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Hello USMCA

A deal has finally been done to renegotiate the North American Free Trade Agreement (Nafta), which is now re-named the US-Mexico-Canada Agreement or USMCA. In the end the deal came in two stages: first, a US-Mexico bilateral agreement; and then – at the last minute before a 30 September deadline – a US-Canada deal that ensures that a single North American free trade area will continue.

Leaders of the three countries hailed the deal as a breakthrough (the story, however, is far from over, as it will still require tripartite congressional approval). Canadian Prime Minister Justin Trudeau said it was "a good day for Canada", US president Donald Trump hailed it as "a great deal for all three countries". Mexican President Enrque Peña Nieto said the deal, reached after 13 months of negotiations, was a "win-win-win" result. The final breakthrough in complex negotiations reportedly came when Canada granted greater US access to its dairy products market in exchange for protection from possible US auto tariffs. There were also changes in the text covering dispute resolution, and the scope of tax-free online shopping.

Officials in the US were quoted saying the aim was for all three countries to sign USMCA at the end of November, after which it would be submitted to their respective legislatures. Politically it was important for the Trump administration to get the deal clinched before the US's congressional mid-term elections (due 6 November). Mexico was also eager to get it in place before Andrés Manuel López Obrador (AMLO) takes office as the country's new president on 1 December. This, it is reasoned, will help reassure markets and minimise the financial turbulence that sometimes accompanies Mexican presidential transitions. The USMCA is of course not a done deal until it is approved by the legislatures, a process that is going to stretch into 2019. Of the three, the treaty could face a more difficult passage in the US Congress, particularly if the Democrats recapture a majority in the lower house in the mid-terms.

President Trump has repeatedly denounced Nafta as the "single worst trade deal" the US ever signed. Predictably perhaps he is already contrasting the USMCA as "great" and "historic". But the contrast between the two is in reality not that big. One point of difference is that the USMCA contains beefed-up rules of origin, particularly in the automobile industry, that are more in keeping with Trump's protectionist instincts. To qualify for tariff-free treatment across the three countries automobiles will have to demonstrate 75% local content (up from 62.5% previously). Around 40%-45% of the labour value added in each car must come from factories that are paying its workers at least US$16 per hour. These provisions may at the end of the day force some 're-shoring' of automobile industry jobs from Mexico back to the United States, which after all has been one of Trump's declared aims all along. However, how much, or how fast this will happen is open to some debate. The Mexican side can point to some loopholes. Even cars assembled by Mexican workers who are paid less than US$16 per hour will still be able to enter the US on payment of an average WTO most-favoured-nation (MFN) tariff of only 2.5%, suggesting it will remain attractive to make cars in Mexico for export to the US. In addition a side agreement partially exempts Mexico and Canada from punitive US Section 232 tariffs – which the US president can invoke on national security grounds. This means that Mexico will be able to export a Section 232 tariff free quota of 2.6m vehicles every year, giving it significant space for growth from current levels (annual exports to the US are running at around 1.5m vehicles at present).

Initial reactions from within the automobile industry are that the USMCA largely preserves the status quo in North America. Higher local content rules are likely to have the biggest cost impact on European companies with Mexican assembly plants such as VW, BMW, and Mercedes. All companies will face slightly higher costs, which could push up car prices in the US market. In any case the industry faces other big structural shake-ups with uncertain effects, such as the looming transition to electric vehicles (EVs). Michelle Krebs of Autotrader said, "It's hard to imagine many new jobs in the US being created because of the US-Mexico-Canada trade deal. The pie is still healthy but it is shrinking a tad. The industry doesn't need more capacity."

Among the other changes enshrined in the USMCA is that there is now a "sunset clause" giving the treaty an end-date. It is a 16-year treaty, not the five years, renewable, that US negotiators had originally sought. The text says that in six years' time the three countries will formally review the workings of the agreement, to decide whether to extend its lifespan beyond 16 years. The final version of the text also reserves the use of independent panels for dispute resolution (such as ruling on anti-dumping cases), which the US had opposed.

Good deal for AMLO?

Agreement on the USMCA is being widely seen as a good sign for Mexico's transition to a new government on 1 December. It reassures the markets about Mexico's immediate economic future. Part of this job has already done by president-elect Andrés Manuel López Obrador (AMLO) who has toned down his left-wing rhetoric and adopted increasingly centrist and market-friendly positions. Two oil-licensing rounds have been delayed, but the incoming government says a new one will be held in February next year. James Heath, an independent economist, has been named by AMLO's team as an appointee to the board of Banco de Mexico, the central bank. Press reports say the new government is planning to increase spending in 2019 by 7.5%, which would widen the fiscal deficit to 2.5%-3.0% of GDP, lower than had been feared by some analysts.

ARGENTINA

Still not out of the woods

Argentina's economy had a terrible month in September. The government made new efforts to stabilise foreign currency markets and negotiated a bigger and more front-loaded International Monetary Fund (IMF) stand-by loan. But the abrupt departure of central bank president Luis Caputo rattled the markets and encouraged further falls in the peso's value. Everything indicates that even in the best scenario it will take until well into 2019 for the economy to be brought back on track.

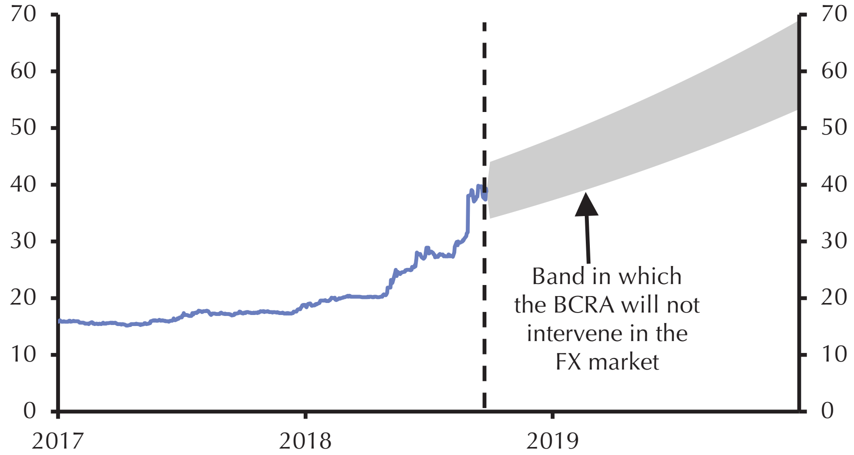
In an attempt to relieve the relentless pressure on the peso, Argentine officials spent most of September preparing a fiscally-tighter budget for 2019 and negotiating to strengthen the IMF stand-by agreement. Half way through these two tasks, and after only three months in the job, came the destabilising resignation of Luis Caputo, president of the central bank (Banco Central de la República Argentina- BCRA). On 17 September finance minister Nicolás Dujovne had presented the draft 2019 budget, which is subject to congressional approval. The draft contemplates an accelerated reduction of the fiscal deficit. The primary balance (excluding interest payments) is to be brought to zero for the first time in a decade, down from a deficit of 3.9% of GDP in 2017 and an estimated deficit of 2.7% in 2018. The faster-than-previously-planned tightening is to be achieved by a combination of spending cuts and increased taxes (such as the new tax on exports). With the budget Dujovne presented a fairly grim set of forecasts. He sees the Argentine economy contracting by 2.0% this year and by another 0.5% in 2019. Inflation, driven by currency depreciation, is expected to peak at 42% this year, falling to 23% in 2019.

