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The contraction of correspondent banking

The contraction (or 'erosion') of correspondent banking relationships has had a major impact on the financial sectors of many of the countries in and around the Caribbean. The challenge, which is not affecting all countries equally, will not be resolved quickly.

Correspondent banking is the process that makes possible payments by non-bank customers across national borders. It is also the process that gives banks in any one country access to services and products available in another. As such, it is the activity that makes the global financial system truly global.

Over the past two years or so, there has been a contraction in the number of correspondent banking relationships globally. The Committee on Payments and Market Infrastructure (CPMI) at the Bank of International Settlements (BIS) notes that this has been a particular problem for banks that are: small (and which therefore cannot generate high volumes of business); and/or are outside major international groups (and thus unable to demonstrate suitable due diligence in relation to their clients); or that are based in small national markets; and/or that based in jurisdictions perceived to be very risky.[1]

What is correspondent banking?

According to the CPMI, correspondent banking is 'an arrangement under which one bank (the correspondent) holds deposits owned by other banks (the respondents) and provides payment and other services to those respondent banks.[2]

The key features of this arrangement include: a bilateral agreement by which one bank provides services to the other; the opening of accounts on each others' books; the importance of payments for third party customers; and, frequently, a reciprocal arrangement in that each of the institutions serves the other – and normally in different currencies.

Suppose that a non-bank customer of Bank A in country X wants to make a payment to another party, who is a customer of Bank C in country Y. Bank B operates in country X and has a correspondent bank relationship with Bank C. The payment is made from Bank A to Bank A's account with Bank B through the national payments system of country X. Bank B then makes a payment through SWIFT or another cross-border payments system to Bank B's account with Bank C. Bank C then passes the payment to the account of the receiver.

Services that are provided by correspondent banks include international funds transfers (as in the example given above), cash management, cheque clearing, loans, letters of credit and foreign exchange services.

In theory, correspondent banking should be a growth business, because of the general expansion in international trade and investment. In practice, the opposite is the case. The CPMI highlights the following:

- **Fewer relationships.** Correspondent bank relationships are being reduced in number – and especially where: the respondent banks are not generating enough volumes to cover the costs of compliance; the respondent banks are located in jurisdictions that are seen as being (very) risky; the respondent banks are dealing with many customers in relation to whom an adequate risk assessment is not possible.

- **Increasing costs associated with correspondent banking.** Often the higher costs are the result of banks' having to address anti-money laundering and counter-terrorism financing (AML/CFT) regulations, as well as customer due diligence and know your customer (CDD/KYC) concerns. In addition, there is a high degree of uncertainty as to exactly what is required by the AML/CFT rules. Some banks believe that it is necessary to 'know your customer's customers (KYCC).

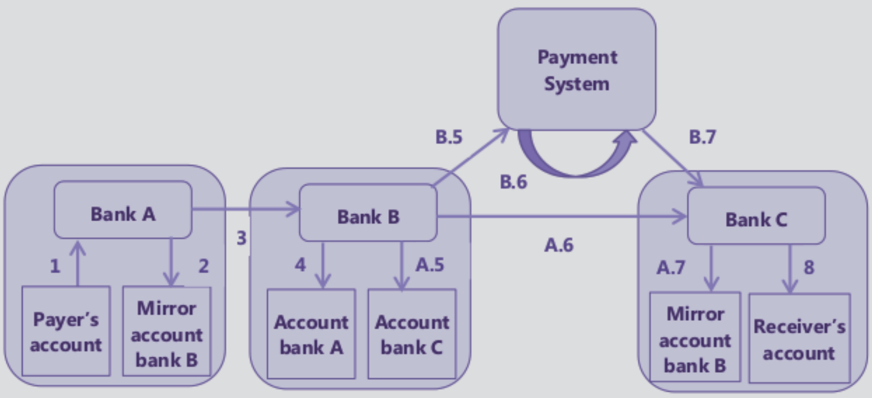
- **A tendency for correspondent banks to focus on services in particular currencies (and often those of the country in which they are based).** This is mainly due to the potential reputational risk and costs associated with non-compliance of AML/CFT requirements. There are signs that correspondent banking activities in US dollars are increasingly being concentrated in US banks.

- **Changing perceptions of risk and correspondent banking as a business.** Perceptions of risk in some countries have risen since the global financial crisis of 2008-2009. A number of banks have come to see correspondent banking as a non-core, high risk/low margin activity – rather than a central, low risk/ high margin activity. Assessments of profitability also usually take into account opportunities to cross-sell other products and services to correspondent banking customers.

The result of this is that correspondent banking relationships are tending to be concentrated in fewer and fewer institutions.

"A number of banks have come to see correspondent banking as a non-core, high risk/low margin activity – rather than a central, low risk/ high margin activity."

Payments settled via correspondent banking



1. Debiting of payer's account with bank A
2. Crediting of bank B's mirror account with bank A, which is kept for accounting purposes
3. Payment message from bank A to bank B via telecommunication network
4. Debiting of bank A's account with bank B (loro account)

A. Use correspondent bank only

5. Crediting of bank C's account with bank B
6. Payment message from bank B to bank C via telecommunication network
7. Debiting of bank's B mirror account with bank C, which is kept for accounting purposes
8. Crediting of receiver's account with bank C

B. Involvement of payment system

5. Payment message from bank B to payment system
6. Settlement via payment system
7. Payment message from payment system to bank C
8. Crediting of receiver's account with bank C

Source: *Bank for International Settlements*

[1]BIS CPMI 'Consultative report - Correspondent banking, October 2015, pp6-10
[2]Ibid

The impact in the Caribbean

Because correspondent banks are numerous in countries that are in and around the Caribbean, this has been a bigger problem for the region than for larger countries in Latin America. What has changed in recent weeks is that regional governments and central banks – which are looking upon the contraction of correspondent banking as a very serious challenge – are now commenting rather more publicly about the matter.

In late March 2016, Dr DeLisle Worrell, the governor of the Central Bank of Barbados, noted in an address to the Financial Stability Board (FSB) in Tokyo that Belize 'has experienced terminations in correspondent bank relationships that account for more than half of their banking assets. Belize's central bank has sought to provide assistance, but some customers in that country still have no access to their funds.'[3]

Dr Worrell noted that, in Barbados itself, eight correspondent banking relationships in the country's International Business and Financial Services (IBFS) sector have been cut. Although some of the companies involved have been able to re-establish correspondent banking relationships with other institutions, others have not. Perhaps most ominous is the inability of the IBFS sector to generate new business – because of banks' reluctance to take on new correspondent banking customers.

Elsewhere, 'in Jamaica, where remittances are a major source of foreign exchange, the number of money transfer businesses and foreign exchange traders has declined as a result of the severance of correspondent banking relationships. Guyana and the countries of the Eastern Caribbean Currency Union[4] have experienced terminations.' Business has also slowed in the IBFS sectors of the Cayman Islands and the Bahamas.

"The limited data that has become available about the impact of the contraction of correspondent banking is alarming..."

The limited data that has become available about the impact of the contraction of correspondent banking is alarming. According to CV Hope Strachan, the Minister of Financial Services of the Bahamas, the main reasons associated with the contraction of correspondent banking relationships have been 'risks in anti-money laundering and counter-terrorism financing (AML/CFT) and customer due diligence and know your customer (CDD/KYC) related concerns.' The Minister added that 'the resultant losses from these challenges [through 2015] took a serious toll on industry professionals. The external legal and regulatory demands are particularly onerous and are constant, and despite increasing demand for personnel to conduct regulatory oversight and oversee compliance matters, job losses outpaced these needs and **the latest statistics show that unemployment in the sector increased to 30%**' [*Emphasis added*][5]. Data published by the Bahamas' Department of Statistics in August last year indicate that the number of jobs in the 'Finance, Insurance, Real Estate and Other Business Service' sector dropped by a massive 36% through the six months to the end of May 2015.

The problem is also being driven by commercial issues. Some banks are abandoning the business of correspondent banking because it is not sufficiently profitable: their assessment will generally also take into account the potential to sell other products and services to correspondent banking clients. In a paper published at the end of March, the International Monetary Fund (IMF) noted that the withdrawal of global banks from Latin America had potentially reduced competition in the financial sector[6]. In the Caribbean, Canada's RBC sold its subsidiary in Suriname to the Trinidad & Tobago-based regional player Republic Bank in July 2015. In August 2015, CIBC First Caribbean, the regional offshoot of another Canadian major, announced the sale of its subsidiary in Belize to Heritage Bank, a local group.

[3]Central Bank of Barbados Press Release 'De-Risking Poses a Major Threat to the Region, 5 April 2016
[4]Antigua & Barbuda, St Lucia, St Kitts & Nevis, St Vincent & the Grenadines, Dominica and Grenada, along with the British Overseas Territories of Anguilla and Montserrat
[5]Remarks of the Hon CV Hope Strachan, Minister for Financial Services, at BSFB's Financial Services Industry Briefing, British Colonial Hilton Hotel, Nassau, 22 February 2016.
[6]IMF, 'Financial Integration in Latin America', 30 March 2016

Interestingly, none of the three large Canadian groups with a regional presence (the two mentioned above plus Scotiabank), nor the two large Trinidad & Tobago groups (Republic Bank and First Citizens), nor the National Commercial Bank of Jamaica (which also has operations outside its home country), nor the two indigenous Bahamian banks (Bank of the Bahamas and Commonwealth Bank), have alluded to the challenges associated with the contraction of correspondent banking in their latest annual reports.

