CANNING HOUSE EDITION

latin american economy & business

August 2014 - EB-14-08

ISSN 0960-8702

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This edition of *Latin American Economy & Business* has been produced for Canning House Corporate Members by LatinNews (www.latinnews.com).

Latin American Newsletters since 1967

Colombia – looking good but no room for error

President Juan Manuel Santos began his second four-year term in office on 7 August. He made some adjustments to his ministerial team, but re-confirmed Mauricio Cárdenas as his finance minister. Many business groups will applaud the decision: Colombia has kept strong market-friendly economic policies in place, and seems set to experience continuing real GDP growth of around 4%-5% per annum, coupled with low inflation (a combination that currently seems beyond the grasp of regional giants Brazil and Mexico). But looking at the economy from the perspective of the challenges posed by a possible future peace settlement shows that there is little room for complacency.

With the economy motoring along, it might be said that all that needs doing by the new government is a bit of tinkering. Real GDP was up by a strong 6.4% year-on-year in the first quarter, driven by booming construction, strong household consumption and dynamic investment flows (particularly in infrastructure, oil and mining). This strong showing prompted Finance Minister Cárdenas to consider increasing the government's official growth forecast for this year, which stands at 4.7%. Growing domestic consumption is underpinned by a falling unemployment rate (now down to 9.2%, from 9.9% a year ago). The Central Bank edged up the monetary policy intervention rate by 25 basis points to 4.25% on 31 July. This is pre-emptive fine-tuning: annual inflation in the 12 months to June was 2.8%, comfortably within the 2%-4% target range. While running a deficit (currently calculated at around 2.5% of GDP), the government has a reputation for being fiscally conservative, and is expected to keep public sector finances well controlled.

Compared to elsewhere in Latin America, Colombia is doing extremely well. Depending on how the data is calculated, many argue that it now has pushed past Argentina to become the region's third largest economy, after Brazil and Mexico. While the UN's Economic Commission for Latin America and the Caribbean (ECLAC) recently downgraded its 2014 regional growth forecast (to 2.2%) Colombia was one of only two countries (the other being Ecuador) to have its growth forecast upgraded. The international credit ratings agency Moody's Investors Service recently pushed up Colombia's rating one notch above investment grade (to Baa2), to which Cárdenas tweeted in response, "This is the first time in history that Moody's has given us such a high rating".

At the beginning of August, the central bank president José Darío Uribe predicted real annual GDP growth next year of around 4.8%, with inflation broadly unchanged at around 3%. "All the information we have shows that consumption will maintain an important pace… equal and even maybe superior to the average of the last 10 or 12 years" he stated. He argues that Colombia is producing at close to its maximum installed capacity. Analysts at Bancolombia believe that actual growth will be close to the potential trend

growth rate, which they calculate at 4.3%-4.5%. Moody's thinks the country's big investment in road infrastructure (the next wave, known as Cuarta Generación or 4G, is due to start in 2015) could push up the potential trend growth rate to 5.0%-5.5% over the next five to 10 years.

There are two sets of reasons to be cautious however. The first concerns potential downside macroeconomic management risks that the Santos administration needs to keep monitoring; the second, much deeper-rooted structural issues connected with the search for a peace settlement with the country's guerrilla movements. Among the first are some of the unwanted by-products of success. Chief among them is a strengthening currency. As Colombia tightens its interest rates to keep domestic inflation in check, and as foreign direct investment (FDI) flows increase, the tendency has been for the Colombian peso to appreciate, boosting imports and undermining export competitiveness. The peso has been appreciating since March this year, and some analysts believe the trend will continue for the rest of this year and well into 2015. Scotiabank recently commented that "the external sector is the weak link in the country's outlook", although it added that a current account deficit equivalent to around 3% of GDP will be adequately financed by capital inflows. Other analysts note that Colombia has become more dependent on exports of two key commodities – oil and coal – which could be a significant risk going forward.

"Colombia, arguably, has done a lot less than many of its neighbours to tackle rural poverty and extreme inequalities of income, issues that have fuelled recurring social and political protests over the last half-century and which will need to be tackled in any lasting peace agreement."

