might win the US presidency, which likely would have severe negative repercussions for the Mexican economy.

So although inflation concerns currently remain well-anchored and recent inflation data does not give cause for concern, Banxico is clearly concerned about the likely impact of the weaker peso on inflation in the next 6-12 months – the typical time-lag between exchange-rate movements and retail price changes.

However, there are questions about the logic of hiking interest rates in order to offset currency depreciation in a context of feeble domestic growth. Higher interest rates will only affect demand-side price pressures, by persuading consumers to save instead of spend. Higher rates will do little, conversely, to address supply-side price pressures that arise from a weaker currency, as retailers are still likely to pass on higher import costs to customers. There is therefore a risk that by increasing interest rates, Banxico might be pushing GDP growth back below 2% (which, given that population growth is over 1% per year, equates to very marginal growth in per capita GDP), while doing little to stymie a rise in inflation.

The outcome of the US presidential election is therefore likely to have a significant bearing on the direction of the Mexican peso in the short term. In this respect, Donald Trump's apparent decline in the polls has resulted in a slight recovery in the value of the peso, to around Ps18.6:US$1 in mid-October.

If the Democrat party candidate Hillary Clinton wins the 4 November presidential election, there may be some scope for a continued rally in the Mexican currency. Other fundamentals remain relatively supportive, with the current-account deficit shrinking and net foreign direct investment rising sharply so far this year. However, in the medium term, it is difficult to envisage that this trend will continue, particularly as the US Fed continues to normalise monetary policy.

Budget

The federal chamber of deputies approved the draft 2017 budget on 20 October.

The finance minister, José Antonio Meade Kuribreña, had presented the plan to the lower chamber on 8 September, complete with significant spending cuts to reassure international rating agencies contemplating credit downgrades for Mexico. The austere plan will primarily affect the state-run oil company, Pemex. But priority areas for the government, especially education, did not escape the cuts as Meade is promising a return to a primary surplus for the first time since 2008 next year.

The spending cuts amount to M$239.7bn (US$12.87bn), a real reduction of 1.7% on the 2016 budget. It follows cuts totalling some M$169bn already implemented this year and M$124bn of cuts last year. Pemex, as before, is forced to absorb the bulk of the cuts, with a total budget of M$391.9bn, down by 28% year-on-year. Public investment, at 2.8% of GDP, is set to fall to its lowest level in 50 years. The plan is based on an ambitious tax take of US$148bn, up 9.7% on this year's projection. Real

GDP growth predictions of between 2% and 3% in 2017 look optimistic.

Nevertheless, the draft plan was approved by 406 votes to 43 in the 500-seat lower chamber. Deputies from the ruling Partido Revolucionario Institucional (PRI) along with allies from the Partido Verde Ecologista de México (PVEM) and Partido Nueva Alianza (Panal) blocked attempts by the right-wing opposition Partido Acción Nacional (PAN) and the left-wing opposition Partido de la Revolución Democrática (PRD) and Movimiento Regeneración Nacional (Morena) to make amendments.

A M$51bn (US$2.6bn) increase introduced by the legislative finance commission was accepted by increasing estimated oil production by 19,000 barrels per day (bpd) to 1.947m bpd. This takes the budget to M$4.88trn (US$261.7bn), allowing for slightly higher government spending. The revised plan now goes before the federal senate for approval, before returning to the lower chamber for final sanction before 15 November.

VENEZUELA

Teetering on the brink

With much international and domestic attention focused on political developments – including the vanishing chance of a recall referendum being held against President Nicolás Maduro – these headlines are detracting from the equally serious question of whether or not the government will default on its external debt in the short term. Few bondholders appear to have taken up the government's swap offer, which seeks to exchange bonds due in 2016-2017 for new 2020 instruments, with the state oil company, Petróleos de Venezuela (Pdvsa), threatening to default if most bondholders shun the offer. Even if this is an empty threat and Pdvsa makes the repayments falling due in late October and early November, prospects for 2017 are dismal. The shape of the supreme court-approved 2017 budget underlines the fact that macroeconomic distortions are worsening, as well as highlighting the opposition-controlled National Assembly's complete inability to alter the policy line.

The ongoing 'will-they or won't they' issue of an external debt default is reaching a crescendo. Scheduled debt repayments stand at US$4bn in October-November, heavily weighted on 28 October (when a Pdvsa 2016 bond matures) and 2 November (with a large US$2.1bn capital repayment on a Pdvsa 2017 bond). The government has been making last-ditch efforts to persuade investors to exchange instruments maturing in 2016-2017 for a new 2020 bond. The hope was that take-up would be high, easing repayments in the near term. The initial offer was tendered in mid-September, with bondholders having 20 days to respond. According to the government's timetable, results would be published on 17 October and the bonds issued two days later, offering the authorities a last-minute reprieve on the large looming repayments.

However, the timetable has slipped to such an extent that it is unclear if the bond swap will go ahead, and even if it does, if the exchange will occur in time to reduce Pdvsa's immediate obligations. Initial investor interest was very low, forcing the government to sweeten the offer and extend the bondholders' deadline on four occasions, most recently to 21 October.

Despite this, many investors have reportedly remained reticent to accept the proposed swap, reflecting concerns about whether the current radical left-wing Partido Socialista Unido de Venezuela (PSUV) will be in power in 2020 (and whether a successor administration would even recognise the debt racked up by the current fiscally-profligate Maduro government).

Pushing back the deadline even further would be cutting things extremely fine: the administrative processes related to swapping the bonds are likely to take days, potentially weeks; while the processes related to transferring funds from the central bank's foreign reserves through the clearing houses to

investors are also likely to take several days. It is therefore unlikely that a swap could be conducted in time for holders of Pdvsa 2016 bonds, and possibly not in time for the 2 November repayments.

Pdvsa's veiled threat that the company might default if more bondholders did not accept the government's swap offer has further increased tensions. Following the government's third extension of the deadline, Pdvsa issued a statement saying that; "it could be difficult for the company to make scheduled repayments…if the exchange offers are not successful".

Although threatening default was no doubt designed to cajole more investors into compliance, the strategy is likely to have backfired. Investors are all-too-aware of the risk associated with holding Venezuelan debt and how that risk has escalated in recent months. Given the choice between receiving full payment now (and next April, when the second-half of the Pdvsa 2017 capital repayments fall due), and dealing with a further four years of exposure to Venezuela's distressed debt, it is hard to see why investors would choose to accept the bond swap. This is particularly true because most bondholders are likely to be aware that Venezuela has the funds to make the payments, if the government chooses, as international reserves currently stand at just under US$12bn.

Against this backdrop, the government may be tempted to finalise the exchange, but with the minority of bondholders who have accepted the terms of the swap. If this materialises, it would indicate that the authorities remain set on "muddling through" in order to continue servicing their debt. They would be likely to tap reserves to pay the majority of investors who have declined the bond swap. Although this would reflect positively on the administration's willingness to continue servicing its debt, there are significant questions over the government's ability to meet the 2017 repayments, as indicated in the 2017 budget, which was approved on 14 October.

More of the same in the 2017 budget

Most governments facing a deep recession, a huge fiscal deficit (and few obvious financing options), hyperinflation and a chronic lack of foreign exchange would take remedial action, cutting spending to reduce the deficit and bring down debt levels. However, Venezuela's 2017 budget remains highly expansionary. The budget is several times the size of the 2016 fiscal package and promises "record" social spending. The opposition Mesa de la Unidad Democrática (MUD) has had no input into its policy design, as the executive did not even bother submitting the package to the MUD-controlled National Assembly for discussion, as required by the constitution. The supreme court (TSJ) in late July ruled the assembly in contempt for failing to adhere to its rulings. As such, it says that all legislative activity at the moment is null and void. On that basis, the Maduro government instead sent the budget to the TSJ, which said that it would review the 2017 plan in place of the legislature.

That plan is severely short on detail; as it did last year, the Maduro government has not published the budget document and has declined to state the macroeconomic assumptions underpinning its projections. One of the only forecasts provided by the government is its baseline oil price forecast – (US$30/barrel) – which, as usual, is deliberately conservative given the fact that over-budget oil revenue is spent discretionally and is not subject to official oversight, making it advantageous for the government to pencil in a low oil price.