Just as the government was finalising details of the enhanced IMF agreement, its plans were rocked on 25 September by Caputo's resignation from the BCRA, attributed to "personal reasons". President Mauricio Macri, in New York at the time for the UN general assembly and for meetings to reassure investors, tried to minimise the impact of the departure, suggesting it had been planned for some time. But extensive media leaks told a different story. According to these, Caputo and Dujovne, long standing rivals, had a series of disagreements over exchange rate policy. Dujovne and other officials are reported to have opposed the BCRA's open market currency interventions, selling dollars to try to stabilise the peso, on the grounds that it could run down the country's dwindling foreign currency reserves at too fast a pace. Guido Sandleris, a finance ministry official closely involved in the IMF negotiations was appointed as the new BCRA president. The official version coming out of Buenos Aires is that the Dujovne-Sandleris formula is at last able to present a unified front within the economic team.

Details of the enhanced IMF stand-by were announced the following day, on 26 September. The value of the stand-by package has been increased from US$50bn to US$57.1bn, confirming it as the largest stand-by ever approved by the IMF. Disbursements have also been rescheduled to make the package much more front-loaded. US$15bn of the loan has already been disbursed. A further US$35bn will be made available before the end of 2019. Analysts believe the package effectively eliminates the risk of Argentina defaulting on its debt repayments: the country should be able to cover all its expected financing requirements between now and next year (totalling some US$40bn) without needing to raise new loans. However, analysts also point out that some extra funding could still be required to bolster foreign currency reserves, particularly if the peso suffers further sell-offs.

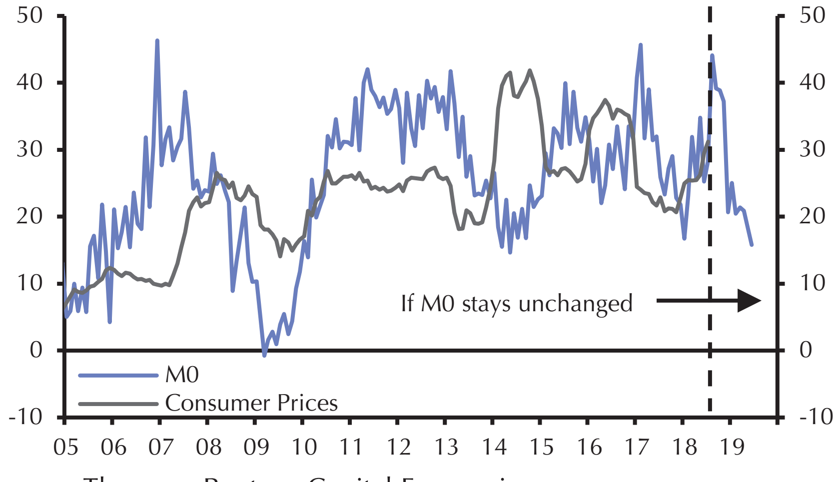
This explains the close focus on BCRA currency operations. In the words of IMF managing director Christine Lagarde, the BCRA will now adopt "a floating exchange rate without intervention". However, she acknowledged that in the case of "extreme overshooting" there would be "limited intervention to prevent disorderly market conditions". Sandleris elaborated further saying that the aim will be to allow the peso to float freely within a band ranging between 34 and 44 pesos to the US dollar. The floor and ceiling of the band will be increased daily, at a rate equivalent to 3% a month. If the peso moves outside that band, the BCRA will be able to use up to US$150m every day, allocated through currency auctions, to support the currency. Sandleris announced another important change: the BCRA will abandon its inflation-targeting regime and instead aim to control the growth of the monetary base. This has been expanding at around 2% a month. The BCRA will hold the

Chart 1: Argentine Peso vs. US$



Sources: Thomson Reuters, Capital Economics

Chart 2: Consumer Prices & Monetary Base



Sources: Thomson Reuters, Capital Economics monthly increase to zero up to June next year. The new BCRA head said, "This will allow us to achieve the reduction in inflation and recover the stability and predictability that Argentina needs."

Reactions have been mixed. Worryingly, and despite the increased IMF support and tightening bond yields, the peso continued to lose value in the currency markets. Following the announcement the currency dropped by 6% in the week ending 28 September to 42.10 to the US dollar. This represented a 54.9% depreciation since the beginning of the year, bringing it close to the upper band that the BCRA had just announced. Consultancy Studio Ber said currency traders might be deliberately seeking to test the ceiling of the band, to assess the efficacy of the BCRA daily auctions.

To put it bluntly, there is a lot that could still go wrong. Consultancy Capital Economics has pointed out that history does not encourage optimism: Argentina has had 22 IMF deals since 1958 and "none have restored macroeconomic stability on a sustained basis." Perhaps the biggest problem is the requirement to make budget cuts in 2019, an electoral year. The proposed fiscal tightening is one of the sharpest ever attempted under an IMF programme. It is already being criticised by opposition parties, and by the labour movement (which held a 36-hour general strike from 24-25 September). The Macri administration may struggle to get it approved in Congress.

BRAZIL

What do the elections mean for the economy?

Brazilians were going to the polls as this issue went to press. Official results are not yet available, but early indications are that Bolsonaro and Haddad will be going head to head in the second round. See our *LatinNews Daily* and *Latin American Weekly Report* for up-to-date analysis of latest developments.

The first round of what are possibly the most controversial and unpredictable Brazilian presidential elections in the last three decades will be held on 7 October (*see sidebar*). Most analysts believe no candidate will get more than 50% of the vote, therefore triggering a second-round run-off ballot that will be held on 28 October. The latest polls suggest the two main contenders will be Jair Bolsonaro (an extreme right winger representing the Partido Social Liberal – PSL) and Fernando Haddad of the left-wing Partido dos Trabalhadores – PT). In both cases there are more questions than answers about the economic policies they are likely to pursue.

In the last weeks of the campaign Jair Bolsonaro (who was the victim of a stabbing attack at the beginning of September) and Fernando Haddad (who benefited from the endorsement of the popular former President Luiz Inacio Lula da Silva, himself banned from standing because of his conviction on corruption charges) have pulled away from the crowd. The two now look like the main contenders. A Datafolha poll conducted from 26-28 September put Bolsonaro in the lead with 28% support, followed by Haddad, who was closing the gap a little, on 22% support. Others could conceivably still push their way into contention (the most likely being another leftist, Ciro Gomes, on 11%, or centrist Geraldo Alckmin on 10%) but it does look as if they have missed the bus.

It is therefore conceivable that the next president of Brazil, the person in charge of the world's ninth-largest economy (and the biggest in Latin America) will be either Bolsonaro or Haddad. It is a prospect that strikes fear into some economists, while others are fairly sanguine. Elena Landau, an ex-director of BNDES, the country's state owned development bank, is among the former. "I'm extremely pessimistic that among the two leading candidates one, Fernando Haddad, has the same economic proposals which didn't work in the past and the other, Jair Bolsonaro, is an anti-PT adventurer who has told us nothing about his economic programme. We are leaping into the dark," she said at a recent conference. Marcos Lisboa, a director of Insper University in São Paulo, shared that pessimistic outlook. He stressed the failure of all candidates to engage in serious debate about the country's problems including the pressing need for social security reform. "I do not feel represented by either of these two candidates and did not expect after 54 years to be witnessing an election such as this one we are currently seeing" he concluded.