But the really big challenges are the structural ones posed by the attempt to reach a peace settlement with the country's rebel groups. Colombia, arguably, has done a lot less than many of its neighbours to tackle rural poverty and extreme inequalities of income, issues that have fuelled recurring social and political protests over the last half-century and which will need to be tackled in any lasting peace agreement. The country had a Gini coefficient of 55.9 in 2010 (the higher the score on a 0-100 scale, the greater the inequality of income distribution), making it one of the most unequal in the region, worse than Brazil, Mexico, and Peru. While the Santos government says it has made some progress on this front (the Gini coefficient fell to 53.9 in 2012), there is still a long way to go.

More dramatically, Juan Ricardo Ortega, the outgoing head of Colombia's tax agency (DIAN), has said: "We face a brutally unequal society, where 25% of the wealth is held by 1% of the population, and land ownership is one of the most concentrated in the world, with a Gini score of 85.0". Colombia lacks basic and comprehensive social security initiatives like Brazil's successful Bolsa Familia programme of conditional cash transfers. It also has much lower taxes (the tax burden is 15% of GDP vs. 37% in Brazil). Brazil may pay a price for having such a high tax burden in terms of bureaucracy, red tape and state interventionism in business, but Colombia, by contrast, pays a high price for having such a low tax rare in terms of poverty and festering social and political conflict. The quality of public education, for example, is abysmally poor.

One of the key issues concerns the future of agriculture. Unequal access to land has held back agricultural development, as has the violence across large parts of the country. The strength of the peso has also been a disincentive to agricultural exports, and at times it has appeared as if agriculture is a very low priority for the Santos administration. But areas like the eastern *llanos* (across the departments of Meta, Cauca, Vichada and Vaupés) are said to have an agro-industrial potential as great as the Brazilian *cerrado* and are attracting growing interest from Brazilian and Argentine maize and soya farmers. Developing this potential would require large-scale commercial cultivation, and a reform of land ownership, which might be resisted by both the old land-holding elite and peasant small holders. But on some estimates, developing this area could bring as much as an additional US$5.0bn per annum to Colombia's export earnings.

REGION

A better deal from the new Development Bank?

At their sixth annual summit meeting, held in Fortaleza, Brazil in July, the heads of state of the five BRICS nations (Brazil, Russia, India, China and South Africa) took the potentially momentous decision to create a New Development Bank (NDB), which eventually should have US$100bn in capital backing, and agreed to set up a Contingent Reserve Arrangement (CRA) between them, also worth US$100bn. Some have seen these two steps as a political response to the limitations of the Bretton Woods Agreement (coincidentally, reached almost exactly 70 years earlier in July 1944), which created the two pillars of the international financial system, the World Bank (WB) and the International Monetary Fund (IMF). Does this BRICS initiative offer a better deal to Latin America's developing economies, and an answer to the long-standing critics of WB-IMF conditionality?

The BRICS initiative certainly reflects long-standing frustration with failed attempts to reform the World Bank and the IMF, but does not appear intended as a lock, stock and barrel replacement of those two well-established institutions. Brazil's President Dilma Rousseff was clear on the latter point, insisting that the NDB and the CRA "were not created against anyone, but for our own benefit". She and the other four heads of state said the New Development Bank would have an initial capital of US$50bn (with US$10bn contributed by each country), would fund development projects within the BRICS countries and elsewhere, and would have its headquarters based in Shanghai (there will also be an African regional office in South Africa). The capital base eventually will be doubled to US$100bn. Key posts at the NDB will rotate. The first president will be an Indian, the first president of the board of directors will be a Brazilian, and the first chair of the board of governors (a body that will set overall strategic direction) will be a Russian. The CRA, on the other hand, is based on a range of contributions, depending on the size of each economy (China contributes an initial US$41bn, Brazil, Russia and India each chip in with US$18bn, and South Africa puts up US$5bn). The CRA starts out as a BRICS-only agreement for mutual currency swap assistance in the event that any individual member suffers a financial crisis or foreign exchange shortages.