President Maduro has stated that the government expects most fiscal revenues to come from tax income next year. However, it has not unveiled new income or corporation tax increases – and to do so would be difficult given Maduro's precarious political position. As such, it is likely that the government is assuming a return to economic growth in its budget assumptions as a driver for increased tax revenue. But it is difficult to identify what

could lift the economy out of its current deep recession, as hyperinflation is eroding disposable income (and thus private consumption), while falling oil production is hampering exports and the unfriendly business environment is prompting disinvestment.

None of these factors are likely to improve in 2017, suggesting that economic performance is likely to be even weaker. In turn, this will raise growing questions about the ability of the government to continue making debt repayments next year, even assuming that it makes the forthcoming payments due in coming weeks.

Postscript

As we went to press on 24 October, Pdvsa issued a statement saying that 39.4% of bondholders, holding US$2.8bn of Pdvsa debt, had agreed to the proposed swap. That take-up is considerably below Pdvsa's initial US$7.1bn swap offer, and also its subsequently-revised offer of US$5.3bn, but nevertheless it throws the company a critical lifeline. More than two-thirds of investors holding April 2017 notes reportedly decided against participating, preferring instead to be paid out (at par) when the bonds come due next year. However, there was a better take-up for the swap among investors holding the November 2017 notes, with 45.3% participation. The swap will reduce Pdvsa's immediate October-November bond outlays by over US$900m, according to calculations by financial newswire *Bloomberg*. Pdvsa still faces US$6.1bn of principal payments by end-2017 however, and according to *Bloomberg*, swaps traders were still pricing in a 51% probability that the company could default in the next 12 months.

VENEZUELA

Maduro urges global oil pact

Making an unexpected visit to the Vatican at the end of his latest tour of key oil producers, President Nicolás Maduro might have lit three candles at St Peter's, one for a rebound in oil prices, one for a miracle in domestic supplies, and one for his own political survival.

Maduro's whirlwind tour took in Azerbaijan, Iran, Saudi Arabia and Qatar. The Venezuelan leader is seeking to encourage participation in a proposed deal between the Organisation of Petroleum Exporting Countries (OPEC) and non-OPEC producers like Russia to cap global crude output, in a bid to put a floor under prices. The proposal would reduce output from the current record levels (33.6bn barrels per year in September) to 32.5bn-33bn barrels; the hope is that this would lift prices to around US$50-US$60/barrel (/b). Following two rounds of talks at the International Energy Forum in Algeria on 27-28 September and the World Energy Congress in Istanbul, Turkey, on 9-13 October, a deal is supposed to be finalised at the next OPEC meeting in Vienna on 28-29 November.

However, producers like Russia, Iran and Iraq remain non-committal. Accompanied by his wife and First Lady, Cilia Flores, Foreign Minister Delcy Rodríguez, Oil Minister Eulogio Del Pino, Information Minister Ernesto Villegas, and the recently-appointed secretary of the presidency, Admiral Carmen Meléndez (who formerly served a stint as defence minister), Maduro began his tour in Azerbaijan, where President Iham Aliev was supportive.

Likewise, Iran's President Hasan Rohani declared upon Maduro's visit that the country would support any measure that aimed for "stabilising oil markets, fair price and equitable quotas for producers". Later, Maduro said that he had a "positive" meeting in Saudi Arabia with Crown Prince Mohamed Bin Nayef, declaring that he was "more optimistic than ever…we are closer to an agreement than ever". Del Pino, who is also president of the state oil company Pdvsa, likewise tweeted that "Saudi Araba supported Venezuela's proposal to reach a consensus that permits market stability".

Maduro and his delegation finished their tour on 24 October in Qatar, hosted by the economy minister, Sheik Ahmed bin Jassim Al Thani.

That same day, however, Iraq's oil minister, Jabar Ali al-Luaibi, sent global oil prices back down towards the US$50-mark, when he declared that Iraq, which is the second-largest producer in OPEC, wanted to be exempt from any output cuts, on the grounds that it urgently needs more funds to fight Islamic State militants.

The Iraqi comments, preceded by similar obfuscation by the chairman of Russia's state giant Rosneft, Igor Sechin (who at one point appeared to contradict President Vladimir Putin over Moscow's commitment to the proposed deal), served to underline the fact that Maduro, for all his roving diplomacy, will have little bearing on the final decision. Ultimately, any global oil deal will be dictated by the big players like Saudi Arabia and Russia, whose representatives have been holding separate talks of their own ahead of the scheduled Vienna meeting. As such, despite boasting the largest land-based oil reserves in the world (beyond even those of Saudi Arabia), Venezuela these days is something of a minion in terms of its weight in OPEC, which it helped found along with Iraq, Iran, Kuwait and Saudi Arabia way back in 1960.

Crucially, unlike the likes of Saudi Arabia and Iran, which can more or less switch the taps on and off at will, Venezuela is simply not in a position to increase production and exports so as to compensate for weak world prices. For reasons including a lack of (productive) investment since re-nationalisation, the diversion of billions of dollars in earnings to the socialist government (and the alleged loss of billions more to corruption), Pdvsa's production has been more or less stagnant at about 2.5m-2.8m barrels per day (b/d) for over a decade (since a major oil strike paralysed the company in 2003), a problem that has only gotten worse since the global oil-price shock hit with such unexpected force in mid-2014.

With earnings falling by half overnight, and the government squeezing the company for every last cent to prop up the Revolution and remain current on external debt obligations, Pdvsa's output since then has fallen further, with key partners (including US drilling companies) reportedly reducing activity for lack of payment. According to OPEC data, Venezuela's oil output hit a low of just 2.33m bpd in August, from an estimated 2.68m bpd in 2014 and the lowest since the 2003 strike.

Thus, even if OPEC and independent producers do agree to a global output cap, Venezuela will most likely *not* be able to participate – it cannot cut production any further without breaching existing supply agreements and falling even further behind on its payments, at a time when it is already on the verge of default. This fact also erodes considerably its diplomatic clout within OPEC, it is worth noting.

In its current predicament, a price war to the bottom – as tacitly threatened more than once by Saudi Arabia and Iran – is the very last thing Venezuela needs. Del Pino has been vocal in warning about the dangers of a potential price war between producers. "Without agreements, without coordination, prices could collapse to less than US$20 a barrel, which would bring crisis", he declared in September, stressing the need for a global agreement to "avoid a catastrophe in prices".

For cash-starved and deep-in-recession Venezuela, the proposed global oil agreement would give the country an immediate revenue boost, without having to increase output – and potentially also without having to cut output. And while this would not be enough to get it out of its current fiscal and balance of payments dilemma, at this point in time any relief at all would be welcome for the beleaguered Maduro, as Venezuela's internal catastrophe worsens by the day.

PEC 241: the marathon begins

For the last two years, Brazilian governments have been talking a lot about narrowing the fiscal deficit (currently somewhere above 10% of GDP), but not achieving very much by way of concrete measures. That, the current government hopes, changed on 10 October, when the lower house voted by 366 to 111 to support constitutional amendment proposal no. 241 (known as PEC 241). At the core of PEC 241 is a proposal to cap federal government spending for the next 20 years. Yet, as we explain here, it will remain something of a battle to get the amendment fully approved by December.

Attending the BRICS summit in India, President Michel Temer described his recipe for Brazil's political and economic recovery as a combination of "fiscal and social responsibility". The president insists that the country's large fiscal deficit must be brought under control, but that this must be done in a way that protects spending on education and health and does not get in the way of job-creation. Clearly, the Temer administration fears that conventional austerity – radical deficit reduction measures – will not work, and might even kill off the first, very tentative, signs of economic revival. It is a difficult balance to strike, and everything suggests that Temer and his key ministers will be busy for the rest of this year trying to get it right.

The government appears to have decided that the key piece of legislation to achieve the necessary fiscal rebalancing that Brazil needs is the PEC 241, first sent to congress in June, after the Temer-led administration had taken over on an interim basis amid the impeachment process against President Dilma Rousseff.