Those that feel less worried about the future appear to be basing their hopes on benign assumptions about what the two men might do once in office. Opponents of Haddad stress that his party, the PT, which was in office for over a decade from 2003-2016, is associated with tax-and-spend policies which took the fiscal deficit up to 10% of GDP and which, after the end of the commodities boom, plunged Brazil into the crippling recession of 2015 and 2016, the steepest experienced in its modern history. The PT is also deeply tainted by corruption. Haddad himself faces allegations that he accepted improper campaign contributions in 2012. In the polarised atmosphere of a bitter election campaign some of Haddad's opponents claim he will follow the path of Venezuela's 'Bolivarian' regime that has destroyed democratic rule and almost entirely destroyed the Venezuelan economy. To emphasise their narrative of dangerous radicalism they also highlight that Haddad's vice-presidential running mate, Manuela D'Avila, is a member of the Brazilian Communist party.

But there is an alternative, much more benign narrative about Haddad. This is that he is positioning himself more moderately than his party (if he is to win he will in any case need to appeal to the political centre). He has been talking to investors and acknowledging Brazil's need for fiscal disciple. Some say this as-yet vague move to the centre may be modelled on the successful presidential campaign fought by the Mexican left winger, Andrés Manuel López Obrador (AMLO), who, despite his ideological background has nevertheless sought to win over the business community with promises to respect the autonomy of the central bank and pursue public sector austerity. Haddad, an economics and philosophy graduate, has a reasonably good track record as education minister (2005-2012) and as mayor of São Paulo (2013-2017). As mayor he was a pragmatist who renegotiated the city's debts. In the end, he proved to be much more of a centrist than a left-wing firebrand.

Economists and business leaders who pronounce themselves relaxed about a Bolsonaro presidency have also come up with their alternative benign narrative. Haddad may be seen as a Brazilian AMLO. But business community supporters of Bolsonaro sell their man as a Brazilian Donald Trump. This boils down to saying that despite making a stream of racist, sexist, and anti-immigrant comments, expressing nostalgia for military rule, and proposing extreme security policies (such as distributing arms to the population and encouraging police to murder criminals) the candidate will at the end of the day be good for business, cutting taxes and pursuing radical pro-market policies, including a vast privatisation programme to slim down Brazil's public sector.

A recent survey by investment bank XP conducted among financial market operators showed that 48% now believe Bolsonaro will win the elections, compared with a minuscule 3% a year earlier. Robson Braga de Andrade, chair of CNI, Brazil's national confederation of industry, recently said Bolsonaro's attitude "could help solve some of the issues that are out of control. We're not worried about the right wing. We want a president who can put the economy back on track." The problem, however, is that the candidate has repeatedly said he knows nothing of economics, and has often contradicted himself on economic issues. Those in the business community who look forward to a Bolsonaro victory are really basing their confidence on one man, Bolsonaro's economic policy adviser, Paulo Guedes. Guedes could be described as Brazil's Chicago boy in-the-making. Bolsonaro has said that if he wins, he will appoint Guedes as a "super-minister" of the economy. An economist with a PhD from the University of Chicago, Guedes advocates radical free market policies, deep public sector spending cuts, an independent central bank, and a sweeping privatisation programme that could even see state oil company Petrobras being sold off.

Yet Bolsonaro and Guedes make a strikingly odd couple and there are doubts about the durability of the bond between them. The candidate has in the past opposed all privatisations and described high interest rates as a bankers' conspiracy against the poor. This, together with his resource nationalism, sits uncomfortably with his advisor's market-friendly stance. Roberto Simon, a Brazil expert at the US-based Americas Society/Council of the Americas (AS-COA) says that if Bolsonaro wins it is unlikely that Guedes will remain in the government for years "or even for months". He also notes that any radical reforms will have to be negotiated with what looks like remaining a conservative Congress – a process that will take time and require compromise that Bolsonaro is ill-suited to make. A Bolsonaro administration will lack a congressional majority and will need to strike alliances (a Haddad government might be slightly better off on that front, but will also fall well short of an automatic majority). There were already signs of tension in the Bolsonaro camp in late September, when Guedes said he planned to re-introduce a financial transactions tax, known as the CPMF. Bolsonaro's team immediately responded that no such move was under consideration.

BRAZIL

Problems mount up for the next government

Whoever wins the presidency will face major challenges to get the economy back on a growth path. The biggest single challenge is likely to be fiscal reform.

Back in July this year the IMF carried out an Article IV consultation on the state of the Brazilian economy. Despite the measured and technical language, the Fund made it clear that the country is in desperate need of fiscal and other reforms. Acknowledging that a modest recovery was under way, the Fund said "the economy is underperforming relative to its potential, public debt is high and increasing, and, more importantly, medium-term prospects remain uninspiring, absent further reforms". It noted that even if last year's constitutional amendment freezing government spending at 2016 levels is honoured, public debt is expected to continue rising and will peak at above 90% of GDP in 2023. The non-financial public sector (NFPS) fiscal deficit was estimated at 8.5% of GDP (current estimates put it a little higher at 9.0% of GDP).

In a recent public discussion Monica de Bolle, a Brazilian economist who is director of Latin American studies and emerging markets at John Hopkins University, made an interesting comparison with Argentina. Brazil's southern neighbour is in the midst of a massive financial and currency crisis, partly because it is running a deficit equivalent to 5% of GDP. Yet Brazil, which so far has avoided a similar run on the currency, has a deficit almost twice as large. Part of the explanation for the different market reactions is that Argentina has larger foreign currency debts than Brazil does; in Brazil the public debt is mainly held in local currency. But De Bolle insists that Brazil's deficit is unsustainable. The next government needs to do something.

In principle that 'something' is pretty obvious. Brazil needs to come up with a combination of spending cuts and tax increases. However, in practice the process is complex and difficult. At around 32% of GDP Brazil's tax burden is already excessively high, meaning further increases would likely have a negative impact on the economy. The tax and spending system is also heavily regressive, to the extent that the Brazilian state has been described as 'Robin Hood in reverse'. According to Rozane Siqueira of the Federal University of Pernambuco, government transfers favour the rich rather than the poor. The government spends more than a third of its tax revenue on pensions, of which 53% goes to the wealthiest 20% of the population by income, and just 2.5% goes to the poorest 20%.

Reform of the loss-making pension system is therefore an inescapable priority. There is an additional problem however: not only pensions but most government spending is mandatory, backed by legislation which fixes its level. Some of the regulations doing so are enshrined in the 1988 constitution. According to some analysts, truly discretionary spending is only around 9%-10% of the total. Therefore, to cut spending the next government will need to get new laws passed in Congress.