The implication is that the withdrawal from correspondent banking by some institutions is giving at least some of the larger players an opportunity to fill the void being created. A senior executive with a regional bank that has an extensive geographic footprint across the Caribbean told *LatinNews* that the contraction of correspondent banking relationships had indeed had an impact on financial sectors in many of the countries. She also agreed with the suggestion that it had also had an impact in Haiti, the Dominican Republic and in Central America. She had no strong view on whether the contraction of correspondent banking had made it harder for her bank to conduct business across the various countries. However, she agreed with the proposition that the bank had picked up more business thanks to other institutions' withdrawal from correspondent banking.

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In his speech in Tokyo, the Central Bank of Barbados' Dr. Worrell suggested that there needed to be a reduction in 'the burden on banks of collecting and reporting detailed information for a variety of purposes...There also needs to be consistency among regulators about the information that is required as well as limits to banks' liability to fines and penalties in cases of inefficiency, where there has been no proven illegal activity.'

The BIS' CPMI has outlined a number of suggestions to curb the contraction in correspondent banking. These include clarification of the rules that define to what extent banks need to know customers' customers (KYCC). The suggestions also include greater use of KYC utilities (centralised databases of clients) and use of Legal Entity Identifiers (LEI) in correspondent banking. These changes are unlikely to be implemented quickly. This is because stakeholders are numerous and include the Financial Stability Board (FSB), the World Bank, the Financial Action Task Force (FATF) and the Basel Committee on Banking Supervision (BCBS). Given the economics of banking in the Caribbean, any changes may in any case have limited impact on the contraction in correspondent banking relationships in the region.

Outlook

In the short-term, it is possible to make a number of predictions. One is that the pressure on politicians and central bankers to do something – and in collaboration with multilateral organisations such as the BIS – will increase. In some countries, there will be consolidation of banking sectors, as the (mainly indigenous) institutions that prove unable to (re)-establish correspondent banking relationships are absorbed by bigger banks able to do so. Particular regional banks may increase their correspondent banking offerings – but at higher prices than previously.

Countries and territories that are very dependent on IBFS (such as the British Virgin Islands and the Turks & Caicos Islands, as well as others mentioned above), will grow more slowly than they otherwise would have done. As the IBFS sectors in Barbados and the Bahamas have found, the contraction of correspondent banking means that it is easier to lose business and harder to generate new business. The dependency of these countries on other sources of (foreign) income, such as tourism and remittances, thus will likely increase. And, finally, unemployment among financial services workers in these countries and territories is likely to remain high (as in the Bahamas), and is at risk of rising substantially.

BRAZIL

The shape of Temer economics

On 17 April Brazil's federal chamber of deputies voted by 367 to 137 (with seven abstentions) to support impeachment proceedings against President Dilma Rousseff, achieving the necessary two-thirds majority to send the process on for consideration by the senate. There is heightened political uncertainty in Latin America's largest economy right now, but at this stage one of the most probable outcomes is that the current vice president, Michel Temer, will be appointed to replace Rousseff in mid or late May, and will serve out the rest of her term in office, running up to the end of 2018. Here, we look at early pointers to what this might mean for economic policy.

Much of the Brazilian business community has been firmly in the pro-impeachment camp over the last few months, and would support a Temer presidency. At its simplest, the argument is that current policies have been so disastrously bad that any new approach is to be welcomed. In the latest (15 April) central bank survey of economists for its weekly Focus Report, the consensus forecast was for an annual economic contraction of 3.77% this year, with inflation remaining above target at 7.1%. Last year, real GDP contracted by 3.8% year-on-year, and inflation was 10.67%. In its latest World Economic Outlook, published in mid April, the IMF remained downbeat about Brazil's prospects, noting that, "domestic uncertainties continue to limit the government's capacity to formulate and execute economic policy". Attempts to control the fiscal deficit have been a complete failure, and it is currently running at somewhere over 10% of GDP. Marcos Lisboa, of a Brazilian think-tank, Insper, says, "Our productivity stopped growing some years back and has turned negative. That means our potential GDP growth is stagnant or negative. The country is becoming poorer, and it will continue doing so if we don't confront our serious structural economic problems."

"Our productivity stopped growing some years back and has turned negative. That means our potential GDP growth is stagnant or negative. The country is becoming poorer, and it will continue doing so if we don't confront our serious structural economic problems."

Marcos Lisboa, Insper

Temer has not published any economic blueprints, but there have been a series of hints and pointers as to what he might do. As far back as October last year, Temer's Partido do Movimento Democrático Brasileiro (PMDB) published the first version of an economic policy paper called 'Uma ponte para o futuro' ('A bridge to the future'). This paper, which pre-dated the party's later split from the governing coalition, called for what at that stage were considered unpopular but necessary fiscal adjustments, including the de-indexation of benefit payments, an increase in the retirement age, and a reduction in mandatory expenditure (legislation that fixes obligatory levels of spending as a proportion of GDP).

More recently, Temer apparently recorded a rehearsal of a speech accepting the presidency, which was leaked to the press (some say deliberately). In the recording, he called for sacrifices to overcome the crisis, promised social programmes would be protected, and spoke of fiscal reform including the privatisation of state enterprises. Separately, Wellington Moreira Franco, a former governor of Rio de Janeiro and Rousseff government minister, and a current adviser to Temer, told the *Reuters* news agency that there needed to be a "gradual fiscal adjustment", coupled with incentives to boost employment. Franco also supports greater private sector investment in infrastructure, public works, and the oil and gas sector. The private sector would be offered more concessions, "with clear rules and without ideology".

Not everyone thinks Temer can turn things around. Francisco Deusmar, who runs the Pague Menos retail chain of budget pharmacies, says that both the president and her potential successor are "birds of a feather", adding, "Neither Dilma nor Temer is capable of recovering business confidence in the economy." He says that when a football team loses, all coaches must be changed – Deusmar would therefore support early general elections, since "a new government would win sustainability with voting legitimacy." According to a survey by the daily *O Estado de S. Paulo*, however, most respondents believe that under a Temer presidency the recession will be less deep this year than under Rousseff. Nelson Marconi of the Fundação Getúlio Vargas (FGV) says whoever the president is, growth will only be viable with congressional support for major structural reforms: "And it is the [same] congress we have right now, isn't it? So we need to see who can best articulate a programme to deliver those changes".

ARGENTINA

Getting better… eventually

The short version of any current economic forecast for Argentina is that things are set to get better, possibly towards the end of this year, but more probably in 2017. But the difficulty for the new government led by President Mauricio Macri is that things are almost certainly going to get worse before they get better, and there is no certainty as to how long this transition will take.

"The bullish outlook for Argentina is that as the country regains access to international capital markets, investment will flow in; with better macroeconomic management at home, inflation will fall and GDP growth will rise."

To start on the positive side, Argentina's economic team has notched up major achievements in its first four months in office. As we went to press in mid April, it was poised to resolve the 15-year long dispute with the country's holdout creditors. On 31 March the government secured senate approval for the deal, following an earlier green light from the lower chamber. On 13 April, the US Second Circuit Court of Appeals lifted injunctions preventing Argentina making payments to other creditors until it resolved the dispute with the holdouts – a decision that ended almost two years of technical default. The government said that with this hurdle out of the way it would begin issuing bonds on 18 April with a view to paying the holdouts later in the month.

The markets are expecting Argentina to raise around US$15bn in bonds. What is left over after paying the holdouts will help fund the fiscal deficit (a break from the previous government's inflationary habit of funding the deficit by printing money). On 15 April, the ratings agency Moody's said it was raising Argentina's sovereign debt to B3 from Caa1, on the strength of the increased likelihood that the remaining holdouts would be paid. Moody's also noted that "The new government has lifted capital controls, allowed the peso to float freely, reduced energy and transport subsidies, and begun to correct longstanding macroeconomic imbalances".

The bullish outlook for Argentina is that as the country regains access to international capital markets, investment will flow in; with better macroeconomic management at home, inflation will fall and GDP growth will rise. At least part of that scenario seems to be slotting into place. Dow Chemicals and American Energy Partners have announced plans to invest in the Vaca Muerta shale deposits; Coca-Cola says it will invest US$1bn over the next four years, while Fiat Chrysler says it will spend US$500m on its car plant in Córdoba. Adelmo Gabbi, president of the Buenos Aires stock exchange, is predicting up to US$30bn of capital inflows this year and expects the country to be upgraded from frontier to emerging market status. In its latest World

Economic Outlook (WEO), the IMF is predicting GDP growth to rise to 2.8% in 2017. The Institute of International Finance (IIF) is even more bullish, predicting growth of 3.2% next year.

But getting from here to there is proving a challenge. Some of the things that impress foreign investors – and which the government sees as long-term necessities to achieve a competitive economy – are having a negative impact in the short term, and are also carrying a high political cost. A case in point is the first set of measures to narrow the fiscal deficit, estimated at 5.8% of GDP in 2015.

These have included raising electricity, gas, water, fuel and transport fares. In the short term at least, the utility hikes are accentuating the problem of stagflation. Bus and train fares have doubled. Gas prices rose by 285% at the beginning of April. Meat prices are 44% higher than year-ago levels. In the absence of reliable figures, some estimates now put inflation at close to 40%, well above the 20%-25% target the government has set for 2016. Despite government action to protect the less well off, the increases have eroded purchasing power. A study by the Catholic University says that 1.4m Argentines have dropped below the poverty line so far this year, taking the total to 34.5% of the population (up from 29% in December).