Temer's finance minister, Henrique Meirelles, has already ruled out any increase in taxes next year, so the focus will be on expenditure control. The draft PEC states that for the next 20 years the annual increase in total federal government spending cannot exceed the rate of inflation. Next year, the upper limit is set at 7.2% – the current inflation forecast for 2017. Thereafter, the increase in nominal spending in any given year will be limited to the annual inflation rate registered in June of the preceding year. After the first ten years, the government of the day will have an opportunity to alter the way that the spending cap is calculated. The reform proposal also tackles the problem of ring-fenced expenditure: current constitutional provisions that fix education, health and other categories of spending as set proportions of the total government spend or of GDP. Taking these into account, it sets 'floor' levels for this kind of spending next year, and then subjects them to the same overall inflation-rate cap from 2018 onwards.

After several months stuck in congress amid the impeachment process and surrounding political instability, the PEC 241 finally got a leg up on 10 October, but it will still face a multitude of challenges. As it is a constitutional amendment, the reform requires approval by a four-fifths majority in a total of four votes in the federal legislature, two in the lower house and two in the senate. The first of the four votes was the one held on 10 October. The bill needed 308 votes to achieve the four-fifths majority, but actually passed with 366 votes. That comfortable majority might suggest that the Temer government and its ruling coalition of parties will have no trouble winning the remaining three votes. On current plans, the PEC was due to face its second lower house vote in late October, with the senate scheduling its first and second votes for 29 November and 13 December. However, there could be complications.

One risk is political, and is connected to the arrest of the former lower house speaker Eduardo Cunha, of the ruling Partido do Movimento Democrático Brasileiro (PMDB), on 19 October. Cunha faces multiple corruption charges. An old-style operator (often described as 'Brazil's Frank Underwood' in reference to the central character in the US TV drama *House of Cards*), at one

point Cunha was considered one of the country's most powerful politicians. In September, he was expelled from the chamber of deputies, meaning that he lost his immunity from prosecution. The danger is that to reduce his potential sentence, Cunha may enter a plea-bargaining deal, in effect turning State's evidence. He might incriminate existing members of the government, distracting and weakening its focus on the fiscal reforms. In a worst-case scenario, his revelations could again induce political paralysis in the ruling coalition. Cunha could even try to use his remaining influence among federal deputies to hold back approval of PEC 241.

Another political problem is that public prosecutors have expressed concerns that PEC 241 might be used to limit resources allocated to anti-corruption investigations (however, Meirelles has noted that the text allows for some marginal above-cap spending in certain areas, to be offset by under-spending in others).

On the more technical side, PEC 241 is only a first step to resolving Brazil's structural fiscal imbalances. Action is also needed to control state-level spending. Nor does the PEC resolve the problem posed by the country's generous pensions, which, according to some estimates, have led to a surge in unfunded pension liabilities to a massive BR$3.3trn (US$1.046trn, or roughly 50% of GDP). The Temer government is saying that it will tackle the thorny issue of pension reform (likely to involve unpopular measures such as lifting the retirement age and increasing pension contribution rates) during the course of next year. A report by the IMF at the end of September warned that, "if key reforms are watered down or get stalled in Congress, the boost to confidence will be short-lived and the recession may continue".

PARAGUAY

Playing the 'Little China' card

A number of Paraguayan officials have begun talking of Paraguay as a country that can pursue a 'Little China' strategy within Latin America. The aim is to diversify an agriculture-based economy, and develop competitive industrial assembly plants known as *máquilas* in border areas. In the short term at least, the economy is looking resilient, with Central Bank President Carlos Fernández Valdovinos lifting the real annual GDP growth forecast for this year to 4.0%, up from 3.5% previously.

Deputy Economy Minister Lea Giménez has described the 'Little China' strategy as offering companies operating in Latin America an attractive manufacturing base with a young labour force, low tax rates, and cheap energy (generated from hydroelectric plants such as the giant Itaipú complex, operated in partnership with Brazil).

Paraguayan government officials say that neighbouring Brazil has been importing US$70bn worth of manufactured goods from China every year. Located right on Brazil's border and with a number of comparative advantages, they suggest that Paraguayan *máquilas* could realistically aspire to produce and sell around 10% of that total to Brazil, which would help diversify the economy and reduce its dependence on the export of agricultural commodities such as soya, cotton, and sugar. According to Finance Minister Santiago Peña, "Paraguay could very well be a province of China".

Fernández, the central bank president, argues that Paraguay should now focus less on short-term macroeconomic management of the business cycle, and much more on longer-term strategic issues, such as investing in the country's infrastructure and seeking to move into the production of higher value-added goods. Doing this is perhaps easier, because Paraguay has so far been conservative in its fiscal and monetary management and has therefore emerged from the end of the commodities boom without major economic imbalances.

In fact, a recent World Bank study identifies Paraguay, along with Chile and Peru, as one of only three countries in South America that are deemed to have completed their post-commodities boom macroeconomic adjustment process and which are therefore now free to seek out new drivers of growth.[1] "The level of and composition of our exports, or the level and composition of our productive matrix, is still below the one in Asia", Fernández says. "For that, you need to attract investment, of course, to bring in new technology, which is going to enhance productivity in the end."

Paraguay: key economic indicators						
	2010	2011	2012	2013	2014	2015
GDP annual % change	13.1	4.3	-1.2	14	4.7	3
Consumer prices annual % change	7.2	4.9	4	3.7	4.2	3.1
Open unemployment %	7.2	7.1	8.1	8.1	8	6.8
GDP by expenditure						
Final consumption annual % change	13.4	5.5	4.8	4.5	3.8	2.8
of which, government consumption annual % change	12	5.3	21	3.5	4.2	6.2
of which private consumption annual % change	13.5	5.6	2.8	4.6	3.7	2.4
Gross capital formationannual % change	22.7	10.8	-13.5	20.2	11	1.5
Exports of goods & services annual % change	19.9	6.2	-6.7	18.4	4.3	-3.2
Imports of goods & services annual % change	24.8	10.4	-3.5	6.8	5.3	-4.7
Fiscal accounts						
Central government Primary surplus/deficit (% GDP)	1.7	1.3	-1.4	-1.4	-0.7	-1.1
Central government surplus/deficit (% GDP)	1.3	1	-1.7	-1.7	-1.1	-1.8
External accounts						
Exports fob (US$m)	10474	12639	11654	13605	13105	10927
Impors fob (US$m)	9593	11784	11083	11942	12079	10317
Trade balance (US$m)	882	854	571	1662	1026	610
Terms of trade in goods (2010=100)	100	102.4	103.4	102.8	102.6	107.5
Current account balance (US$m)	-57	109	-501	477	-127	-493
Gross foreign debt (US$m)	3621	3864	4471	4600	5978	6317
Source: *ECLAC, July 2016*						

Paraguay's economic growth rate rose to 6.2% year-on-year in the second quarter, despite the fact that its two largest neighbours, Brazil and Argentina, have both been in recession. It has been helped because the prices of its commodity exports have held up better than those of some of its neighbours, on the whole.

Moreover, it has also become evident that Paraguay can profitably produce and sell manufactured goods, even to a Brazil that is still mired in recession. X-Plast, a plastic injection mould company making toys and garden chairs, notes that energy is cheaper and salaries are lower than in Brazil, while payroll taxes are also lower. With low inflation (of around 3%-4%), domestic demand has also held up, and has benefitted from an earlier halving of the poverty rate in the 11 years to 2014, from 40% down to 20% of the population.

Lingering development challenges still an obstacle

Yet the country still struggles with many development issues. Up to two-thirds of the population still earns a living in the informal sector, paying little or no tax and receiving no benefits. In this sector, salaries are ever lower. Education and health provision is also insufficient. According to the Global Competitiveness Index (GCI) produced by the World Economic Forum (WEF), Paraguay is ranked 117th out of 138 countries, and deemed to be particularly weak in technological readiness, and education and training. Corruption, inadequate infrastructure, and a poorly educated workforce are all identified as key problems.

[1]See reference to World Bank report, '*The big switch: restoring growth through trade*', in the next article.

That said, the direction of travel for the economy is largely seen as encouraging. At a briefing earlier this month, the IMF's Western Hemisphere director, Alejandro Werner, was asked to explain why the country was still growing despite the Argentine and Brazilian recessions. His answer was that Paraguay had consolidated macroeconomic conditions, improved access to international financial markets, strengthened the banking system, and begun to invest in infrastructure. This meant it had been able "to generate countercyclical forces that have enabled it to maintain its dynamism", he noted.