Critically, Brazilian politics makes reform more difficult to achieve. Just like the United States, Brazil has a multitude of lobbies and special interests that will resist spending cuts. But the United States is a largely two-party system, while Brazil has over 30 political parties, of which 28 are represented in Congress, making the negotiating process much more complex. Presidents must therefore put together multi-party coalitions to govern. Everything suggests that the next Congress will be as politically fragmented as the current one. Almost certainly, the next president will lack a majority in Congress and will have to negotiate. De Bolle says she fears that the next Congress will suffer from a similar kind of political paralysis to that experienced during much of the last two presidencies.

REGION

Don't spend more: spend better

Governments across Latin America and the Caribbean spend a lot of money, but there is significant waste and inefficiency in the way they do it. According to a new (September 2018) report, *Better Spending for Better Lives: How Latin America and the Caribbean Can Do More With Less,* by the Inter-American Development Bank (IDB), inefficiencies and fraud in procurement, civil service, and targeted transfers could be as large as US$220bn a year or 4.4% of GDP – enough to eliminate extreme poverty in the region.

In the good times, government spending goes up, but it isn't necessarily allocated to areas where it is most needed, or managed in the most efficient manner. In fact, the report says there are major variations in government spending across the region. Total public spending averages 29.7% of GDP, up by six percentage points since the early 2000s. However, it varies from 35% of GDP or above in Brazil and Argentina, down to 20% of GDP and below in the Dominican Republic and Guatemala. After the global financial crisis of 2007-2008 many Latin American counties rode a commodity windfall and raised their spending on things like public sector salaries and pensions. But the commodities boom has been over for a number of years now, and governments are finding it hard to cut back. Because spending is already skewed in various ways, simple across-the-board spending cuts are likely to be counterproductive.

The report suggests real savings can be made, but argues that they must be carefully targeted, and take into account the need to correct existing distortions. One result of the cuts so far is that public investment, needed to support future growth, has been hit much more than current expenditure. While per-capita public investment has grown by more than 50% in every other region of the world, in Latin America it has edged up by only 5%, remaining in real terms at roughly the same level as in the 1980s. Another interesting distortion in the current pattern of spending is that it is heavily skewed to favour older members of the population. Latin American and Caribbean governments spend four times more on the elderly than on the young. Pension and health expenditure takes 35% of the public sector budget now, and because of a rapidly ageing population, could rise to an unsustainable 78% by 2065.

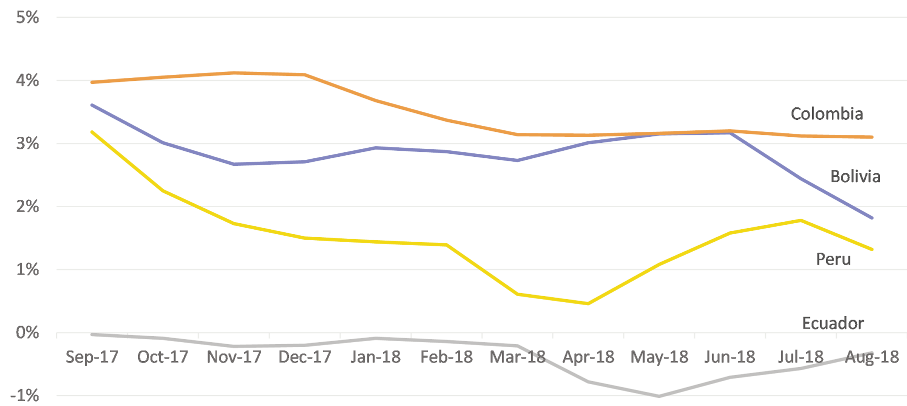
Despite political rhetoric, government spending programmes actually do very little to redistribute income in favour of the poor. For 16 Latin American countries, direct taxes and cash transfers reduce inequality by an average of only 4.7%, compared with a reduction of 39% in a sample of developed economies. The report also says that better management of government funded infrastructure projects, which frequently overrun and come in over budget could save an amount equivalent to 1.2% of GDP or US$50bn.

Better management of health budgets could extend life expectancy for four years. There is also evidence that Latin America's approach to combating crime is inefficient in resource terms. Heavy spending on policing and incarceration takes security spending up to 5.4% of government budgets, compared with only 3.3% in OECD countries where crime is actually much lower. The IDB says spending would be more effective if police organisation and efficiency is improved, and if there is better management of crime prevention programmes, targeting high risk places, people, and behaviours.

One of the most interesting comments in the report concerns the intangible elements that underpin budget decisions. One of these is that citizen levels of trust in government are low. The IDB notes "A lack of trust implies, among other things, that voters will prefer public policies that provide immediate benefits (such as transfers) over investing in education and infrastructure, whose benefits will not be perceived until many years later."

ANDEAN COUNTRIES

Andean Countries: Inflation rate (%)
Percentage variation (year-on-year)

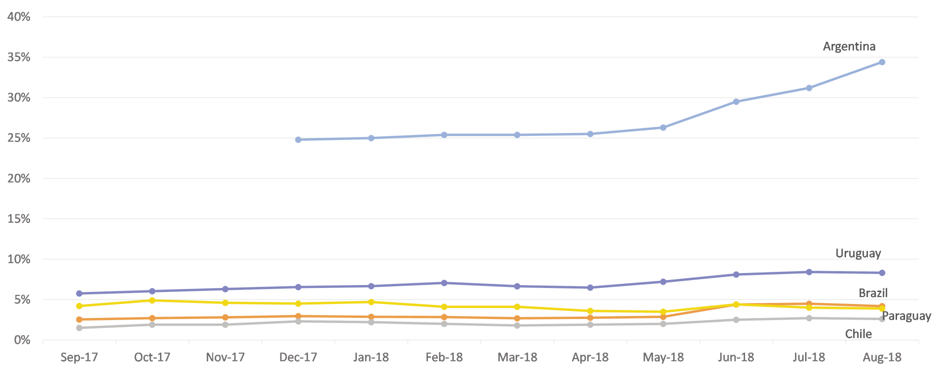


Source: *Local central banks. No reliable data available for Venezuela.*

Andean Countries: GDP growth (%)						
Quarterly figures are year-on-year growth						
GDP	**end 2017***	**2018 forecast***	**Q3 2017**	**Q4 2017**	**Q1 2018**	**Q2 2018**
Bolivia	3.9%	4%	Not available yet	Not available yet	Not available yet	Not available yet
Colombia	1.8%	2.6%	2.0%	1.6%	2.2%	2.8%
Ecuador	1%	1.3%	3.8%	3.0%	1.9%	Not available yet
Peru	2.5%	3.5%	2.5%	2.2%	3.2%	5.4%
Venezuela	-9.5%	-5.5%	No data	No data	No data	No data
**Figures from the United Nations Economic Commission for Latin America & Caribbean August 2018*						
Quarterly growth based on figures from the local central banks. Bolivia has ceased providing quarterly y-o-y GDP data.						