At the same time an estimated 11,000 public sector workers have been laid off. According to a report by a local consultancy, Tendencias Económicas y Financieras, a total of 19,424 workers were laid off across public and private sectors in March, an increase of 95% over the same month in 2015. A Catholic University report warned that if inflation is not brought under control and new jobs created, "it will be hard to reverse the rising trend that we're seeing in urban poverty and indigence rates". Retail sales have come down by 5.8% over the past year, according to the CAME business chamber. Despite its prediction of recovery in 2017, the IMF is projecting a recession this year, with real annual GDP falling by 1%. The danger is that these issues could feed through to rising trade union militancy and political protests, which in turn could undermine confidence in the recovery. However good its long term planning, the pressure will be on the government to improve its short term management: the key indicator over the next few months will be its ability to get the rate of inflation back down again.

"Despite its prediction of recovery in 2017, the IMF is projecting a recession this year, with real annual GDP falling by 1%."

CHILE

The micro-economic approach to growth

On 30 March Finance Minister Rodrigo Valdés and Economy Minister Luis Felipe Céspedes announced a package of 22 measures designed to stimulate the economy, promote service exports, and simplify bureaucratic procedures. These steps come as prospects for the Chilean economy are looking less sunny this year than a few months ago, with the central bank and the IMF both cutting back growth predictions.

The new measures are the antithesis of bold and dramatic: in fact, they are a collection of small, detailed and decidedly micro-economic steps aimed at oiling the gears of a slowing economy. Still, Finance Minister Valdés said their combined effect would be to increase access to finance across the economy by around US$8bn. Among the incentives, the government says it will establish a new credit line from the state development corporation, Corporación de Fomento a la Producción (Corfo), for non-bank financial intermediaries; reduce invoicing time limits to help small and medium-sized businesses (SMEs); create a web-based system to speed up legal processes requiring notary publics; allow insurance companies to invest directly in infrastructure projects; alter regulations governing AFPs (private pension funds) to make it easier for them too to invest in infrastructure and further diversify their portfolios; and make changes to bank regulation to move closer to the latest Basel II standards on risk-based capital reserve requirements.

Another group of measures is aimed at encouraging service exports and includes steps such as standardising the descriptions of services in a way that is expected to allow more of them to claim VAT-exemption. There will also be new steps to help reduce double taxation, and to cut the tax burden on the export of software and engineering services. Here too, there will be a new web-based system to support service exporters. Action will also be taken to enable mutual recognition of professional titles between Chile and the other three members of the Pacific Alliance trade group (Peru, Colombia and Mexico). The government will promote the take-up of SII, another online tool that allows banks to access relevant tax information so that they can conduct faster credit checks before lending to corporate clients. The authorities will also prioritise new legislation designed to give formal legal status to electronic signatures.

Valdés said that the measures were in-line with the government's current commitment to fiscal austerity, and would not increase overall government spending. The aim was to focus on a combination of steps that would gradually help raise productivity levels across the economy. Economy Minister Céspedes noted, "More and better financing is essential to help raise our economy's productive and growth potential. On this issue of growth there is no silver bullet, what we have to do is work across a whole range of measures that expand capacity and growth over time, and for that financing is critical".

"The initiative certainly comes at a time when the outlook for the economy is rather gloomy. Days prior to the 30 March package, the central bank (Banco Central de Chile, BCC) cut its real annual GDP growth forecast for 2016 to a range of 1.25%-2.25%, from 2.0%-3.0% previously."

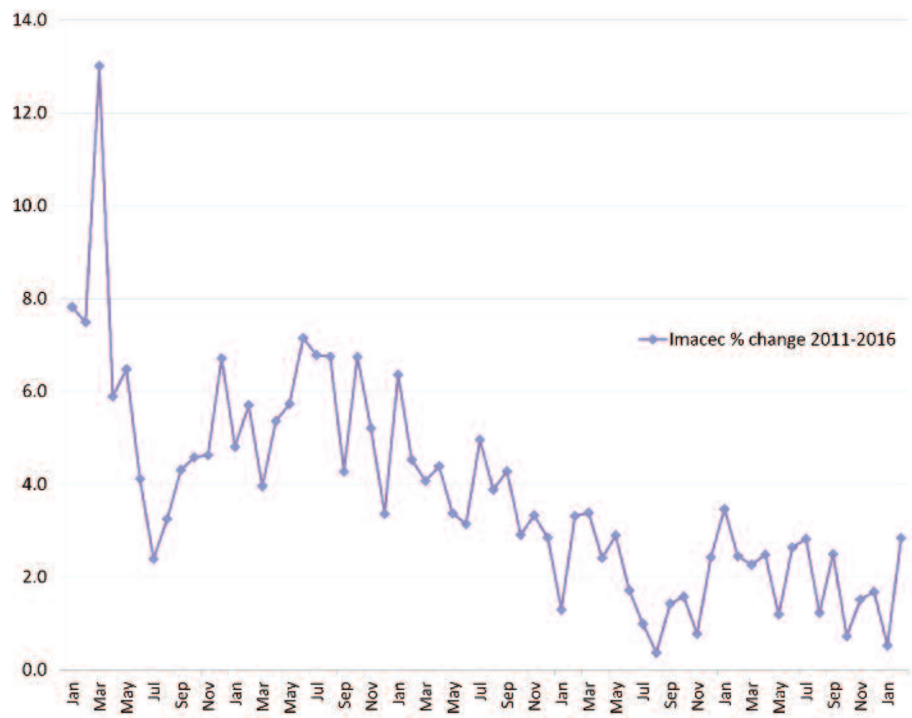
The initiative certainly comes at a time when the outlook for the economy is rather gloomy. Days prior to the 30 March package, the central bank (Banco Central de Chile, BCC) cut its real annual GDP growth forecast for 2016 to a range of 1.25%-2.25%, from 2.0%-3.0% previously. It said it expected inflation to remain above the target range at over 4% for a few months before declining in the second half of the year. The BCC president, Rodrigo Vergara, admitted that these new forecasts were disappointing. Chile has achieved an average annual growth rate of around 5% over the last 30 years, but if the BCC's forecast proves correct, in the four years to 2016 the average will come down to only around 2%. In its April World Economic Outlook, the IMF also cut back its projections for Chile to GDP growth of 1.5% this year, down from 2.1% in 2015. With its open economy, one of the key factors slowing Chile's growth has been the end of the commodities boom. Mineral exports (mainly copper) still account for around 50% of the merchandise goods exports, and copper prices are expected to remain weak – on some projections for another four years until 2020.

According to critics, falling business confidence has also been a factor in the slower economy, with the private sector said to be unhappy with President Michele Bachelet's programme of reforms, which included tax increases to fund the introduction of free university education and health reforms. In mid-April, congress finally approved another of Bachelet's key initiatives, a labour reform that shifts the balance of power back somewhat in favour of trade unions, making it more difficult for companies to replace striking workers or to extend benefits to non-unionised employees. The original bill was nevertheless diluted at the request of centrist parties within the ruling Nueva Mayoría coalition, leading one Partido Socialista senator, Juan Pablo Letelier, to comment, "The labour reform is like a horse without a tail. It is not pretty, but it walks".

The BCC in mid-April opted to leave its key interest rate unchanged at 3.5% for the fourth month running. The bank noted that March inflation was still above the 2%-4% target range. Analysts concluded that the recent weakening of the economy is top-of-mind for BCC policymakers, who therefore remain reluctant to tighten monetary policy at this stage. Real GDP growth slowed to 1.3% year-on-year in the fourth quarter of 2015, and despite a stronger-than-expected February (the Imacec activity index rose by 2.8% year-on-year), the economy does not seem poised at this stage to begin a sustained recovery.

Trending down, but still positive

Index of monthly economic activity (Imacec) % change year-on-year



Source: *Banco Central de Chile*

> "Valdés has ratified his commitment to maintaining fiscal austerity while fine-tuning the micro economy. In recent comments he confirmed the US$540mn worth of spending cuts announced earlier this year."

For his part, Valdés has ratified his commitment to maintaining fiscal austerity while fine-tuning the micro economy. In recent comments he confirmed the US$540mn worth of spending cuts announced earlier this year, noting, "We have to adapt our spending to the new reality…we have to spend well, not spend more". But at the same time, he insisted that the government would look at ways to boost growth. There could be more micro-measures coming. The national productivity commission has recommended a further 21 measures for the government's consideration, across a wide range of areas including the governance of state companies, project evaluation, youth employment, immigration, tele-commuting, digital publishing of government documents and liberalisation of shipping regulations.

PERU

The battle of the centre right

The battle for the presidency of Peru is now a two-way affair between Keiko Fujimori of Fuerza Popular (FP) and Pedro Pablo Kuczysnki of Peruanos Por el Kambio (PPK). In the first round on 10 April, Fujimori took 39.8% of the vote against 21.0% for Kuczynski, but in the second round due on 5 June the contest is still open: much will depend on how the supporters of other defeated first round candidates re-assign their votes. Both candidates are seen as market-friendly centre-right candidates. Here we look at their main economic policy promises.

The main dividing line between Fujimori and Kuczynski may be more political than economic. The key polarising factor is the legacy of Keiko Fujimori's father Alberto, who was president in 1990-2000. Although credited with helping stabilise a chaotic economy, Alberto is also remembered for his authoritarian rule (in April 2002 he closed congress and took control of the judiciary), for human rights violations, and for corruption. He is currently serving a 25-year prison sentence on charges of kidnapping and murder. His daughter has taken distance from her father's past, but the issue remains a live one. Peru's Nobel prize-winning novelist Mario Vargas Llosa weighed in after the first round, saying that if Keiko Fujimori won the second round, "the dictatorship will be legitimised". This elicited a quick response from the candidate herself who said it was regrettable that the writer had "indirectly discredited the vote of 40% of Peruvians".