REGION

A different kind of export growth

The countries of Latin America and the Caribbean (LAC) are beginning to emerge from two years of negative or subdued growth. An export-led recovery is in prospect. But much will depend on what kind of exports are pursued, and on whether the first signs currently emerging of a global shift to more protectionist policies develop further. According to a new World Bank report entitled '*The big switch: restoring growth through trade*', countries that are able to develop higher-value added exports are likely to perform better.

Augusto de la Torre, the World Bank's chief economist for the LAC area, observes that "The regional slowdown seems to finally be coming to an end, with average growth expected to turn positive in 2017. Now, we are emphasizing the need for a major switch of resources (workers, capital, entrepreneurial talent, financing) towards the production of goods and services that are traded in international markets – that is, towards tradable activities." According to the report, consensus forecasts indicate that the combined GDP of the LAC economies will contract by 1.1% in real annual terms in 2016, but is set to recover by 1.8% in 2017. Not yet clear, however, is how strong – and sustainable – the recovery will be.

The report argues that the commodities boom that dominated the first decade of the 21st Century is over, and is unlikely to resume with anywhere near its previous vigour. Future regional economic growth, therefore, will depend on the ability to develop more diversified exports, but this in turn will be challenged by slower growth in global trade. Just when the region seems ready to make the necessary effort to strengthen its presence in international markets, the world seems to be threatening to go in the opposite direction, with global trade flattening, import volumes into China and East Asia contracting, and signs of a policy shift towards more protectionist positions.

Despite this concern over global headwinds, there is some good news. The World Bank says there is evidence that two necessary processes of change are progressing, although at a different pace in different countries. These are, first, a macroeconomic adjustment in response to the end of the commodities boom, typically to rebalance supply and demand by reducing fiscal and current account deficits, and second, structural changes and reforms to allow new, competitively-based export growth. The challenge is to try and achieve both these things either at the same time or in quick succession, and in a manner that stops one getting in the way of the other. De La Torre says the question is whether "the structural transformation required to make this shift in production is consistent with the process of macroeconomic adjustment that is still underway in many countries in order to adapt to the post-boom reality. To sustain growth, the adjustment process should avoid unduly sacrificing investment, so crucial to boost further growth", he stresses.

The report notes that these processes of change are most needed in South America (SA), which, on the whole, has been more dependent on the commodities boom than the sub-region of Mexico, Central America and Caribbean (MCC), which is a net commodities importer. Within SA, the World Bank singles out Peru, Chile and Paraguay as three countries that have completed their post-boom macroeconomic adjustment, and are now in a better position to focus on delivering longer-term growth, which will include boosting investment in education and infrastructure. It says that both the adjustment, and the switch of resources into the tradable sector, has been greatly facilitated by the use of flexible exchange rates. Currency depreciation has tended to help diversification of export products and export destinations.

The World Bank additionally notes a range of issues holding back the adjustment process in other countries or sub-regional groups. Comparing the MCC sub-region to similar countries in other parts of the world, it identifies "a persistently lower growth rate which, given the relative stability of domestic demand, points towards supply-side factors". This is most acute in the case of Mexico, which despite an impressive wave of structural reforms, and a close trading relationship with the US, is still experiencing slower growth throughout all phases of the economic cycle. In the case of SA, it highlights the problem posed by fluctuating domestic demand in countries with low domestic savings rates, particularly Argentina, Brazil, Colombia, Uruguay and Venezuela. The post-commodities-boom decline in domestic demand had led to large fiscal deficits (particularly acute in Argentina and Venezuela, where the deficits reflect a large primary imbalance). Adjustment is also difficult for dollarised or inflexible exchange rate countries like Ecuador and Bolivia (in the former, price and wage cuts are needed to achieve real exchange depreciation). The report produces a useful schematic representation of macroeconomic misalignments and policy adjustment priorities in the main SA economies. One way of reading it is as an indicator of "unfinished business" in economic policy.

Macroeconoimic misalignments and policy adjustments for South American countries

Average savings rate	Macro policies		Countries	Policy adjustments needed		
	Exchange rate regime	Fiscal		Real exchange rate	Fiscal	Structural saving
High	More flexible	Fiscal balance	Chile			
			Peru			
			Paraguay			
	Less flexible	Primary imbalance	Ecuador	X	X	
			Bolivia	X	X	
Low			Venezuela	X	X	
			Argentina		X	
	More flexible	Debt imbalance	Brazil		X	X
			Colombia		X	X
			Uruguay		X	X

Source: *World Bank*

The report's overall conclusion is that the necessary macroeconomic adjustment in Latin America and the Caribbean, while far from complete, is at least under way. The trade 'switch' is also judged to be in progress, in response to both push factors (higher competitiveness and the entrepreneurship of local exporters) and pull factors (described as "the demand from richer countries for upscale products"). The authors note, however, that how far and how fast these linked adjustments take place is open to question, as it will depend on the global environment and the strength and adequacy of the structural reforms undertaken within the region.

REGION

Better connecting Argentina and Chile

Argentina and Chile share a very long frontier, and bilateral relations at times in the past have been volatile. Now, however, both governments appear committed to improving transport and economic links.

The Santiago and Buenos Aires governments have signalled that they are ready to move ahead with one of Latin America's biggest bi-national transport projects, a trans-Andes mountain road tunnel linking Chile's Coquimbo region to Argentina's San Juan province. The Agua Negra tunnel, which will be some 14km long, has been costed at around US$1.5bn, and is expected to take eight to ten years to complete. The Inter-American Development Bank (IDB) is offering funding support. Tender documents are being issued, describing the tunnel as designed to improve freight and passenger transport connectivity between the two countries, supporting economic development and tourism. It is also seen as a key component of a 'bi-oceanic transport corridor' that will ultimately run from Chile's Pacific coast ports through to Porto Alegre, on Brazil's south Atlantic coast.

The tunnel is to be built at a lower height above the sea than the existing border crossing; this means that it will operate on a year-round basis, unlike the existing crossing, which closes for a number of months every year because of heavy snow during the Southern Hemisphere winter. Companies are expected to present their tenders for the project in 2017, with the 8-10 year contract being allocated in 2018.

Double taxation treaty

In another development, both governments have announced that a treaty to avoid double taxation will come into force at the beginning of 2017. Announcing the decision, Chile's finance minister Rodrigo Valdés said this was "good news", because it would "promote an improved flow of investment, commerce, and technology between our countries". Argentina's finance minister, Alfonso Prat-Gay, described the new treaty as "an important step in the process of integrating with our sister nation…. Taking advantage of how we can compliment each other is going to result in more high quality jobs on both sides of the Andes mountains." The agreement adopts the Organisation for Economic Co-operation and Development (OECD) model for avoiding double taxation.

While border tensions are now largely a thing of the past (Chile's foreign minister Heraldo Muñoz recently said that bilateral relations with Argentina were enjoying an "optimum moment"), there has been some controversy over claims by an Argentine TV programme, *Periodismo para todos*, presented by Jorge Lanata, that the Chilean copper mine Los Pelambres has been dumping "a mountain of toxic waste" on the Argentine side of the border in San Juan province. Los Pelambres, owned by Chile's Grupo Luksic conglomerate, responded that since 2004 it has been moving mine rocks into an area of Cerro Amarillo, having obtained all necessary environmental permits to do so from the Chilean government.

However, it noted that in 2012 a bi-national border limits commission carried out a routine survey that resulted in an adjustment of the border line, such that parts of Cerro Amarillo dump, previously considered to be entirely in Chilean territory, are now officially considered to be part of Argentina. Since then, Los Pelambres claims, it has stopped dumping rocks in the relevant area, and has been pro-actively seeking "a technical mining solution to a problem that was not caused by us".

The company also argues that what has been dumped in the area are "inert rocks" not waste material. It suggests that these rocks could be used in future in large infrastructure projects, such as the proposed Agua Negra tunnel. The Chilean company also complained that the Argentine TV programme had not made prior contact to discuss the story, but instead relied on information from mining rival Glencore, which has concession rights on the Argentine side of the border. The facts are still disputed, however, with some Argentine campaigners insisting that parts of the material dumped on what is now the Argentine side of the frontier are indeed toxic.