BRAZIL & SOUTHERN CONE

Brazil & Southern Cone: Inflation rate (%)
Percentage variation (year-on-year)

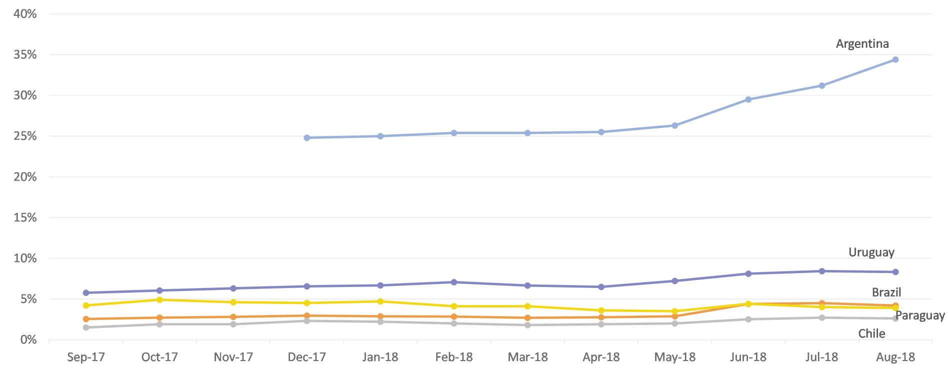


GDP growth (%)						
	End 2017*	**2018 forecast****	**Q3 2017**	**Q4 2017**	**Q1 2018**	**Q2 2018**
Argentina	-1.30%	2.20%	3.80%	3.90%	3.60%	4.20%
Brazil	-0.90%	2.00%	-0.17%	0.99%	1.29%	1.03%
Chile	1.50%	2.80%	2.50%	3.30%	4.10%	5.30%
Paraguay	4.00%	4.50%	3.10%	4.50%	4.10%	Not yet available
Uruguay	3.00%	3.20%	2.20%	2.00%	2.20%	2.50%
Annualised quarterly growth based on figures from local central banks.						

CENTRAL AMERICA & CARIBBEAN

Central America & Caribbean: Inflation Rate

Percentage variation (year-on-year, selected countries, latest available data)

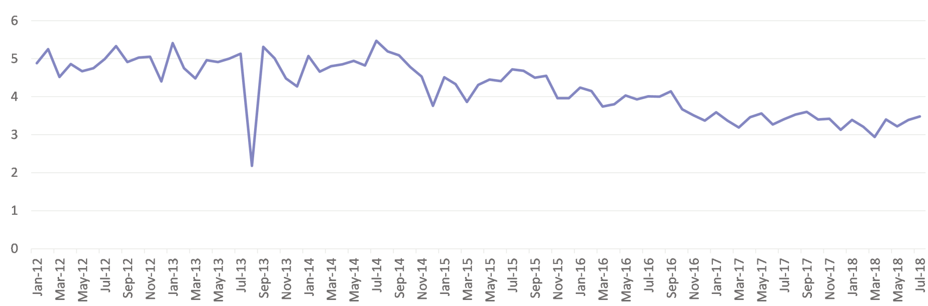


Central America & Caribbean, selected countries: GDP growth (%)						
Quarterly figures are year-on-year growth						
GDP	**end 2017***	**2018 forecast***	**Q2 2017**	**Q3 2017**	**Q4 2017**	**Q1 2018**
Costa Rica	3.9%	4.1%	2.7%	2.8%	3.2%	3%
Dominican Republic	4.9%	5.1%	3%	3%	6.5%	6.4%
El Salvador	2.4%	2.5%	2.3%	2.4%	2.4%	3.4%
Guatemala	3.2%	3.5%	2.3%	2.7%	2.9%	2%
Honduras	3.9%	3.9%	4.5%	6.5%	3.6%	3.1%
Nicaragua	4.9%	5%	4.3%	3.2%	4.3%	2.3%
Panama	5.3%	5.5%	5.4%	5.4%	4.9%	4.2%
Jamaica	1.2%	1.3%	-0.1%	range of 0.5%-1.5%	range of 1.0%-2.0%	range of 1.0%-2.0%
Trinidad & Tobago	-2.3%	0.5%	-3.4%	2.7%	-1.2%	Not available yet
**Figures from the United Nations Economic Commission for Latin America & Caribbean Dec 2017*						
Quarterly growth based on figures from the local central banks						

MEXICO & NAFTA

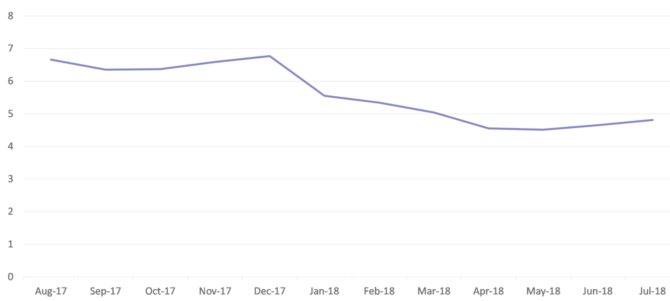
Mexico's unemployment rate

Economically active population



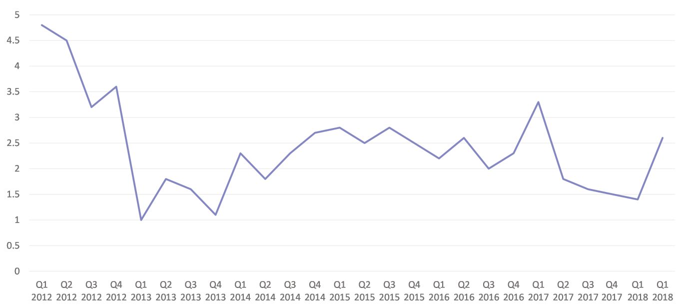
Mexico's inflation rate

Percentage variation (year-on-year)



Mexico's GPD

Percentage variation (year-on-year)



Source (all Mexico Highlights data): *National Statistics Institute (Inegi)*

COLOMBIA

No jam today

The new administration of President Iván Duque has been promising tax reforms and other measures to improve the country's public finances. But by refusing to offer jobs and other benefits to political parties, he may be making it more difficult to get congressional approval for these initiatives.

Next year's government budget, currently under discussion in Congress, has been set at COP258.9tn (US$87.4bn). The overall value of the budget was fixed under the outgoing government in July. The new administration must work within that global figure although it can submit supplementary funding requests. The final version of the budget must be approved by 20 October. At the end of August finance minister Alberto Carrasquilla said there was a COP25.6tn (US$8.6bn) shortfall, which would have to be found to ensure the country kept to its fiscal rule, under which the deficit must be narrowed from 3.1% of GDP this year to 2.4% next. More recently, officials say a rescheduling of public debt might reduce the short fall to COP14tn (US$4.72bn).

Carrasquilla described the fiscal outlook for Colombia as "worrying". The fear is that Colombia's investment-grade credit rating may be at risk if the deficit is not controlled. In December last year S&P downgraded the country's credit rating to BBB- (one notch above junk status) while in February Moody's revised its outlook on Colombia from stable to negative.

Various plans have been under discussion to help cover the shortfall. The government has been promising a tax reform package, although Duque has recently been speaking instead of a "financing reform" which might be one smaller and less ambitious component of a wider package. One proposal is to increase VAT revenue, possibly by expanding the scope of the tax while lowering the rate from 19% to 17%. Together with other tax tweaks that might raise between COP12tn (US$4.05bn) and COP13.5tn (US$4.56bn) which would plug most of the budget gap.