Economic policies

The US educated, 40 year-old Keiko Fujimori has promised to maintain the current market-friendly economic model. In the face of Peru's economic slowdown, she says she will use the country's stabilisation fund to promote recovery, and will borrow to fund infrastructure programmes. Public sector investment will be increased, and there will be a specific focus on boosting agri-exports and small-scale farming.

"We know we have to step on the growth accelerator so that the benefits reach the most isolated communities", she has said. The FP supports Peru's free trade agreements and says that if elected it will deepen the country's participation in the Pacific Alliance (the trade grouping with Chile, Mexico and Colombia) and the Asia-Pacific Economic forum (APEC). Other policy proposals include offering a two-year tax exemption for small- and medium-sized enterprises (SMEs). An FP government would allow a temporary increase in the fiscal deficit to stimulate the economy. It would also seek to give local communities a shareholding interest in big mining projects in their area.

Pedro Pablo Kuczynski is 77 and has worked for the World Bank and the IMF as well as being a former mining minister, economy minister and prime minister. He is regarded as the favourite of the financial markets. He says he will attract foreign investment to stimulate big extractive projects that have been delayed because of local opposition on environmental and other grounds. In the later stages of his campaign he said he would renegotiate Peru's gas export contracts (forged in 2001-2005, during which time he was in government), despite having opposed this idea initially and branding a journalist who questioned him on the subject as being "ignorant".

"Pedro Pablo Kuczynski is 77 and has worked for the World Bank and the IMF as well as being a former mining minister, economy minister and prime minister. He is regarded as the favourite of the financial markets."

Under a PPK government, says VAT would be reduced over three years from 18% to 15%. There would also be reduction in petrol prices; with tax breaks for SMEs, less red tape, and a new unemployment insurance scheme. "To grow we have to invest, and we will promote investment. The first thing we will do it to reduce bureaucratic red tape" Kuczynski has declared. One of his campaign promises is to ensure that all Peruvians have access to drinking water and sanitation services. He has also promised that if elected, in its first 120 days his government will reactivate the economy and fight crime, in order to improve security for all Peruvian families. Another promise is to allow elderly convicts to exchange prison for house arrest – a subtle move that would benefit his opponent's father and is seen as an attempt to make it easier for *fujimoristas* to change sides and vote for PPK.

Commenting on the first round, US ratings agency Moody's Investors Service said the outcome was positive. Analyst Jaime Rausche said "Beyond the short-term impact, we expect business sentiment will improve through the end of the year, a key development given the importance of investment in Peru's economic performance". Gross fixed capital investment had slowed in 2013 and contracted in 2015 and 2015. The agency said, "We expect a new government by either candidate will have a strong mandate to resolve several social conflicts that have halted large-scale mining projects in Peru".

PUERTO RICO

More noise, same road

The Puerto Rico government and its various creditors have started using the media for negotiations over debt restructuring. The Puerto Rico House of Representatives has passed a bill that would allow Governor Alejandro García Padilla to declare a moratorium, until January 2017, on payments to creditors. As of 18 April 2016, it was unclear as to whether the US Congress will pass a bill, sponsored by the House of Representatives Speaker Paul Ryan (GOP), that should facilitate an orderly workout for the Puerto Rican government and its agencies, which collectively are burdened by a debt of around US$73bn. Nevertheless, an orderly workout remains the most likely outcome.

On 1 May 2016, the Government Development Bank (GDB) of Puerto Rico is due to make a payment of US$422m to holders of its notes. As the [**table**] indicates, this deadline has prompted a number of public comments and proposals from the Working Group for the Fiscal and Economic Recovery of Puerto Rico (essentially, the government-backed body charged with negotiations with creditors). In essence, the looming deadline has resulted in a vast increase in the 'noise' surrounding the negotiations.

"Aside from the deadline, a number of factors have complicated the discussions between the various parties..."

Negotiations over debt of government of Puerto Rico and its agencies: Recent developments	
01-Feb-16	Proposal to creditors in relation to US$48bn of central government debt.
04-Feb-16	Holders of senior COFINA bonds publish proposal for restructuring of COFINA.
23-Mar-16	Government privately makes counter-proposal to holders of central government debt.
05-Apr-16	Ad Hoc Group of General Obligation bondholders publishes restructuring proposal.
06-Apr-16	Puerto Rico's House of Representatives passes debt moratorium bill.
11-Apr-16	Working Group for the Fiscal and Economic Recovery of Puerto Rico publishes restructuring counter-proposal of 23 March.
14-Apr-16	House Speaker Paul Ryan says that Congress must pass new legislation that will facilitate an orderly restructuring of Puerto Rico's debt, under an oversight board appointed by the US Government.
01-May-16	Government Development Bank of Puerto Rico due to make payment of $422mn .
Sources: *Government Development Bank of Puerto Rico, Working Group for the Fiscal and Eocnomic Recovery of Puerto Rico, press reports.*	

Aside from the deadline, a number of factors have complicated the discussions between the various parties. One is Puerto Rico's current inability to seek protection from its creditors under Chapter 9 of the US Bankruptcy Code. Chapter 9 protection is available to municipal governments, but not to Unincorporated Territories like Puerto Rico. Another factor is the tendency

“Perhaps most importantly, the various creditors have not been negotiating as a unified bloc.”

for the bill in the US Congress supported by House Speaker Ryan to be seen as a bailout. The bill in fact envisages an orderly debt resolution for the government of Puerto Rico and its agencies, under the aegis of an oversight board that would be appointed by the US government: however, it does not envisage the use of US taxpayer money.

Perhaps most importantly, the various creditors have not been negotiating as a unified bloc. In early February this year, holders of senior bonds issued by COFINA (Sales Tax Financing Corporation) suggested that that the agency be allowed to default. This proposal would have given the government a significant boost to its cashflows over the next five years or so. However, a central part of the proposal was that the senior bondholders would be repaid in full before any payments of principal and interest were made to sub-ordinated bondholders, many of whom are residents of Puerto Rico.

In early April, the Ad Hoc Group of Bondholders of the General Obligation (GO) Bonds of the Commonwealth of Puerto Rico (the ‘Ad Hoc Group’) publicly released a restructuring proposal of their own. This included: a deferral of principal payments for the next five years, continued interest payments at contractual rates and US$750m in new financing. The government rejected this, in part because it would still be subject to cash shortfalls in the short-to-medium term: in addition, there would be no surplus with which to make payments on other securities. These securities include bonds issued by COFINA, even though the Ad Hoc Group’s proposal had included Sales and Use Tax receipts in projections of government revenues.

The government of Puerto Rico has published a revised proposal (or ‘counter-proposal’) that it presented to the various groups of creditors in late March. This seeks to meet the comments/ objections that it had received from the creditors in relation to its original proposal, presented in January this year. Whereas the original proposal had envisaged debt service payments rising from US$795m in 2018 to US$3.07bn in 2051 (with a peak in each of the three preceding years of US$3.50bn), the counter-proposal envisages that debt service payments begin in 2017 (at US$456m) and then remain at US$1.85bn annually until 2068.

Subject to certain assumptions, including a 5% yield, the government’s counter-proposal implies significant ‘haircuts’ for the various groups of bondholders. Holders of the GOs and other bonds that are guaranteed by the government should recover around 74% of their investment. Holders of COFINA bonds should recover about 57%, as should holders of bonds issued by the Highways and Transportation Authority (HTA). Holders of bonds issued by most other agencies should recover a little less than this. Worst off are holders of securities issued by the GDB, who should recover 36% of their investment.

The government’s counter-proposal seeks to lower the ratio of debt service payments to revenue on tax-supported debt from the current level of about 36% to around 15% by 2021. ‘The new debt service schedule has been structured to give [the government] the opportunity to further reduce that ratio as a result of economic growth and to develop into a stronger credit over time.’

In this context, the passage of the bill that gives Governor Alejandro García Padilla the ability to declare a moratorium on debt service payments until the beginning of next year is a device that gives the government more flexibility in its negotiations with the various groups of creditors. All parties have a vested interest in an orderly restructuring of the debt owed by the government of Puerto Rico and its agencies. That is the road on which they all remain.

Two year plan, and then...

The government of Trinidad & Tobago will rely heavily on revenues from one-off sources to maintain spending in the fiscal years to September 2016 and September 2017. Thereafter, the budget should benefit from changed spending priorities and, perhaps, from diversification of the economy.

The economic environment has been even worse than feared by the authorities in Trinidad & Tobago. As recently as October 2015, the government assumed that the average price of oil in the current (September 2016) fiscal year would be US$45 per barrel (/b) and that the average gas price would be US$2.75 per mmbtu. As noted in the **[box below]**, the government has revised its assumptions downwards sharply in relation to the second half of the fiscal year.

Even allowing for around TT$15bn (US$2.25bn) in one-off revenue items, the government expects the fiscal deficit this year to run to around TT$6.7bn, or 4% of GDP. Given that the economy is – for the second year in a row – expected to contract, the implication is that debt will rise in absolute terms and relative to GDP.

Asset sales – such as the 42% stake in Republic Bank held by various elements of Clico, the insurance-based conglomerate which the government rescued in the wake of the Global Financial Crisis – and other one-off items (such as a further drawdown from the country's sovereign wealth fund, the Heritage and Stabilisation Fund (HSF) – will also feature in the fiscal year to September 2017. The government has asked the Central Bank of Trinidad & Tobago (CBTT) to transfer to the government *in specie* stakes held by Clico in Angostura, Home Construction and CL World Brands. These businesses are estimated to have a value of around TT$3bn.