Both governments seem committed to stepping up cross-border cooperation. A date has been set in early November for the next of the so-called 2 + 2 joint meetings between the foreign and defence ministers of both countries. These meetings have a long-term strategic focus and are designed to look at issues such as connectivity, the environment, energy, migration flows, the prevention of drug trafficking and security, all over a time horizon stretching to 2030.

ARGENTINA

Business lists government hits and misses

In welcome news for the government led by President Mauricio Macri, in a new survey 80% of business leaders were confident that the economy would be on a good path in 2017 – their most optimistic assessment in 15 years. But the survey also revealed a detailed list of the mistakes that the private sector believes the government has been making.

The survey was carried out by polling company D'Alessio IROL and presented at the annual meeting of the Instituto para el Desarrollo Empresarial de la Argentina (IDEA), a business association. Its headline numbers were encouraging. Eighty percent of the 193 business leaders who took part in the survey were positive about the state of the economy next year. This was the highest score in 15 years – since the default and devaluation crisis of 2001-2002. Well over half – 57% – of respondents said they would increase their investments next year, and 45% said they were planning to hire new staff. Luis Secco, an economist, who presented the results at the annual IDEA forum held in October, noted that "the results have been very positive, showing expectations of economic growth and lower inflation, and an acknowledgement that the government understands the country's real problems." He added that business leaders were indicating they had little spare capacity to meet extra demand, which suggested that many would be increasing their investments.

There was a range of opinions about the government's performance, however. A number of companies remained concerned over the high level of inflation, currently projected at 35% for calendar 2016 which, according to the government, will be reduced to 20% in 2017. Eduardo D'Alessio, head of the company that carried out the survey, nevertheless said a consensus of opinion was that the worst was over on the prices front.

Asked about the top issues facing the government over the coming year, a majority of 61% of respondents said that the priority should be to improve the quality of public education. This was followed, in order of importance, by the need for improvements in security (57%), justice (45%), infrastructure (30%), stronger action against drug-trafficking (27%) and social issues (24%). The emphasis on education may be linked to the fact that many companies say they are having difficulty recruiting suitably qualified staff.

Part of the questionnaire specifically asked business leaders to identify the government's successes and failures during its first year in office. On the plus side, respondents highlighted the decision to end exchange rate controls and allow the peso to float freely; the opening up of the Argentine

economy to the world; and the administration's willingness to hold a dialogue with civil society (in contrast with the previous administration, which was seen as being unwilling to consider alternative viewpoints).

But the government's biggest mistake, as highlighted by 58% of respondents, was considered to be its handling of adjustments in public utility tariffs such as gas and electricity. These were increased sharply, then reversed when the courts ruled that legally-required consultation procedures had not been followed, and then, following the required consultations, increased again, but this time by a lower amount and in more gradual fashion. The second government mistake or weakness, listed by 54% of respondents, was its poor communications. Other 'misses' were described as a tendency to implement initiatives on a 'trial and error' basis, poor results on controlling inflation, and a lack of progress in reducing crime.

EL SALVADOR

Pensions at the centre of fiscal deadlock

El Salvador appeared to be on the brink of a public-sector payments default for much of October, as the ruling left-wing Frente Farabundo Martí para la Liberación Nacional (FLMN) government ran out of money and the right-wing Alianza Republicana Nacionalista (ARENA), which has the largest number of seats in congress, refused to authorise further borrowing. The two parties have been trying to agree a fiscal responsibility pact; much of the fiscal problem is due to large unfunded pension liabilities.

Operating in a dollarised economy, El Salvador's government cannot simply print money to cover its fiscal deficit. The deficit stood at 3.4% of GDP last year and, according to the IMF, will widen to 5.5% of GDP over the next five years unless something is done to bring it under control. The problem is that the government has been borrowing to cover the deficit, mainly through treasury bonds (known as Letras de Tesorería, or Letes), but it has already exceeded its borrowing limits. The government wants to issue US$1.2bn worth of international bonds to repay Letes and meet other commitments, but ARENA has been refusing the necessary congressional authorisation. Officials warned there could be a default in the first week of October, but just managed to avoid it. Hopes for breaking the deadlock rest on the FMLN and ARENA reaching agreement on a fiscal responsibility pact that would balance tax increases (favoured by the FMLN) with spending cuts (sought by ARENA).

Pensions deficit

Whatever the solution, pensions form a large part of the problem. According to Jonathan Menkos of the Instituto Centroamericano de Estudios Fiscales (Icefi), over the last seven years the pensions system has been responsible for about half the total fiscal deficit. This is despite the fact that a pension reform was implemented almost 20 years ago (in 1998) in an attempt to avoid excessive growth in liabilities. The reform introduced private defined contribution (DC) pensions that were supposed to exist alongside and alleviate some of the pressures on the state-owned defined benefit (DB) system.

However, this did not happen, for various reasons. One is that both systems suffered inadequate asset returns and the government committed itself to guarantee pension benefits and regularly top up pension funds. According to Icefi, the special fund created to top up the system by issuing debt, known as the Fideicomiso de Obligaciones Previsionales (FOP), had debts of US$3.48bn, or 13.5% of GDP, by the end of 2015.

According to the IMF's Article IV consultation paper on El Salvador published in July, "The pension deficit is currently about 2% of GDP and will rise substantially in the next decade without policy change." Unfunded pension liabilities were estimated to have risen to almost 100% of GDP in net

present value terms. In addition, coverage, participation and contribution payments are low, and funds have poor asset diversification. Only about one in four Salvadoreans have pension coverage. Financial returns are low, partly because the private pension funds are forced to buy government bonds, which pay low rates (although a recent decision by the constitutional court has forced the government to offer better rates).

A new pension reform proposal presented by the government in February this year would buy some time, in the IMF's opinion, but would fall short of securing the long-term sustainability of the system. The proposal would reduce some recent increases in pension benefits, partially transfer some private pensions back into the public sector, and introduce a new flat pension scheme for low-income contributors. However, it would not significantly reduce total unfunded pension liabilities.

The IMF's conclusion is that there is no alternative to what it calls "parametric" reforms of the system – meaning politically unpopular changes like increasing the retirement age and raising the contribution rate. Currently, the retirement age is 60 for men and 55 for women; both must have made 25 years of contributions to qualify for a minimum pension. However, it is not clear whether such unpopular measures to reduce the pensions deficit will be contemplated within any forthcoming FMLN-ARENA agreement on a fiscal responsibility pact.

PERU

Reality kicks in for Kuczynski

Faced with damaging corruption scandals before even reaching the 100-day mark, President Pablo Kuczynski has sought to distinguish himself from his predecessors by reacting quickly and proactively.

On 17 October Kuczynski announced a new package of anti-corruption measures in response to the first corruption scandal to affect his new centre-right government. Having run on a strongly anti-corruption platform in this year's election, only for one of his own presidential advisors to be implicated in wrongdoing, Kuczynski had to been seen to act fast. His approval ratings dropped eight percentage points (to 55% from 63%) after news of the case broke.

Promising a "full frontal battle" against corruption, which he described as a "structural problem", the president announced new measures including a bill introducing 'civic death' for offenders. "Corruption is a structural, historic problem in our country…but those days are over", Kuczynski declared in a televised address in which he directly referred to the scandal implicating the presidential advisor on the health sector, Carlos Moreno, who was uncovered seeking to gain from public-private contracts. Kuczynski said he was "immensely upset" over the case. "That person betrayed my confidence; I want you to know that the case, as it should be, is in the hands of justice" he stressed. "The corrupt elements will resist, I know, but we will win. My pledge to you is to lead this fight, I need you with me in his fight", Kuczynski emphasised. "Corruption is fought from the top", he continued, announcing "immediate action".

This includes the fast track introduction of 'civic death' for those found guilty of corruption (including collusion, embezzlement, influence trafficking, international bribery, misappropriation or wrongful receipt of payment, among other crimes), which will permanently bar them from working in the public sector. This was one of Kuczynski's election campaign proposals; now expedited.

Secondly, the executive will convene the state council, comprising the president along with the leaders of congress and the judiciary, to coordinate

actions to combat corruption. Third, Kuczynski said that he had ordered "a revision and reorganisation" of the office of the presidency, to be led by Prime Minister Fernando Zavala, including an overhaul of the process by which government advisors are selected and appointed. Each cabinet minister must do likewise, closely evaluating their departmental advisors. Finally, a new presidential integrity commission led by Eduardo Vega Luna (a lawyer and former ombudsman) was given 45 days to propose concrete new legislative and administrative measures to tackle corruption in the public sector.