But getting reforms and tax changes agreed may be that bit more difficult this year. Traditionally, Colombian governments offer jobs and influence to parties in the ruling coalition to ensure support for its legislative programme in Congress. In a number of countries offering such inducements is called pork barrel politics: ethically questionable perhaps, but often central to the realpolitik of getting things done. In Colombia handing out favours is known as 'mermelada' ('marmalade'). Duque, mindful of the strength of feeling about corrupt practices, has said his government will not be offering any marmalade. As he put it, "Relations between the powers of government cannot be transactional."

It is estimated that though a series of alliances the ruling Centro Democrático (CD) party can count on a majority in the Senate (54 out of 106 seats) and, while falling short of a majority, controls the biggest minority group in the lower house (83 out of 170 deputies). In theory, that should mean that by clinching a few more votes in the lower house, Duque can get his legislation approved. But the votes of at least one allied party, the Partido de la U, are not guaranteed: almost half of its deputies say that because their party was not given ministerial positions they may not vote for Duque's reforms. CD Senator Paloma Valencia has argued that the pressure of public opinion will replace the need for mermelada, but not everyone is as optimistic.

What is the big sister thinking?

Venezuelan President Nicolás Maduro visited China from 14-16 September, signing a series of cooperation agreements. According to the Venezuelan version, the agreements were worth billions of US dollar and showed that China, a country Maduro described as Venezuela's 'big sister', remains fully committed to helping his nation in a time of need. But despite a lot of smoke and mirrors, some say Beijing is still limiting its exposure to Venezuelan risk.

The Venezuelan account was definitely upbeat. Maduro said that as a result of the visit "there are financing commitments to increase oil production, and gold production, as well as investment in more than 500 development projects within Venezuela." The Venezuelan information ministry said a total of 28 bilateral cooperation agreements had been signed in Beijing, including US$184m in financing for an oil joint venture and the transfer of 10% of another project to China. Maduro spoke of billions of dollars' worth of incoming oil and gold investments, as well as an agreement to import Chinese pharmaceuticals into his country. The biggest headline-grabbing announcement was that the China Development Bank (CDB) had agreed to extend a US$5bn credit line to boost heavy oil production from three joint ventures between PDVSA of Venezuela and CNPC of China. In a subsequent good-will gesture China sent *Peace Ark*, a hospital ship, on a week-long visit to the port of La Guaira to offer free medical attention to the local population.

But there is reason to believe that, not for the first time, the Venezuelans are hyping up their description of the relationship to a couple of notches higher than Chinese officials believe it is at. Maduro admitted that in the last three years there had been "difficulties" in the bilateral relationship. Notably, Chinese officials made no specific mention of the US$5bn CDB loan and adopted a friendly, but more measured tone (this suggests that the loan is not yet a done deal). It is widely estimated that over the years China extended between US$60bn and US$70bn in financial loans to Venezuela. There is little clarity over how the money was used. The Latin American country has lagged behind on repayments to China (and indeed, also remains in partial default on loans and bonds held by Western creditors). Most repayments to China are now made in kind through crude oil shipments. While no precise data has been published it is thought that Venezuela owes China at least US$20bn in overdue interest and principal. Given this state of affairs the Beijing authorities may well be hesitant to throw more good money after bad.

The visit may nevertheless be significant as at least a partial move to rebuilding the Sino-Venezuelan relationship. Since 2014 relations between the two countries had cooled as a result of Venezuela's failure to properly account for the loans it had been given and because of its apparent inability to stop the decline in its oil production and boost crude exports back to China. To some extent Russia's state-owned Rosneft stepped in to fill the gap, providing US$6.5bn in oil-backed loans to PDVSA.

China's re-engagement with Venezuela can be at least partly explained by a tightening international oil market, which increases the attractiveness of acquiring more 'barter oil' from Venezuela. The emerging trade war between Beijing and Washington may also have been a factor. In addition, the Chinese seem to be taking some practical measures to protect their investments. Interestingly if the US$5bn loan to the PDVSA-CNPC joint venture goes ahead, China will deploy officials to monitor that it is spent appropriately.

REGION

Andean interest rates heading up?

Central bank interest rates in three Andean countries (Chile, Peru, and Colombia) could be about to begin moving up, heralding a new monetary tightening cycle.

London-based consultancy Capital Economics has come up with a formula to try and anticipate when a monetary tightening policy is about to begin. This formula is currently suggesting rates will shortly move up across three of the major Andean economies, Chile, Peru and Argentina. Five criteria are involved. First, the question is whether each central bank has previously warned that an increase is on the way (the Chilean central bank tends do so explicitly, while those in Peru and Colombia tend to give more subtle hints). The second criterion is whether inflation is rising. The third is whether inflation has reached the upper half of the target band. Fourth, a good predictor of a tightening cycle is if GDP growth has accelerated by at least one percentage point in the year before the rates are increased. And in fifth place, a rise in forward-looking inflation expectations also provides an important marker.

Taking all these factors into consideration Capital Economics sees higher rates on the way. Chile meets four out of the five conditions, although inflation remains below target. The country's inflation rate is nevertheless expected to push up and exceed the target in September, with a possible interest rate hike on the way in October. Colombia meets three of the five conditions. Inflation is above target, but has not accelerated recently and there have been no central bank hints about a rate increase. So tightening is not expected to begin until the end of Q119. In Peru, which meets the least criteria, inflation is not rising particularly strongly, and the rate is still in the lower half of the target band. However, the rate is also expected to increase quite sharply triggering rate hikes by the end of the year.

PANAMA

Government seeks to loosen the purse strings

The government submitted a request to the National Assembly in late September to modify fiscal responsibility legislation in order to allow a US$300m increase in spending. A commission from the finance ministry gave its initial approval on 1 October, but debate has continued in the legislature on the issue. If the bill is approved by the National Assembly, the fiscal deficit ceiling will rise to 2% of GDP this year, significantly above the legally-mandated ceiling of 0.5% under the current fiscal responsibility legislation.

The Panamanian government has a mixed record in complying with the fiscal responsibility legislation that came into effect from 2009. That law established a maximum deficit ceiling of 1% of GDP, but aside from an initial success in cutting the deficit to 0.9% of GDP in that year, the authorities missed the target in the following few years. Recognising this slippage, the fiscal framework underwent modifications in 2012, with new legislation establishing new and looser targets, envisaging a consolidation from a deficit of 2.9% of GDP in 2012 back to 1% of GDP in 2017, after which the reform targeted a reduction in the deficit to 0.5% of GDP. Since then, the authorities have managed to reduce the deficit, using funds from the Panama Canal Authority and the sovereign wealth fund to keep budget shortfall under control. However, the authorities have indicated that they will miss this year's target by a wide range, talking recently about a deficit level of 1.6%-1.7% of GDP.

Deficit ceiling set to be adjusted upwards

The government argues that changes are necessary to the legislative framework to allow greater flexibility when domestic economic growth slows. However, opposition parties have criticised this justification, stating that the original fiscal responsibility legislation provides adequate provisions for an easing of deficit targets when GDP growth slows, or in times of national emergency (for example following severe weather damage, with flooding in the past lifting government spending). The proposed changes to the fiscal responsibility law would mean that the deficit ceiling would rise to 2% of GDP this year, falling to 1.75% of GDP in 2019 and 1.5% from 2020 onwards.