In a press release in mid-March, following the end of its latest Article IV consultations with the government, the International Monetary Fund (IMF) noted that Trinidad & Tobago had under-saved and under-invested for the future during the energy price boom. Nevertheless, asset sales and access to the HSF mean that the government has the flexibility to maintain spending at a much higher level than would otherwise be the case. In essence, it can run a counter-cyclical fiscal policy for two years.

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In the meantime, the government recognises that tough measures are needed to ensure a sustainable budget position. It has already reduced the VAT rate, but substantially broadened its base; required all ministries and departments to cut operating expenses; and looked to streamline the government bureaucracy. The 2016 Mid-Year Budget Review, presented on 8 April 2016 by Finance Minister Colm Imbert, highlighted several new taxes and a commitment to greater efficiency in collection of VAT. The government is also looking to introduce a comprehensive property tax. In addition, it will negotiate a new tax regime with oil and gas companies, who currently pay little or no corporation income taxes.

Moves to reduce spending are even more politically contentious than the various measures to boost tax. The government has ended the subsidies on super gasoline, and has reduced the subsidy on diesel. The proposed mass transit project has been assessed by the Inter-American Development Bank (IDB) as being not feasible, given the government's budgetary position at current energy prices: it has been shelved.

There are also major changes to the Unemployment Relief Programme (URP) and the Community-Based Environmental Protection and Enhancement Programme (CEPEP), the combined costs of which had soared from TT$400m or so in 2004/05 to TT$1.3bn. Minister Imbert noted in the Mid-Year Budget Review that these projects had distorted the labour market of Trinidad & Tobago, in that 'some people prefer to remain in these relatively low productivity programmes rather than take up more demanding but higher paid jobs in the private sector.' The focus of the URP will shift from 'maintenance activities of questionable value to substantive community construction projects and other infrastructure projects with clearly defined outputs,' which, in rural areas, will include agricultural production. Starting in 2017, direct support from the government to CEPEP contractors will be reduced over time: the aim – as per the original concept of the programme – is to encourage entrepreneurship among the CEPEP contractors. A committee that is looking at reform of the government Assisted Tertiary Education (GATE – essentially the provision of free tertiary education to citizens of Trinidad & Tobago) will report by the end of July. Spending on GATE currently amounts to around TT$600m annually.

"The Mid-Year Budget Review also pointed to diversification of the economy, with a focus on international financial services, tourism and some related maritime activities. Specific projects include a new hotel and convention centre at Invaders Bay in Port of Spain and a new shipbuilding/ industrial complex on the eastern side of the city, south of the Beetham Highway."

The Mid-Year Budget Review also pointed to diversification of the economy, with a focus on international financial services, tourism and some related maritime activities. Specific projects include a new hotel and convention centre at Invaders Bay in Port of Spain and a new shipbuilding/ industrial complex on the eastern side of the city, south of the Beetham Highway. The government envisages that at least one major Chinese bank that is looking to lend into Latin America and the Caribbean could serve as an anchor tenant in the International Finance Centre. The government is also making arrangements for US dollar credit lines to be available to exporters through the TT Exim Bank. In addition, the finance minister is talking to the commercial banks a about 'guidelines for the distribution of foreign exchange that will see priority being given to trade, inputs into manufacturing, medical expenses, tuition fees and the like, as well as greater availability of foreign exchange for small and medium-sized businesses.

If all these initiatives come to fruition, then the country will be far better placed for sustainable economic growth from 2018, by which point the government will no longer be able to rely on one-off revenue items to plug (much of) the gap between its revenues and expenses. In the meantime, the 2016 Mid-Year Budget Review has provided a long list of specific details to watch for.

The 2016 Mid-Year Budget Review at a glance

Finance Minister Imbert presented the 2016 Mid-Year Budget Review on 8 April 2016. Key features included the following:

- **GDP** is estimated by the Central Bank of Trinidad & Tobago (CBTT) to have fallen by 2% in 2015. It is expected to contract by a similar amount this year. GDP is expected to grow again in 2017, thanks to higher public sector investment, improved private sector sentiment and investment and increased gas production.

- **Revenue collection in the five months to the end of February 2016** was TT$2.96bn lower than anticipated. This was due mainly to lower receipts from oil and gas companies (of around TT$2bn) and lower receipts from the non-oil sector (of about TT$1bn)

- **Government spending in the five months to the end of February** was $7.75bn less than originally anticipated. This was partly due to the December 2015 decision that all ministries and departments would cut spending by 7%. It was also partly due to deferral of payment of arrears of salary to public servants due to the lack of cash.

- Budgeting is now based on an **oil price** of US$35 per barrel and a **gas price** of US$2.00 per mmbtu for the next six months.

- **Total revenues** for the current (September 2016) fiscal year are now expected to be TT$53bn. The budget deficit should be about TT$6.7bn, or 4% of GDP.

- **One-off revenue items** in this fiscal year are expected to amount to about TT$15bn and include: TT$500m in profits from the CBTT; TT$3,600m in loan repayments from Trinidad Generation Unlimited; around TT$3,000m from sale of a stake in Methanol International Holdings Limited (MIHL – TT$2,000mn) and traditional life insurance policies (TT$1,000m) owned by Clico; the proceeds of the Phoenix Park IPO; dividends from the National Gas Company (NGC) and draw-downs from the Heritage and Stabilisation Fund (HSF).

- The CBTT has been asked to prepare for the orderly **disposal of Clico's holding in Republic Bank** in 2017.

- **New revenue measures** to be introduced include: a 7% tax on purchases through the Internet from retail companies that are resident overseas; a 50% hike in customs duty and motor vehicle tax on cars with engine size exceeding 1999cc; better collection of taxes from the gaming industry; and higher taxes on alcohol and tobacco.

- **Total spending** in the current fiscal year is expected to be TT$59bn.

- **New spending reduction measures** include the end of the subsidy on super gasoline and the reduction in the subsidy on diesel. (The government will, however, remove taxes on CNG, electric and hybrid cars with engines up to 1999cc.

- **The proposed mass transit project has been scrapped.** Instead, the government will focus on road improvements, some of which are already underway.

- **Reforms will be made** to the Unemployment Relief Programme (URP), the Community-Based Environmental Protection and Enhancement Programme (CEPEP) and the Government Assisted Tertiary Education (GATE) programme.

REGION

Poverty rate begins to edge up

According to the 2015 Social Panorama of Latin America, published in March by the UN Economic Commission for Latin America and The Carribbean (ECLAC), more than a decade of steady reductions in poverty rates may have come to an end last year. If this is more than a temporary blip, there are at least two implications: one is that the region may begin to see a moderate increase in social and political tensions, and second, that the strong growth of the middle classes, which has boosted consumer demand, may also be easing back.

According to ECLAC, poverty and indigence rates were unchanged in 2014 compared to the preceding year, at 28.2% and 11.8% of the total population. But the organisation estimates that last year these edged up to 29.2% (a total of 175m people) and 12.4% (75m people). Another way of saying the same thing is that nearly one in three Latin Americans are poor, and one in ten are extremely poor, or indigent.

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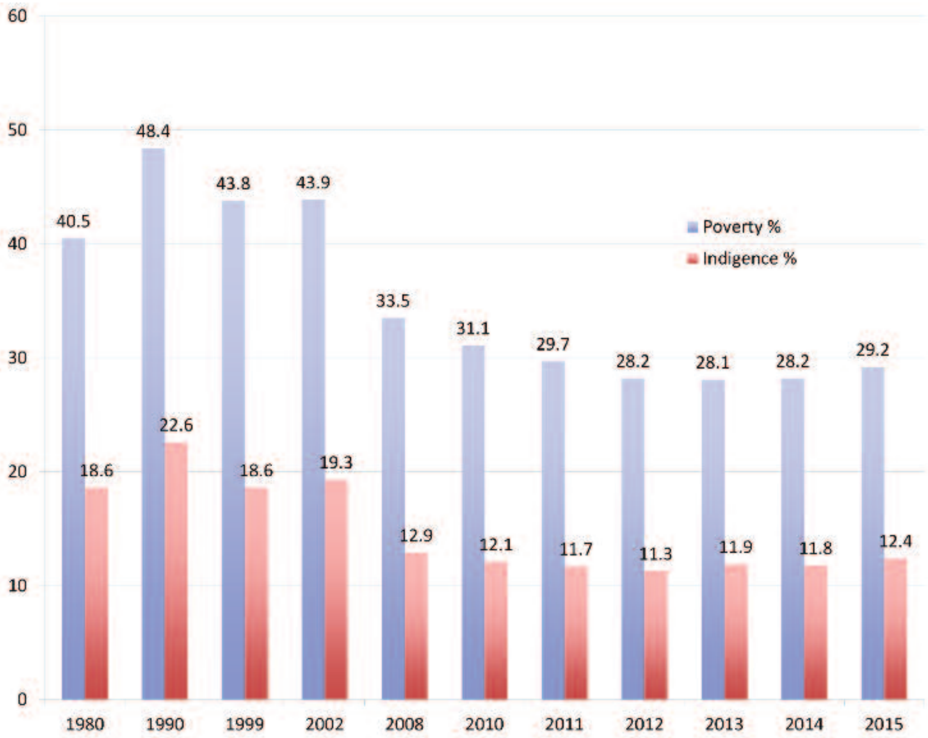
As a UN body focused on socio-economic issues, ECLAC does not comment on the political implications. However, we can make the general assumption that higher poverty rates could lead to moderate increases in social tensions. Admittedly, a one percentage-point increase in the rate of poverty from one year to the next is unlikely to have dramatic implications. But if this is a beginning of a trend, it suggests that there are groups of people who will have emerged from poverty for a few years and then slipped back below the poverty line. These groups may be more likely to behave as dissatisfied and rebellious voters. It is possible to speculate that some of the political trends seen in recent years – the disaffected middle classes in Brazil, the rise of independent candidates in Mexico, falling support for traditional parties in various countries – could become more acute in this context.