The Moreno scandal broke just a matter of weeks after Kuczynski had secured special powers from congress, for 90 days, to legislate in five areas, including corruption. Among his priority proposals for this period, Kuczynski had already proposed the creation of a national transparency body to ensure access to public information and an autonomous attorney general's office to help in the fight against corruption. As noted by our sister *Latin American Weekly Report*, while Zavala was attempting to persuade congress to confer these special powers on the Kuczynski administration, he argued that "We must end corruption and our job starts now; if we don't forge a common front against corruption it will be very difficult to defeat it." For his part, during his swearing-in ceremony on 28 July, Kuczynski described his vision for "a modern country, which means honest not corrupt", where those found guilty of corruption face justice before a judiciary, which, he stressed, "must undergo a profound reform".

Other kinks

Aside from Moreno, two other presidential advisers, Jorge Villacorta (social conflict) and Jose Labán (regional affairs), also stepped down in mid October over alleged irregularities. They were accused of selling places on the election lists of Kuczynski's ruling Peruanos por el Kambio (PPK). Both denied the charges and said they had stepped down so as not to damage the government and also to be free to clear their names.

And on 24 October, prosecutors asked a court to sentence the government's deputy agriculture minister, Juan Carlos Gonzales, to a hefty nine-year prison sentence on corruption charges. In a statement, the attorney general's office said that Gonzales had been charged with colluding with a businesswoman, identified as Esther Consuelo Véliz Alcántara, to award her supply contracts for local nutrition programmes when he was an official in the city of Tumbes.

Gonzales denies any misdemeanour and claims that Kuczynski's agriculture minister, José Manuel Hernández, was aware of the investigation at the time of Gonzales' appointment in late July. It is not clear whether Kuczynski would have known. Gonzales hails from the Alianza para el Progreso (APP), the political outfit of one of the 2016 disqualified presidential aspirants, César Acuña, who gave his support to Kuczynski in his tight run-off race against Keiko Fujimori on 5 June. As we went to press, Gonzales was still refusing to step aside, but his departure seemed inevitable.

While the right-wing opposition Fuerza Popular (FP) was quick to jump on the Moreno scandal as evidence of the Kuczynski administration's alleged 'cosy' ties with the private sector, and unscrupulous advisors and lobbyists, the head of Transparency International, the respected Peruvian judge José Ugaz, has applauded the Kuczynski administration's rapid response to the Moreno scandal, stating that "this is how the state should react when these kind of people are found out".

Kuczynski's efforts to tackle corruption, and his new government's economic and structural reform proposals, are closely linked to his ambition to improve the image of the country and attract more foreign investment. The government's reformist strategy is also closely aligned with Peru's efforts to secure membership of the Organisation for Economic Co-operation and Development (OECD).

Kuczynski is very keen on OECD membership, not only for the investment potential, but also because the OECD countries (currently numbering 35) are expected to meet and uphold international model good governance and business operating standards. In a media interview in October to mark the 2016 OECD-Peru Forum, Kuczynski noted that the OECD "is an organisation that promotes good standards on economic policy, governance, the environment and institutional transparency". "It's like being in a neighbourhood football league and going up to the national league", he continued. "Peru will get there, I think we will make it in the next three years", he declared.

Kuczynski argues, for example, that excessive red tape fosters graft. "The more complicated the state becomes the more possibilities there are for corruption", he notes. A former prime minister, Ana Jara (2014-2015), estimated that public corruption amounted to 2% of Peru's GDP.

Certainly, the OECD is supportive of Peru's entry (in Latin America, Chile and Mexico are already in the Organisation; Colombia likewise is seeking membership). The OECD secretary general, Angel Gurría, opened the recent Peru Forum noting that "the OECD and Peru engaged in a fruitful dialogue on the direction and design of public policies, and we are extremely encouraged by the results to date". "Our objectives in the Peru Country Programme are in line with those of President Kuczynski and his government, and have the main goal of improving public policies for more inclusive growth. We are pleased to report today on new areas of policy analysis, including economic diversification, territorial development, public governance and skills and vocational training. We are encouraged by the commitment of the Peruvian government to collaborate with the OECD, and expect this fruitful relationship to continue and expand in the coming years."

OECD Peru

The OECD Country Programme with Peru was launched in December 2014. It includes 19 projects in a broad range of policy areas, with policy reviews analysing challenges in areas such as the effectiveness and integrity of the public sector, vocational training, skills, youth employment, health, statistics and environmental policy.

Nonetheless, the OECD also notes that while economic and social reforms in the past 20 years have driven Peruvian efforts to achieve sustainable economic growth and important reductions in poverty, against a new context of weak global growth Peru will need to diversify its economy, boost skills, reinforce productivity across the labour force and unleash the potential of all of its regions in order to spur more inclusive national growth.

Notably, the OECD in mid October also published a new Public Governance Review of Peru, which analyses key areas of public governance and identifies opportunities for improving the performance of the state. Among other things, the report assesses the management of the civil service, legal and regulatory frameworks and open-government and transparency policies. It also examines co-ordination from the centre of government, evidence-based strategic planning, and the decentralisation process.

While Peru's solid growth prospects continue to attract keen investor interest (*see box*), there is a long way to go. In the World Bank's new 2017 Doing Business Report, Peru slipped four places to 54, from 50 in the last report, with an overall country ranking of 70.25 points, from 71.33 in 2015-2016. Peru has been falling in this Doing Business ranking since 2011, although it is worth noting that the WB has amended its methodology this year, meaning that the latest results are not strictly comparable across all indices.

At the regional level, Peru is in third place in the latest ranking, behind Mexico (38) and Colombia (53). Chile, for its part, was below Peru at 58. At the global level, New Zealand, Singapore and Denmark took the top three spots (New Zealand knocking Singapore off the top into second).

Looking at Peru's result in detail, the country posted a weaker score in eight sub indices, including 'ease of starting a new business', 'construction permits', 'electricity supply', 'property registration', 'access to credit', 'protection of minority shareholders', 'fulfilment of contracts' and 'insolvency resolution'. While Peru still ranks well in several of those indicators

(construction permits, property registration and access to credit), it only improved in two indices overall, notably including 'ease of paying taxes'. Indeed the World Bank specifically noted recent tax reform efforts in Peru, and highlighted that income tax had come down in recent years, thereby helping business dynamism.

Also positively, Peru remains a regional leader for things like the process of opening a new business (which takes 6 procedures and 26 days in Peru vs. a regional average of 8.3 procedures and 31.6 days), while the cost of that process is significantly lower than the regional average, at 9.9% of income per capita vs. 31.5%.

Recovery continues

Economic output rose by 5.5% year-on-year in August, according to the national statistics institute (Inei), the strongest result in six months. While growth continues to be led by surging copper output, in line with the start of large new mines including Las Bambas, all 14 economic sectors registered positive results, indicating a spreading economic recovery in the country after a couple of weaker years. Manufacturing was particularly dynamic in August, amid a rebound in fishmeal production. Indicative of still-subdued domestic sentiment, however, construction activity was still weaker, with year-on-year growth of just 1.3%, well off the sector's peaks in the boom times. The government is aiming to kick-start the sector in 2017 with new legislation to unblock stalled large infrastructure schemes. The IMF expects real GDP growth of 4.1% next year, up from 3.7% this year.

PERU

The 2017 investor darling

The Sol was trading at PEN 3.35/US$ on 25 October.

With the fastest growing economy in the region, and the new business-friendly government hoping to kick-start a US$70bn infrastructure portfolio next year, Peru is positioning itself as among the most attractive investment opportunities in Latin America.

The main index on Lima's stock exchange has gone up by 9% since Pedro Pablo Kuczynski was elected by the slimmest of margins in a run off against the right-wing Keiko Fujimori on 5 June. As Kuczynski promised in his campaign, the veteran economist and international financier and his team of talented technocrats have hit the ground running, including winning approval in the *Fujimorista*-controlled congress for temporary legislative powers to introduce new economic and structural reforms, and doing and saying all the right things to boost investor confidence. Kuczynski also made China his first big foreign trip, in search of investment in Peru's sizeable and diverse infrastructure needs. According to Jaime Reusche of the ratings agency Moody's Investor Service, "confidence is flying, and that should help drive growth, particularly in investment".