Upward revisions to the permitted fiscal deficit will place continued pressure on public debt levels. Although as a share of GDP this is not particularly onerous (around 40% of GDP), this ratio has risen in recent years as public debt has risen sharply in nominal terms. According to the finance ministry, the public debt stock stood at US$24.7bn in August 2018, up over US$7bn since President Juan Carlos Varela took office in July 2014. Public debt stocks also rose sharply under his predecessor, Ricardo Martinelli, with a US$6.8bn increase during his five-year term in office. The danger is that continued persistent fiscal deficits will require financing, meaning that the public debt:GDP ratio will rise further.

GDP growth is slowing

This comes at a time when domestic economic growth is decelerating, albeit to still-strong levels. According to the authorities, real GDP growth has decelerated steadily from a rate of 6.1% in the first quarter of 2017 to 3.1% in the second quarter of 2018. The slowdown has been broad-based across many sectors, but weaker activity in the transport & communications sector (which includes Canal activity and accounts for 12% of GDP) has undoubtedly contributed to this trend. The sector is still growing, but more weakly (from 10.6% in the first quarter of 2017 to 5.2% in the first quarter of 2018, before a slight rebound in the second quarter). The construction sector is a similar size and has also witnessed a weakening in growth, from 6.6% in the first quarter of 2017 to a contraction of 1.2% in the second quarter of 2018. The financial services sector (which includes both national retail banking and offshore services and accounts for around 6% of GDP) has also registered slowing growth rates.

The second-quarter results mean that average real GDP growth stood at 3.7% – a far cry from the 6% envisaged in the 2018 budget bill. This is likely to be having an impact on budget revenue inflows, as a result of below-target tax earnings, which in turn will partly explain the larger-than-anticipated budget deficit. The danger is that economic growth momentum is clearly slowing, making the government's projected 5.9% GDP growth target that next year's budget is based on look equally ambitious. Assuming that the government's proposals related to fiscal responsibility legislation pass, there will be somewhat of an extra boost from government consumption, but this is unlikely to fully compensate for signs of decelerating growth elsewhere.

"Renewed passion and energy" for Caribbean integration

From 5-6 September Barbados played host to two Caribbean Community (CARICOM) meetings. In a briefing to the press afterwards, chairman of CARICOM and prime minister of Jamaica Andrew Holness and chairman of the Council on Finance and Planning (Cofap), Antigua's Prime Minister Gaston Browne said that there was a "renewed energy and passion" in the Community.

The meetings in Barbados were of two CARICOM sub-committees: Cofap; and the prime ministerial sub-committee on the Caribbean Single Market and Economy (CSME), the proposed initiative currently being explored by CARICOM that would integrate all of its member states into a single economic unit.

The next important event for the Community falls in December, in the form of a special meeting of CARICOM Heads of Government which will take place in Trinidad and Tobago. Both the CSME and Cofap meetings came up with recommendations to send to the December special meeting which, if adopted, could have far-reaching consequences for CARICOM members.

Outlining the recommendations to come out of the CSME meeting, Barbados's Prime Minister Mia Mottley drew attention in particular to the threats faced by the region from climatic events and natural disasters, and highlighted proposals to help mitigate them in the future, among which would be an expansion of the categories of workers who can move and work across the region on the CARICOM Skills Certificate.

"Right now there are 10 categories [of workers] and we have agreed to recommend an eleventh category of agricultural workers, primarily because we recognise the importance of being able to obtain food security across the region, particularly in these difficult and turbulent times.

"And…after the realisation of what the climate can do and hurricanes can do and now we see earthquakes disrupt the whole production and distribution cycle, we are conscious and sensitive to the fact that we have to be able to move the region closer to a level of food security in ways that we were not perhaps as assiduous about doing in recent times," Mottley said.

In addition to the new worker category, the CSME sub-committee is recommending that CARICOM establish a single registration mechanism for companies, through the principle of mutual recognition, so that in the future businesses would be able to operate within a single, pan-CARICOM jurisdiction. The measure is designed to boost cross-Caribbean investment, reduce companies' operating costs, and remove regulatory impediments.

The sub-committee has also recognised the capacity constraints on law makers and their institutions at a national level, which limits their ability to draft and pass legislation that would boost economies and living standards, and assist with further CARICOM integration. To counter this, the sub-committee is recommending the establishment of a regional law reform centre able to develop 'model laws' for social and economic sectors.

Prime Minister Browne set out the Cofap recommendations, saying that leaders had agreed to the establishment of a regional deposit insurance system to help to establish a higher level of protection for depositors against losses due to the failure of financial institutions.

He added that the need for the system was clear given the precedent set by the past failure of financial institutions within the region, and was required as a matter of urgency to enhance the financial safety-net for depositors and even for investors in the CSME.

"We also took follow up action on the mandate from the CARICOM Heads of Government calling for the finalisation of some of the relevant instruments before the Inter-sessional meeting in February of 2019, and others by next July. These include the Community Investment Policy; an investment code; an incentives régime; and an integrated capital market; starting with the adoption of model securities market legislation," he added.

Prime Minister Browne said that agreement was also reached on expediting the finalisation of the CARICOM Financial Services Agreement, and approval was given in principle for the objectives of the CARICOM Credit Reporting policy. He explained that the policy would promote financial inclusion for nationals across CARICOM by providing for the regulation of the operations of credit bureaux and cross-border exchange of credit information within the Community.

In the past, criticism of CARICOM has focussed on it's becoming stagnant. In 2017, Guyana's President David Granger, then-Chairman of CARICOM, said that the Community, in particular the CSME, "must not be allowed to become a victim of equivocation and procrastination". The outcomes of the two meetings demonstrate a growing awareness among the region's political leadership that unless CARICOM nationals and businesses can see firm outcomes from the CSME the integration process will stagnate, and eventually fizzle out.

The indications are that all of the recommendations brought to December's special meeting will be approved by heads of government, paving the way for further integration. CARICOM Secretary-General Ambassador Irwin LaRocque said that he expects the recommendations to lead to important agreements.

REGIONAL BUSINESS REVIEW

BRAZIL

Amid higher oil prices, Petrobras targets higher production

Higher global oil prices have benefitted state-run oil company Petrobras' underlying accounts, generating a higher second-quarter profit, even while underlying production volumes have disappointed. However, in mid-September the company's CFO – Rafael Grisolia – stated that he expects the recent slide in oil production to reverse in 2019, with the company targeting firm growth in output of 8%-10%. Combined with the possibility of still-high oil prices, this would allow the company to reduce its heavy debt burden.

The Petrobras CFO did not provide any details about where the anticipated increase in production would come from, but the firm has previously stated that it intends to begin producing oil from four new platforms during the fourth quarter of 2018, with a fifth platform coming on stream in 2019, which combined are likely to have a more significant impact on average production levels in 2019. These platforms are in the pre-salt Santos basin, with two fields located in the Lula oil field and two in the nearby Buzios field. Both fields are already active, with new blocks beginning to come on stream. The fifth platform is located in the smaller Berbigao oil field, again located in the same cluster in the Santos basin. The company said that further details of new production would be outlined in Petrobras' 2019-2023 business plan, which is set for release in December.