On the business front, companies selling consumer goods may also see their natural middle class markets growing less dynamically than in the past, putting pressure on sales growth. This will create both threats and opportunities – among the latter a trend among consumers to shift to economy or 'no frills' products, at the expense of higher end/luxury options.

Three decades-plus of poverty reduction

Poverty and indigence rates as % of Latin American population



Source: *ECLAC*

"It does appear that sustaining poverty reduction, along with efforts to reduce income inequalities, is getting more difficult as the end of the commodities boom leads to slower growth across the continent and to greater fiscal pressures."

It does appear that sustaining poverty reduction, along with efforts to reduce income inequalities, is getting more difficult as the end of the commodities boom leads to slower growth across the continent and to greater fiscal pressures. During the boom years, social spending increased substantially. ECLAC says it rose from 12.6% of GDP in the early 1990s to 19.5% in 2014. Growth occurred mainly as an expansion of social security and social assistance programmes (up by 3.5 percentage points of GDP), followed by education (up by 1.9 percentage points), and by health (up by 1.5 percentage points). Overall social spending is now coming under downward pressure. ECLAC's executive secretary, Alicia Bárcena, says governments need to find new sources of funding and fiscal mechanisms in order to "ensure the sustainability of social progress achieved in the last decade".

One long-term factor may help this, while another will hinder it. On the plus side the working age population (usually defined as those aged 15-60) is still growing faster than dependents (the under 15s and over 60s). This 'demographic dividend', which creates opportunities for investment in education and health, will last for another 15 years, although it is reducing in intensity.

According to ECLAC, Latin America will transition from being 'a youthful society' in the period leading up to 2023 to becoming a 'young adult society' in the period running up to 2045, and to an 'adult society' up to 2052. After that it will be classified as an 'ageing society', although the turning points will vary from country to country.

On the negative side, there are still deeply entrenched inequalities. The Gini income distribution coefficient (a measure of inequality where 0 means full equality and 1 maximum inequality) fell from 0.507 in 2010 to 0.491 in 2014, but in the lower-growth scenario further progress is looking difficult.

The top 10% of Latin America's population by income earns 14 times more than the bottom of 40%. ECLAC also notes persistent inequalities of income by sex, race and ethnicity. Indigenous and Afro-descendent ethnic groups earn less than the average, and women earn less than men. The key to trying to change this may lie in the creation of high quality jobs. ECLAC says 80% of household incomes come from work, and therefore what it calls quality employment "is the key to equality, the cornerstone of social and economic integration and a fundamental mechanism for the construction of autonomy, identity, personal dignity and an enlarged citizenship". It is therefore suggested that efforts to expand formal employment, strengthening minimum wages and access to social protection should be intensified.

REGIONAL BUSINESS REVIEW

BRAZIL

Troubled times for Odebrecht

Odebrecht, Brazil's large construction and civil engineering group, continues to be shaken by its implication in the major Lava Jato ('car wash') federal investigation into corruption at key state companies and other large firms in Brazil. In March, the former company CEO, Marcelo Odebrecht, who has been under arrest since June 2015, was sentenced to 19 years and four months' imprisonment for his involvement in paying bribes (he continues to deny any wrongdoing and is appealing the sentence). That same month, his successor, Newton de Souza, confirmed plans to sell BRL12bn (US$3.3bn) worth of assets as the company seeks to reduce its debt load and survive the crisis.

"Federal prosecutors allege that Odebrecht was at the centre of a major network of bribes and kickback schemes. To date, Odebrecht has paid BRL240.7m (US$65m) in fines for wrongdoing."

Federal prosecutors allege that Odebrecht was at the centre of a major network of bribes and kickback schemes. To date, Odebrecht has paid BRL240.7m (US$65m) in fines for wrongdoing. In March, the 26th phase of the Lava Jato investigation focused largely on the company. Investigators are reported to have discovered a unit within Odebrecht dedicated to managing corrupt payments. It included a bank account containing BRL66m (US$18.2m) and lists of bribes paid in connection with works at the Arena Corinthians stadium in São Paulo, metro lines in Rio de Janeiro and Rio Grande do Sul, and the international airport in Goiánia. Documents were seized, including detailed lists with currency amounts paid out, addresses and code names of the recipients of kickbacks. According to the Brazilian press, the 'Odebrecht list' of payees includes the names of over 200 Brazilian politicians from 24 political parties. It appears to have been what Brazilians often refer to as a 'Caixa 2' – an off-the-books second account.

While revelations continue, the current management of the company is in damage limitation mode. Newton de Souza, the new chief executive, said

Odebrecht would sell some US$3.3bn worth of assets, commenting, "We believe that selling off this amount will give us a good basis to get past this storm." Proceeds will be used to pay down some of the company's estimated debt load of BRL100bn (US$28.8bn). Among the assets to be divested are the Chaglla hydroelectric plant in Peru, water and sanitation subsidiary Odebrecht Ambiental in Brazil, an oil block in Angola, and a highway project in Peru. De Souza said the company had decided to collaborate with the federal investigators. Plea-bargaining deals may be made. "We are learning a lot from this crisis and are creating a solid foundation so that we can leave all of this behind us," he said. In an interview with the daily *Folha de S. Paulo*, De Souza said Odebrecht's 38.3% stake in Braskem, Latin America's largest petrochemicals company, was not for sale, although it would be used for collateral in a loan agreement with banks. At its peak, Odebrecht reportedly employed some 180,000 staff and contractors in 21 countries. According to De Souza, up to 70,000 employees have been laid off.

What remains to be seen is the severity of the impact on Odebrecht's international operations. In Peru, the company says it has sold its 55% stake in the Gasoducto del Sur consortium that is building a US$7bn gas pipeline linking the Camisea gas fields to the Pacific coast. It has been alleged that Odebrecht made illicit payments in connection with this project, including contributions to outgoing President Ollanta Humala's campaign funds. Some doubts have also been raised in Colombia over the impact on Navelena, a consortium managing the US$1.3bn project to improve the navigability of the Magdalena River. Odebrecht has a 50% stake in Navelena, which must close bank financing for the project by an 11 June 2016 deadline. Odebrecht is also involved in a highway project, as part of the Concesionaria Ruta del Sol, and is bidding for a wastewater treatment plant project in Bogotá. Colombian government officials have hinted that Odebrecht will come under increased scrutiny because of the revelations in Brazil.

"What remains to be seen is the severity of the impact on Odebrecht's international operations..."

At the end of March moreover, it was reported that the US Department of Justice was opening an investigation into Odebrecht, Braskem and Petrobras, Brazil's state-run oil company. At issue was whether naphtha supply contracts signed since 2009 between Petrobras and Braskem violated the Foreign Corrupt Practices Act. Braskem said it was collaborating with the Department of Justice. Since 2015 Braskem also faces legal action by US-based shareholders who accuse it of giving them false information.

MEXICO

Encouraging outlook for renewables

Mexico held its first-ever long-term power supply auction on 29 March, with mainly wind and solar companies competing for 15-year contracts to supply the state-owned Comisión Federal de Electricidad (CFE) with electricity. Despite an embarrassing glitch, the auction was widely hailed as a success, attracting total investment of over US$2bn, and positioning the country as a regional leader in renewable energy use.

Two points are important to put the auction in context. First, it took place under the framework of the government's wide-ranging energy reforms, introduced in 2015, which saw the CFE and state-owned oil company Pemex lose their monopolies. CFE eventually will be one among many players in a competitive electricity market coordinated by the Centro Nacional de Control de la Energía (CENACE). Second, this first auction was also designed to help the government meet its objective of reducing greenhouse gas

(GHG) emissions and hitting its target of generating 25% of its electricity supply from renewable resources starting in 2018. At present around 12% of electricity supply comes from renewables.

In the auction itself – a computerised process run by CENACE – companies could offer different combinations of three 'products': generation capacity, electricity supply, and clean energy certificates (CELs), the latter being required by law to be ultimately purchased by polluting industries. In the first auction, nobody offered generating capacity (not seen as a problem since Mexico currently has spare capacity). But the successful companies did offer 5,385 GWh of energy and 5.38mn CELs, which met 85% of CFE's needs and led officials to deem the process a big success. "The results were better than some of the most successful auctions in the world", trumpeted the deputy energy minister, César Emiliano Hernández. Michael Liebrich, chairman of the advisory board for Bloomberg New Energy Finance, has noted that the Mexican auction and another recently completed in Morocco have resulted in winning bids from companies that promised to produce electricity at the cheapest rate, from any source, anywhere in the world.

"The embarrassment came when it was discovered there had been a glitch in the computer algorithm used to match buy and sell bids, and there had also been "errors in the data-entering process" – apparently one bid was entered incorrectly in "thousands" of pesos, rather than the intended "hundreds of millions" of pesos."