Taking advantage of this positive sentiment, the government in late September issued over US$3bn in long-term local currency bonds on the international market, an impressive first foray on global capital markets. In detail, the sovereign placed PEN 10.3bn (US$3.1bn) in Sol-denominated 2028 global bonds, with a yield of 6.375%, reflecting Peru's investment-grade status.

In exchange, the treasury retired dollar-denominated bonds expiring in 2019, 2025, 2033 and 2037. Demand for the swap was strong at over PEN 24bn (US$7.3bn). The economy and finance ministry (MEF) noted that Peru's public-sector debt previously was held mostly in foreign currency, with 55%, or US$24.5bn, foreign currency-denominated; and 45% held in local currency (PEN 68.1bn, or US$20.1bn). The latest debt swap issue, it noted, would reduce the foreign currency proportion to about 50%. This not only reduces external risk for Peru at a time of continued volatility on interna-

tional markets (over Brexit and other factors), it also serves to boost liquidity on the local capital market, which should help to stimulate investment. Notably, the 2017 budget contemplates additional debt to the tune of US$2.5bn, most likely also for issue in local currency.

The Kuczynski government also plans some reforms to the local capital market, which, like some of its peers in the Andean region, could benefit from some deepening. While full details of these reforms are not expected until late this year or early 2017, the aim is the same – to boost domestic liquidity and investment. One of the suggested proposals, for example, is to allow foreign investors to purchase Peruvian treasury bonds (treasury bonds typically considered a safe investment).

These reforms will complement the government's proposed tax reforms, which among other things aim to gradually reduce the rate of Value Added Tax from 18% to 15% and streamline corporate income and dividends tax in support of private-sector-led investment. Despite the surge in copper volume output, global commodity prices are still low and so overall fiscal revenues remain under some pressure. In this context, the government argues that the growth stimulus in Peru needs to be diversified and shifted more definitively to the private sector. To this end, there are also plans to incentivise credit for small businesses, streamline bureaucracy and cut red tape, especially for infrastructure projects. Kuczynski's overall ambition is to lift real GDP growth over 5% a year, starting from 2018.

REGION

Doing Business

Doing business in Latin America is getting easier, according to the World Bank.

The Washington-based World Bank (WB) released its latest (2017) ease of doing business report on 25 October. The report examines and analyses regulations that apply to a businesses across its life-cycle, from start-up and operations, to trading across borders, paying taxes, and resolving insolvency, among others.

The new report, entitled '*Doing Business 2017: Equal Opportunity for All*', says that 137 of the 190 economies it examined around the world have adopted key reforms in the past year (in the 12 months to June 2016) that make it easier to start and operate small and medium-sized businesses. The WB noted that developing countries implemented over 75% of the 283 reforms in that period, with Sub-Saharan Africa accounting for over one-quarter of all reforms.

Amid some methodology adjustments, the new 2017 rankings cannot be directly compared with those for 2016. Nonetheless, in the WB's global country rankings of business efficiency, New Zealand took the top spot in the Doing Business 2017 report, knocking Singapore into second place. These were followed thereafter by: Denmark, Hong Kong SAR, China, South Korea, Norway, the UK, the US, Sweden and Macedonia. The top 10 improvers, based on reforms undertaken in the review period, were: Brunei, Darussalam, Kazakhstan, Kenya, Belarus, Indonesia, Serbia, Georgia, Pakistan, the United Arab Emirates (UAE) and Bahrain.

A good business-operating environment helps improve economic equality

The report this year emphasises that a better performance in the Doing Business Index, is, on average, associated with lower levels of income inequality, thereby reducing poverty and boosting shared prosperity. Paul Romer, the WB's chief economist and senior vice president noted that, "Simple rules that are easy to follow are a sign that a government treats its

citizens with respect. They yield direct economic benefits – more entrepreneurship; more market opportunities for women; more adherence to the rule of law". "But we should also remember that being treated with respect is something that people value for its own sake and that a government that fails to treat its citizens this way will lose its ability to lead", he added.

The environment for women

With that in mind, this year's report adds gender measures to three indicators – Starting a Business, Registering Property and Enforcing Contracts – finding disparities in 38 economies. Of these, the WB noted, "23 economies impose more steps for married women than men to start a business. Sixteen limit women's ability to own, use and transfer property. Doing Business found that, "in these economies, fewer women work in the private sector, both as employers and employees". Gender disparities were highest in the Middle East, with 70% of the economies creating barriers for women entrepreneurs.

Amid growing scrutiny of tax environments, tax reform accelerates

The 2017 report also features expansions to the Paying Taxes indicator, to cover post-filing processes – such as tax refunds, tax audits and administrative tax appeals, so as to better understand the overall tax environment. Since 2004, when the first Doing Business report was compiled, a total of 443 reforms have been recorded under the Paying Taxes indicator, the second highest number of reforms, with 46 reforms implemented in the past year, the WB notes.

Public procurement – an important 'opportunity pool'

The new report also includes a pilot indicator on public procurement regulations. The WB examines procurement in 78 economies across five principal areas: accessibility and transparency, bid security, payment delays, incentives for small and medium enterprises and complaints mechanisms. Public procurement represents, on average, 10%-25% of an economy's GDP, it notes, making the procurement market "a unique pool of business opportunities for the private sector".

Finally, easing requirements for Starting a Business is by far the most common reform area each year, according to the WB, with almost 600 reforms recorded since 2004. Of those, 49 were introduced in the latest period. Starting a new business now takes an average of 21 days worldwide, compared with 46 days 10 years ago.

Latin America

While still a laggard in the overall global rankings compared to a region like Asia, the WB reported that business reform activity accelerated in Latin America and the Caribbean in the past year, with over two-thirds of the region's countries implementing a total of 32 reforms in the past year, compared with 24 reforms the previous year. The bulk of these reforms were aimed at improving tax payment systems, facilitating cross-border trade and starting a new business. According to the report, Brazil implemented the most reforms in the past year, which may come as a surprise given the severe political and economic crisis in the country.

Mexico the regional leader

Mexico again ranked best in the region in the 2017 report, with a decent overall ranking of 47 out of the 190 countries ranked for ease of doing business by the World Bank. Second and third in the region were Colombia (53) and Peru (54), followed thereafter by Puerto Rico, a US territory (55), Costa Rica (62), Jamaica (67) and Panama (70). Brazil, however, was well down the table, with a global ranking of 123, putting it below the likes of the El Salvador (95), Honduras (105) and Paraguay (106), and also its chief neighbour Argentina (116).

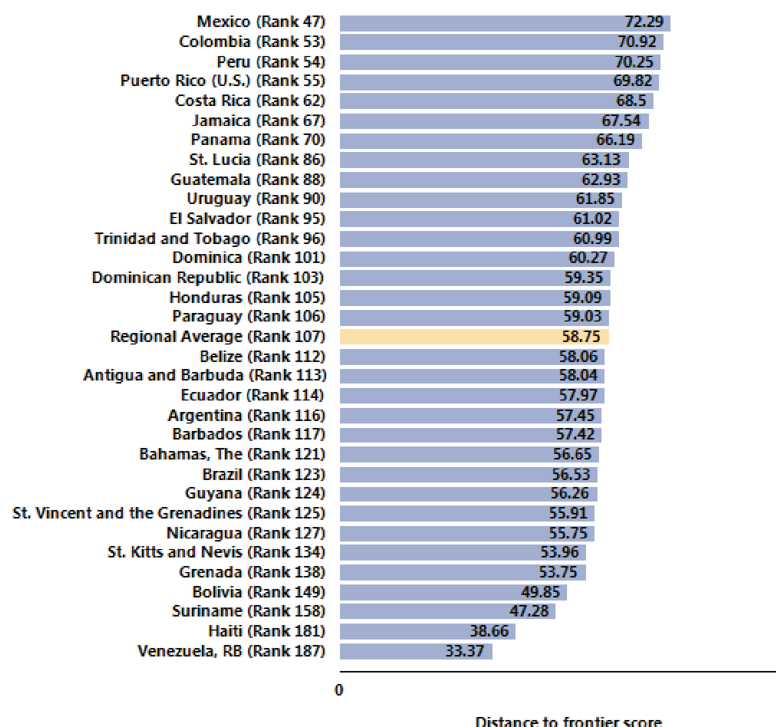
The Doing Business report notes that "for policy makers, knowing where

their economy stands in the aggregate ranking on the ease of doing business is useful". Also useful is to know how it ranks compared with other economies in the region and compared with the regional average. Another perspective is provided by the regional average rankings on the topics included in the ease of doing business ranking and the distance to frontier scores. We include below the relevant tables for Latin America.