Higher oil prices facilitate debt reduction

The company's ambitious oil production targets are accompanied by plans to reduce its large debt stock, with the CFO also outlining plans to cut debt by US$10bn next year, from an estimated US$69bn at the end of 2018. This forms part of a broader plan to reduce the ratio of net debt to earnings before interest, tax, depreciation and amortisation (EBITDA) from around 3.5 currently to 2 in 2019 (and 1.5 beyond that, which would bring Petrobras in line with levels of other large oil companies).

The recent trajectory of global oil prices will provide renewed confidence that Petrobras might continue making progress on reducing its debt stock. Brent oil was trading at close to US$85/lb in early October, a level not seen since late 2014, with prospects of still-higher prices in the coming months as the impact of US sanctions on Iran (which come into effect on 4 November) feed through to tighter oil market supplies. Futures prices are continuing to rise, with investors even beginning to talk about the prospect of oil prices reaching the psychologically-important mark of US$100/b – something that would have appeared inconceivable even six months ago, when Brent was trading at only around US$65/b. Petrobras has indicated that an improved bottom line would allow the company to resume building oil platforms again, rather than the current policy of leasing them from other firms, although – pending the publication of the 2019-23 business plan – this is not currently likely before 2023.

CUBA

Gloomy picture for agricultural sector

Despite long-running government efforts to boost domestic agricultural production, output levels remain weak. Not only has final data released from the Oficina Nacional de Estadisticas (ONE, the national statistics office) downgraded total agricultural production figures for last year, but a separate data release from ONE in mid-September stated that agricultural sales fell by 14.4% year on year in the first half of 2018, implying still-weak levels of domestic productivity.

A breakdown of the statistics from ONE show a broad-based decline across all major crops. Production of most fruit fell, as did meat, with a particularly sharp fall in cereals production. There was also a similar decline between state and non-state sub-sectors. Agriculture comprises a relatively small share of GDP but it is a large source of employment. Domestic production levels are important because slippage puts pressure on the government to increase food imports, which can cause difficulties given Cuba's limited holdings of foreign reserves. This has particularly been the case with the demise of the Venezuelan economy, since Cuba has seen its supplies of cut-price oil fall sharply, pushing up the cost of energy imports on the open market. The government's goal is therefore to lift agricultural production, in order to ease the burden of food imports and bolster the overall balance of payments (efforts to increase currently low levels of foreign reserves form part of a broader policy goal of unifying the dual exchange-rate system).

In this context, the news that agricultural production slipped last year, and appears to have fallen further in the first half of this year, is disappointing.

The government had stated at the end of 2017 that agricultural output had risen by 3% during the full calendar year, which at the time came as somewhat of a surprise as the sector had been hampered by drought earlier in the year and then the effects of Hurricane Irma, which hit the island last September. The recent downward revision to agricultural production data is therefore more in line with the state of play in the sector last year, while ongoing weak conditions in early 2018 are likely to explain the apparent continued fall in production in 2018.

Cuban president seeks to boost food imports from US

Data from the first half of the year show that sales of agricultural produce fell by 11.5% year on year. State-run markets registered only a small, 3.1% decline, while the privately-run markets saw sales fall by 10.8%. Other retail channels, which include small kiosks, agricultural co-operatives, and independent 'cuenta propria' producers, saw a much sharper drop in sales, of close to 30%. Import data is not yet available, but it is likely that weaker domestic production levels have forced the authorities to increase food imports, which already stand at over US$2bn. A visit by Cuban President Miguel Diaz-Canel to New York in late September, where he met representatives from US agriculture, was designed to encourage agricultural exports from the US to Cuba, with the president acknowledging that boosting food imports from the US would ease freight costs compared with other import markets that are further away.

FALKLANDS

Slow progress on Sea Lion project

Rockhopper Exploration has given renewed signs of optimism about the prospect of eventually beginning exploration as part of the Sea Lion project in the Falkland Islands. In late September, the firm stated that the field development plan is "substantially agreed" and that it is doing all it can to begin operations next year.

Rockhopper is one of the partners in the Sea Lion project, which aims to explore potential oil reserves in the North Falkland Basin, which it believes could contain 1.7bn barrels. The other partner is Premier Oil, with both firms reportedly investigating partnerships with service providers in order to expedite the start of drilling. Rockhopper has indicated that it is looking at exploring 23 subsea wells, with an anticipated initial cost of US$1.5bn until oil comes on stream (targeted at 2021). It stated that that discussions are continuing with the Falkland Islands government regarding the necessary documentation to secure a final investment permit.

However, the company also indicated that "much work" still needed to be done to finalise the funding of the project, which could delay the start of drilling. The project has long been in the works, but various factors have delayed progress. These have included questions over the quantity of potential oil reserves, uncertainty over whether they are commercially viable to exploit, political tensions with the Argentine government, as well fundamental uncertainties over financing of the project. With oil prices having risen sharply in recent months, and the prospect of further increases in the short term, Rockhopper and Premier Oil may be hoping that it will be easier to secure financing for the project, which they hope may produce 80,000 barrels/day. However, given that financing currently does not appear to be in place, the targeted start date of next year appears optimistic.

Corporate Radar

Walmart buys Cornershop: US based retail chain Walmarket International said it was buying online grocery company Cornershop, which has a strong presence in Mexico and Chile, for US$225m. The purchase appears to be part of a move into e-commerce in Latin America. The Mexican and Central American operations of Cornershop will be put under the control of Walmart de México (Walmex), which holds the number one slot in the retail market in that country. The company recently hired Ignacio Caride, former chief executive of online retailer Mercado Libre, to help develop its e-commerce operation in Latin America. Walmart said it had been particularly interested in Cornershop's "innovative crowdsourced delivery platform: with its own assets to accelerate growth for both companies".

Juan Valdéz shuts down in Mexico: Juan Valdéz, the Colombian coffee shop chain, closed down its Mexican outlets in September. The surprise move came after Procafecol, the Colombian coffee growers' company that owns the brand, terminated its franchising agreement with Mexican company Kaffeehaus. Procafecol said the closure came because of a contract dispute. It is clear that initially ambitious plans to develop Juan Valdéz across Mexico, which envisaged setting up 100 coffee shops, hit obstacles: there are only ten retail outlets in the country, all concentrated in the financial district in the west of Mexico City. By comparison US-owned Starbucks, which has been operating in Mexico for 16 years, now has a total of 687 outlets across the country. Mexican rivals include Cielito Querido, Punta del Cielo, and The Italian Coffee Company. According to Euromonitor, the Mexican coffee house sector has annual sales of US$560m.

Salar Blanco goes for Maricunga lithium: Salar Blanco, a joint venture between Lithium Power International of Australia, Minera Salar Blanco of Chile, and Bearing Lithium of Canada, said it was planning to invest US$527m to develop a lithium mining project at the Maricunga salt flat, 740km north of Santiago at a height of 3,700 metres above sea-level. The company envisages gaining necessary environmental permits in time to allow construction to begin in 2020. Salar Blanco will have an annual capacity to produce 20,000 tonnes per year (tpy) of lithium carbonate, and 58,000tpy of potassium chloride. Lithium reserves are reportedly plentiful, meaning production levels could eventually be ramped up to higher volumes.

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