The embarrassment came when it was discovered there had been a glitch in the computer algorithm used to match buy and sell bids, and there had also been "errors in the data-entering process" – apparently one bid was entered incorrectly in "thousands" of pesos, rather than the intended "hundreds of millions" of pesos. As a result the authorities produced one list of winning bids on 29 March (skewed by an erroneous and incredibly low-priced bid), and a rather different one on 30 March. Critics say CENACE was less than forthright about what went wrong and this may erode future confidence. One recommendation is that future auctions should use software programs that detect anomalous entries.

But even the modified results were very encouraging. A total of 227 bids were made by 69 companies, of which 18, made by 11 companies, succeeded. The successful bidders were Aldesa Energías Renovables, Consorcio Energía Limpia 2010, Energía Renovable de la Peninsula, Enel Green Power México, Energía Renovable del Istmo II, Jinkosolar Investment, Recurrent Energy Mexico Development, Photomeris Sustentable, Sol de Insurgentes, SunPower Systems México, and Vega Solar 1. Between them they will build 11 new solar parks and five windfarms by 2018. Enel Green Power (EGP) said that the auction results made it the largest renewable energy operator in Mexico in terms of installed capacity and project portfolio. It expected to invest around US$1bn in three solar farms: Villanueva (427MW) and Villanueva 3 (327MW) in Coahuila state, and Don José (238MW) in Guanajuato. The company recently won wind and solar contracts in Peru, and is planning to take part in a tender due in Chile in July. Vega Solar is an Indian company, which as a result of the auction will build a solar facility in Yucatán. China-based Jinkosolar will generate its electricity supply from three projects in Jalisco and Yucatán states.

Analysts noted that the process in Mexico was extremely competitive – the prices set for renewable energy supply ended being among the lowest in the world, and even some big international players such as Iberdrola of Spain seem to have been out-competed. CFE said it had expected an average offer price of MXN1,328 (US$74.90) per MW, but the result had come in 38% lower at MXN827 (US$46.70) per MW. Politically, the auction was seen as a defeat for some of Mexico's big carbon-emitting industries that have been mounting a legal challenge against the Energy Transition Law (which requires them to purchase the CELs). It shows the renewables sector is commercially viable and therefore increases the pressure on them to comply and reduce emissions. Horacio de Uriarte, a legal expert in the renewable energy sector, recently commented that the acceptance of the CELs "leads us to think that renewables have the most promising future."

The auction is certainly a good sign for renewables in Mexico. At a conference in February in Mexico City, Steve Sawyer, general secretary of the Global Wind Energy Council (GWEC), said that with Brazil, Mexico will be one of the world's fastest growing wind energy markets in coming years. Brazil is currently ranked 10th in the world by installed wind capacity, and Sawyer says Mexico may joint the top 10 in the near future. Estimates suggest that around US$20bn could be invested in wind farms in Mexico in the next 10-15 years. Current installed wind capacity is 3,283MW, coming from 31 wind farms dotted around the country. Existing players include SunEdison, Gamesa, AES, IENova, Iberdrola and InterGen. Solar power is also on a growth path. According to Mexico's energy regulator (Comisión Reguladora de Energía, CRE), a total of 286 solar projects, representing 8GW of capacity and some US$27bn worth of investment, have been approved for development, although only six of them are actually in operation.

MEXICO

Banks - strong, often foreign, and not much used

As of early 2016, Mexico's commercial banking sector has many strengths. By many metrics, financial inclusion has improved over the last four years or so. However, it has much further to go match the standards of other countries in the Latin America & Caribbean region, let alone those of other upper middle-income countries. Lack of financial inclusion remains a major challenge for policy-makers.

"At first glance, it is easy to identify the strengths of Mexico's commercial banks..."

At first glance, it is easy to identify the strengths of Mexico's commercial banks. According to the regulator, Comisión Nacional Bancaria y de Valores (CNBV), the total assets of the 46 banks in the country amounted to MXN8,049bn (US$456bn) at the end of February 2016, having risen by 13.0% in local currency terms over the preceding 12 months. Total deposits were 10.1% higher at MXN4,242bn (US$240bn), while total loans to non-bank customers had grown by 13.9% to MXN3,846bn (US$218bn).

In short, the commercial banks are large in absolute terms, and have by many metrics been growing rapidly – in spite of the general softness of the Mexican, US and global economies. At the end of last year, the banks' overall capitalisation ratio was nearly 15% – or higher than the minimum required by international norms. According to the CNBV's latest figures, the return on assets and equity has been, respectively, 1.32% and 12.58%. Non-performing loans amount to just under 2.6% of the total, although the percentage is somewhat higher (at 4.2%) for consumer loans.

And the identities and market shares of the largest banks also point to strength. As of the end of February, the seven largest banks accounted for 82% of total commercial banks assets, and a similar percentage of total loans to non-bank customers. BBVA Bancomer, the Mexican subsidiary of the Spanish multi-national BBVA, is the largest commercial bank in Mexico, and speaks for around 23% of total assets (and a marginally higher percentage of total loans). The next two main players, each accounting for about 14% of assets, are the local subsidiary of Spain's Santander, and Banamex, the local offshoot of Citigroup. Banorte, an indigenous financial services group, is in fourth place, with 12% of assets. It is followed by HSBC (8%), the local group Inbursa (5%) and Canada's Scotiabank (5%)[7].

[7]CNBV data, as at the end of February 2016

Past financial crises, the opening up of the sector to foreign investment and mergers and acquisitions mean that the leading commercial banks have the advantages of scale, branding, access to capital through global markets and technical know-how.

However, the banks collectively have yet to build trust. Most Mexicans do not have dealings with banks: this is not just the case with poorer Mexicans. Data collated by the World Bank in relation to financial inclusion found that, in 2015, just over 39% of people aged 15 or over in Mexico had a bank account [**see table**]. In the rest of the Latin America & Caribbean region, the corresponding figure was a little over 51%. In countries around the world that are at a broadly similar level of per capita incomes to Mexico, the figure is just over 70%.

Financial inclusion in Mexico

Key metrics, 2015 (% of people aged 15 or over unless indicated otherwise)

	Mexico	Latin Am. & Carib.	Upper Middle Income
Accounts	39.1	51.4	70.5
Accounts (adults belonging to the poorest 40%)	29.3	41.2	62.7
Mobile Accounts	3.4	1.7	0.7
Debit card	26.8	40.4	45.9
Had a debit card in 2011	22.3	28.9	38.5
ATM is the main mode of withdrawal (% with account)	69.1	71.1	55.7
ATM was the main mode of withdrawal in 2011 (% with account)	57.4	57.0	42.8
Used an account to receive wages	17.2	18.0	18.1
Used an account to receive government transfers	10.5	9.0	9.6
Used an account to pay utility bills	5.3	6.3	12.3
Sent remittances	10.6	9.5	15.4
Sent remittances via a financial institution (% senders)	53.2		37.2
Sent remittances via a mobile phone (% senders)	21.3		8.8
Sent remittances via a money transfer operator (% senders)	34.6		19.7
Received remittances	11.7	11.3	17.8
Received remittances via a financial institution (% recipients)	56.9	34.2	29.8
Received remittances via a mobile phone (% recipients)	13.1	4.3	5.6
Received remittances via a money transfer operator (% recipients)	37.6	28.4	17.9
Saved any money	58.4	40.6	62.7
Saved any money at a financial institution	14.5	13.5	32.2
Saved at a financial institution in 2011	6.7	9.6	25.1
Borrowed any money	50.8	32.7	37.7
Borrowed from a financial institution	10.4	11.3	10.4
Borrowed from a financial institution in 2011	7.6	7.9	7.9

Source: *World Bank, Little Data Book on Financial Inclusion, 2015 - p105.*

To the extent that they save or borrow money, Mexicans do not use banks. The World Bank found that 58% of Mexican adults saved some money in 2015. This is well ahead of the figure for the rest of the region, and only marginally lower than the figure for other upper middle income countries.

> "At around 69%, the number of Mexicans with bank accounts for whom Automatic Teller Machines (ATMs) are the main method of withdrawing cash is about the same as it is across the region, and well ahead of what it is in similarly wealthy countries."

However, only 15% saved with banks. Over half of Mexicans borrowed money in 2015, but overwhelmingly from family/ friends and other sources. Just over one tenth borrowed through banks.

A part of the problem is that too many people in Mexico's workforce work in the informal economy – and are largely cut off from the government's tax collection and social security systems. Less than a fifth of adults receive wages through a bank account. Just over one tenth use a bank account to receive government transfers; fewer still, to pay utility bills.

Nevertheless, the banks have been successful in distributing products and services to those Mexican adults who actually have accounts with them. A far greater percentage of Mexicans with bank accounts have debit cards or use mobile phone banking than do their counterparts in comparable countries. At around 69%, the number of Mexicans with bank accounts for whom Automatic Teller Machines (ATMs) are the main method of withdrawing cash is about the same as it is across the region, and well ahead of what it is in similarly wealthy countries. And, to the extent that Mexicans receive or send remittances, the banks account for a majority of the business.

The World Bank's data indicates that the numbers of people with bank accounts, the number of people who use debit cards or ATMs, and the people who borrow from or lend to financial institutions has increased – in some cases from very low bases – since 2011. However, it is impossible to avoid the conclusion that the lack of financial inclusion is a major structural problem for Mexican policy-makers. Until a lot more Mexicans become customers of the commercial banks, households will remain somewhat isolated from the global economy, and it will be more difficult than it need be for the government to implement social welfare policies.