How economies in Latin America and Caribbean (LAC) rank on the ease of doing business

Note: The rankings are benchmarked to June 2015 and based on the average of each economy's distance to frontier (DTF) scores for the 10 topics included in this year's aggregate ranking. The distance to frontier score benchmarks economies with respect to regulatory practice, showing the absolute distance to the best performance in each Doing Business indicator. An economy's distance to frontier score is indicated on a scale from 0 to 100, where 0 represents the worst performance and 100 the frontier. For the economies for which the data cover 2 cities, scores are a population-weighted average for the 2 cities.

Source: *Doing Business database.*

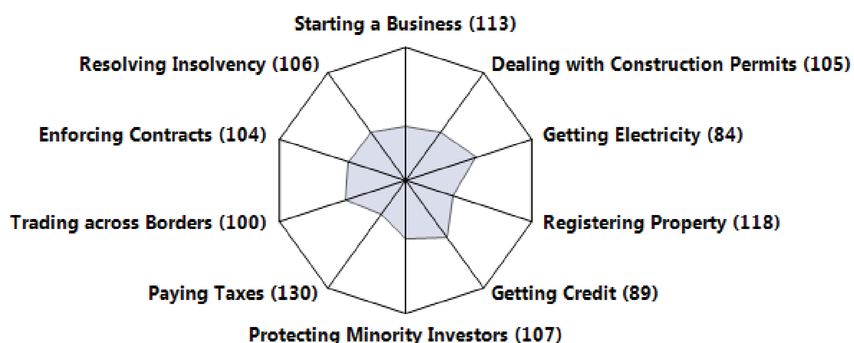


Rankings on Doing Business topics - Latin America and Caribbean (LAC)

(Scale: Rank 190 center, Rank 1 outer edge)

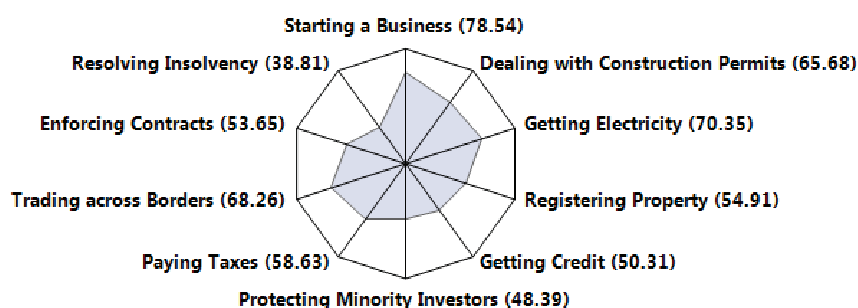
Regional average ranking

Source: *Doing Business database.*



Distance to frontier scores on Doing Business topics - Latin America and Caribbean (LAC)

(Scale: Score 0 center, Score 100 outer edge)



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Source: *Doing Business database.*

Note: The distance to frontier score shows how far on average an economy is from the best performance achieved by any economy on each Doing Business indicator. Starting a business is comparable to 2010. Getting credit, protecting minority investors, paying taxes and resolving insolvency had methodology changes in 2014 and thus are only comparable to 2013. Dealing with construction permits, registering property, trading across borders, enforcing contracts and getting electricity had methodology changes in 2015 and thus are only comparable to 2014. The measure is normalized to range between 0 and 100, with 100 representing the best performance (the frontier). See the data notes starting on page 114 of the Doing Business 2017 report for more details on the distance to frontier score.

Source: *Doing Business database.*

Corporate Radar

Intercorp bets on Peruvian growth: A recent profile by the Spanish newspaper *El País* highlighted the steady growth of the Peruvian conglomerate Intercorp, led by the extremely low-profile businessman Carlos Rodríguez-Pastor Persivale, known by his initials, CRP. According to the US magazine *Forbes*, CRP has assets worth US$2.3bn, making him the wealthiest businessman in the country; yet Peruvian media report that he is known only to have conceded one press interview.

At first glance, the Intercorp group looks like an almost random spread of unconnected businesses. It includes Interbank, Peru's fourth-largest bank; an insurance company (Interseguro); a nationwide supermarket and hypermarket chain (operating under the Plaza Vea and Vivanda brands); a department store (Oeschle); chains of film theatres and pharmacies; hamburger and BBQ chicken fast food outlets (Bembos and Don Belisario); and even schools (Innova Schools) and a university.

However, those who follow the group closely say it has a clear strategic focus: its businesses are all designed to benefit from the growth of the Peruvian middle class. Interbank is the flagship of this approach within the wider group. According to General Manager Luis Felipe Castellanos, the bank's customer service paradigm is the US coffee chain Starbucks. The bank has made a point of opening mini-branches in supermarkets and malls. These branches open late (until 9-10pm) and over weekends for the convenience of their customers. The formula seems to be working.

Brokers Credicorp Capital report that Interbank is currently the most profitable bank in Latin America, with a return on assets of 23%. For the moment however, Intercorp, which has been built up over the last twenty years, since CRP acquired control of Banco Internacional del Perú (later renamed Interbank), appears to have no overseas ambitions and continues to concentrate on the Peruvian market.

Itaú snaps up Citibank: Itaú Unibanco, Brazil's largest private banking group, announced in October that it had bought Citibank's network of

Brazilian retail bank branches for BRL710m (US$221m). In a press release, the Brazilian bank said it was acquiring 71 Citibank branches, together with its loan book and insurance and credit card businesses. Itaú Unibanco was also acquiring Citibank's stake in technology company TECBAN (Tecnología Bancaria). The takeover remains subject to regulatory approval by Brazil's central bank and by CADE, the competition authority.

Colombia setback for Novartis: The Colombian government says that the anti-cancer drug Imatinib, sold in the country by Novartis under the brand name Glivec, will be roughly 40% cheaper as a generic drug. The change came after a government decision in June to end Novartis' exclusive rights to sell the drug, and to allow its production as a generic medicine.

Health Minister Alejandro Gaviria said that the government had benchmarked the price of the drug in 17 different countries where it is sold as a generic drug, and concluded that the retail price should be reduced from 12 US cents per milligram to 7 US cents. Novartis had the exclusive rights to sell Imatinib in Colombia for 12 years, during which the public health system paid around US$22.8m per annum acquiring supplies of the medicine for patients.

The government had initiated talks to persuade Novartis to make a voluntary reduction in the price. Those talks failed to reach agreement, triggering the government's decision to allow production of Imatinib as a generic medicine.

Pac Rim loses El Salvador mining dispute: Canadian and Australian-owned mining company Pac Rim Cayman has lost a long-standing arbitration dispute with the government of El Salvador at the World Bank's International Centre for Settlement of Investment Disputes (Icsid). The case dates to 2009, when Pac Rim (subsequently acquired by Oceana Gold) said that El Salvador's government had unfairly refused to grant it a concession to begin operations at its El Dorado mining project. It argued that government officials had encouraged it to invest in exploration activities, only to withhold permits once deposits had been discovered. Pac Rim's demand for compensation and loss of profits initially ranged up to over US$300m, but eventually settled at US$250m.

However, the government of El Salvador countered that Pac Rim had failed to meet regulatory requirements for the requested permits, lacked environmental permissions, did not hold legal rights over much of the land required for the project, and failed to submit a final feasibility study.

The country's attorney general, Douglas Meléndez Ruiz, said that the Icsid decision was a vindication for the people of Cabanas, who had been opposing the mine on the grounds that it would damage the environment, adding, "It is an important step for the country to have been victorious in this lawsuit".

In a statement, Oceana Gold said it believed a modern resource industry operating in a safe and sustainable manner could unlock "a multi-decade development opportunity" for El Salvador, but that the government would need to "take positive and definitive steps towards establishing a stable business environment" if it wished to attract foreign investment.

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