Corporate Radar

Corpbanca and Itaú Fuse: On 1 April, the Chile-based Corpbanca and the local subsidiary of Brazil's Itaú Unibanco formalised their long-drawn-out merger process. The merged entity, the fourth largest bank in the Chilean market, will be known formally as Itaú Corpbanca. It will trade under the Itaú brand, and will have US$41bn in assets and a US$31bn loan book. The Brazilian parent, Itaú UInibanco will control the bank, with a 33.58% shareholding. CorpGroup, former owner of Corpbanca, will have 33.13% of the shares, with the remaining 33.29% in the hands of a range of minority shareholders. The merged Chilean bank will have a 66.28% controlling interest in Corpbanca Colombia and 100% of the shares of Itaú Colombia.

Flying Latin Americans: Despite the current slowdown in economic growth, Latin American aviation markets will see "robust expansion", various industry executives said at FIDAE, the Santiago-based international aviation fair. Germán Efromovich, president of Avianca Holdings, said that "future opportunities are immense", citing low market penetration. Latin America has 0.4 available aeroplane seats per capita, only one-sixth of the level in the US. At FIDAE, Boeing said that between now and 2035 the region will need to spend US$330bn to purchase 2,040 new commercial aircraft. Demand for air travel in Latin America has grown at an annual average of 7% over the last five years, above the global average of 5%, according to Brazilian plane manufacturer Embraer. According to the regional president of Airbus, Rafael Alonso, by 2034 nine of the world's 91 mega-cities will be Latin American, boosting the region's significance in terms of the global aviation market.

IMF and ECLAC agree that things are slow

The United Nations Economic Commission for Latin America & The Caribbean (ECLAC), followed by the International Monetary Fund (IMF), revised down economic expectations for the region in their respective Spring forecast updates, released in April.

ECLAC went first on 7 April, forecasting an overall annual contraction of 0.6% this year for the region, following on from its estimated contraction of 0.5% last year. The commission said its new, weaker forecast was evidence of "the difficult global scenario, in which low growth continues in developed countries, there is a significant deceleration in emerging economies (China in particular), increasing volatility and costs in financial markets, and low prices for commodities – especially hydrocarbons and minerals". "In addition", it added, "there is greater weakness in internal demand in the region's countries, with the decline in domestic investment accompanied by a deceleration of consumption."

As last year, there is a marked North-South discrepancy in the performance, with Mexico and Central America doing better than the Southern Cone, which is now suffering the triple whammy of deep recessions in Brazil and Venezuela and the continued oil and commodity price rout. As such, growth in Central America and Mexico in 2016 is forecast at 2.6% year-on-year, below the 2.9% registered in 2015, reflecting a slightly weaker performance in Mexico. In Central America too however, ECLAC also forecasts slower growth, of 3.9% year-on-year, compared to the decent 4.3% registered in 2015, when the sub-region enjoyed a rebound based on the US recovery and the strong fiscal benefit of reduced oil import costs. However, with US growth steady but not markedly increasing, and European and Chinese growth still in uncertain territory, coming months look to be less dynamic for the region.

Meanwhile, South America will register a contraction of 1.9% in 2016, with Brazil a major drag. Noting the cumulative impact of fiscal adjustments this year in several regional countries, ECLAC notes that efforts should be made "to protect the social gains achieved in recent years and avoid rollbacks in the face of a lower economic growth scenario. In this context, it suggests that countries "need policies that sustain social and productive investment in the framework of smart fiscal adjustments". Regional finances, it says, need to be made sustainable with "policies that take into account the impact on growth capacity in the long term, as well as the social conditions of the region's inhabitants". And in support of this, ECLAC repeats its well-worn mantra about the need to stimulate investment and increase productivity "so as to resume a path of sustained and sustainable growth in the long term".

Meanwhile, the IMF a week later said that Latin America and the Caribbean would post an overall contraction of 0.5% for a second year running in 2016, before strengthening to 1.7% in 2017. Again, it emphasised the substantial differences between the various performances. For Mexico, the Fund now forecasts a more moderate, but still positive pace of growth (2.4% in 2016 and 2.6% in 2017) "supported by healthy private domestic demand and spillovers from a robust US economy".

By contrast, the Fund expects Brazil to post an annual GDP contraction of 3.8% for the second year running, as the recession takes its toll on employment and real incomes and domestic uncertainties "continue to constrain the government's ability to formulate and execute policies". With many of the large shocks from 2015–16 expected to have run their course, and helped by a weaker

China – not SO bad

The IMF now expects GDP growth in China to slow to 6.5% in 2016 and 6.2% in 2017, which is a little better than its October 2015 forecast. This reflects another round of stimulus measures in China, however the Fund notes that further weakening is expected in the industrial sector, as excess capacity continues to unwind, "especially in real estate, related upstream industries, and manufacturing". This is not good news for Latin American exporters of iron, steel and other inputs to China. The IMF is hopeful that services sector growth in China will be robust as the economy rebalances from investment to consumption. Whether Latin American companies can position themselves in the race to supply the expanding Chinese services sector, however, is unclear. To date, it has not been a competitive advantage.

currency, growth is projected to turn positive during 2017, the Fund says, perhaps tacitly anticipating a change of government to a more orthodox, reform-minded and market-friendly administration. Hedging its bets however, the Fund notes that its Brazil forecast “is subject to large uncertainty”.

Venezuela is in deep recession and will stay there, the Fund says. Next door, Colombia too, suffering still from low oil prices and tighter macroeconomic and financial conditions, will decelerate to 2.5% this year, from 3.1% last year, which may make political life more difficult for President Juan Manuel Santos as he struggles to get a peace agreement with the country’s main left-wing guerrilla group, Fuerzas Armadas Revolucionarias de Colombia (Farc), over the line.

There are some bright spots in the region, notably including Peru, where a surge in copper output is driving up the headline result, which the Fund now puts at 3.1% in 2016 and 4.1% in 2017, setting a welcoming scene for the new government set to take office in July, which will be centre-right in hue. By contrast, in neighbouring Chile, where the fall in copper prices is exacerbated by the protracted decline in copper output, weighing on financing conditions at a time when the government is trying to fund its structural reforms, the IMF expects growth to slip to 1.5% this year, from 2.1% last year.

Finally, the IMF – for once – has nice words for Argentina, noting that “the ongoing push to correct macroeconomic imbalances and microeconomic distortions has improved prospects for growth in the medium term,” albeit it cautions that the adjustment will generate “a mild recession” in 2016.

Western Hemisphere Economies: Real GDP, Consumer Prices, Current Account Balance, and Unemployment

	Real GDP			Consumer Prices			Current Account Balance			Unemployment		
		Projections			Projections			Projections			Projections	
	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017
North America	**2.3**	**2.3**	**2.4**	**0.4**	**1.1**	**1.7**	**–2.8**	**–2.9**	**–3.3**	...	...	...
United States	2.4	2.4	2.5	0.1	0.8	1.5	–2.7	–2.9	–3.3	5.3	4.9	4.8
Canada	1.2	1.5	1.9	1.1	1.3	1.9	–3.3	–3.5	–3.0	6.9	7.3	7.4
Mexico	2.5	2.4	2.6	2.7	2.9	3.0	–2.8	–2.6	–2.6	4.3	4.0	3.9
Puerto Rico	–1.3	–1.3	–1.4	–0.8	–0.6	1.2	...	...	...	12.0	12.0	11.9
South America	**–1.4**	**–2.0**	**0.8**	...	...	...	**–3.8**	**–2.8**	**–2.2**	...	...	...
Brazil	–3.8	–3.8	0.0	9.0	8.7	6.1	–3.3	–2.0	–1.5	6.8	9.2	10.2
Argentina	1.2	–1.0	2.8	...	...	19.9	–2.8	–1.7	–2.2	6.5	7.8	7.4
Colombia	3.1	2.5	3.0	5.0	7.3	3.4	–6.5	–6.0	–4.3	8.9	9.8	9.4
Venezuela	–5.7	–8.0	–4.5	121.7	481.5	1,642.8	–7.6	–6.6	–2.5	7.4	17.4	20.7
Chile	2.1	1.5	2.1	4.3	4.1	3.0	–2.0	–2.1	–2.7	6.2	6.8	7.5
Peru	3.3	3.7	4.1	3.5	3.1	2.5	–4.4	–3.9	–3.3	6.0	6.0	6.0
Ecuador	0.0	–4.5	–4.3	4.0	1.6	0.2	–2.9	–2.3	–0.2	4.8	5.7	6.5
Bolivia	4.8	3.8	3.5	4.1	4.0	5.0	–6.9	–8.3	–7.1	4.0	4.0	4.0
Uruguay	1.5	1.4	2.6	8.7	9.4	8.4	–3.9	–3.9	–3.7	7.6	7.8	7.6
Paraguay	3.0	2.9	3.2	2.9	3.8	4.5	–1.8	–1.2	–1.1	6.1	6.2	6.1
Central America	**4.1**	**4.3**	**4.3**	**1.4**	**2.7**	**3.2**	**–4.0**	**–3.9**	**–4.0**	...	...	...
Caribbean	**4.0**	**3.5**	**3.6**	**2.3**	**4.1**	**4.3**	**–4.1**	**–3.4**	**–3.5**	...	...	...
Memorandum												
Latin America and the Caribbean	–0.1	–0.5	1.5	5.5	5.7	4.3	–3.6	–2.8	–2.4	...	...	...
East Caribbean Currency Union	2.2	2.6	2.5	–0.6	–0.1	1.3	–12.2	–11.7	–12.5	...	...	...

Source: *IMF*

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