One of the reasons the BRICS are setting up the NDB/CRA duo is that they feel under-represented within the WB/IMF system. It is estimated that the five BRICS, with 40% of the world's population, have accounted for a full 50% of global economic growth over the last decade, making up 25% of global GDP and representing 18% of global trade. But under current arrangements, the US government always appoints the head of the World Bank and the role of IMF managing director always goes to a European. Despite their 25% share of world GDP, the BRICS have only 10.3% of IMF voting rights. The US government led by President Barack Obama has recognised that IMF governance arrangements are out of date and proposed some limited reforms, but these have been deadlocked, due to Republican opposition in Congress.

"The bank is vitally important to the BRICS, because it gives the five countries the capacity to act as a group. Just as the World Bank is used as a mechanism to turn G20 decisions into action, the BRICS' New Development bank can turn the BRICS' words into action."

Christopher Wood, South African Institute of International Affairs

So the BRICS are going it alone. "The bank is vitally important to the BRICS, because it gives the five countries the capacity to act as a group. Just as the World Bank is used as a mechanism to turn G20 decisions into action, the BRICS' New Development bank can turn the BRICS' words into action", says Christopher Wood of the South African Institute of International Affairs. It does remain to be seen if all the BRICS, with their different political and economic systems, can agree on the same words and actions, of course. Although the precise modus operandii of the NDB has yet to be worked out, the initial suggestion is that it will focus on helping meet the immense deficit in

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developing countries' infrastructure needs. As such, it may be less of a World Bank clone and perhaps will be modelled more closely on Brazil's National Development Bank (BNDES) or the China Development Bank. In recent years both, incidentally, have lent more money than the World Bank itself.

The conditionality imposed by the IMF and, to a lesser extent, the World Bank, has been much criticised, so a key question is whether the NDB/CRA duo will be different. The answer is probably yes and no. Yes, in that lending criteria are almost certainly going to be drawn up in a different way. No, in that some form of conditionality is inevitable. Clearly, China's desire to promote 'soft power' and its reluctance to focus on the human rights record of the countries it assists will be influential. Russia is facing sanctions from the US and Europe over its role in the Ukraine, but there was no mention of that in Fortaleza. However, there is an inherent tension within the BRICS between the democracies (Brazil, India, South Africa) and the more authoritarian political systems (Russia, China), yet all seem agreed on keeping overt political conditionality out of the funding picture. A paper by the US Brookings Institution even suggests that, "The BRICS are not looking to replace the Western-led order. They are purchasing an insurance policy against the risk of US sanctions".

One initial difference in approach suggested by Kevin Gallagher, an economic development expert at Boston University, is that the NDB will "put a premium on infrastructure and energy, which was the World Bank's model in the 1970s, and which got them into trouble with local environmentalists". Nowadays, the World Bank tends to steer clear of funding coal mining projects, as they are considered environmentally damaging. But China and India rely heavily on coal for electricity generation, and Russia and South Africa are key exporters. So the NDB may be much more flexible in its approach to fossil fuels, and might help push experimental technologies like carbon capture and storage (CCS). This could be beneficial for Latin American coal producers such as Colombia. Armond Cohen, executive director of the US-based Clean Air Task Force, welcomes this, as he thinks anti-coal sentiment has gone too far, with people believing that if coal use is forcibly reduced, somehow "everyone's going to have wind and solar". As he puts it, "the disconnect between the actual power requirements of the BRICS and other developing countries and what people in Washington think is do-able is almost surreal. So this could be a very healthy wake-up call".

Many economists welcome the NDB not as a replacement for, but as an addition to, the World Bank and other developing economy lenders. Zhao Xijun of Renmin Univerity in Beijing suggests that "the additional competition will push multilateral institutions to improve". It is not as if there are too many of them, or too few capital projects needing funding. On the contrary, on most estimates existing infrastructure needs stretch way beyond the international financial system's ability to fund them. According to economists Amar Bhattacharya, Mattia Romani and Nicholas Stern, developing economies' infrastructure investment needs are set to rise from 3% of GDP now to 6%-8% in 2020. Other estimates put the development finance shortfall at over US$1.0trn per annum. World Bank lending rose from US$25bn in 2007 to US$60bn in 2010, but has subsequently fallen back to an estimated US$30bn in 2013. For most Latin American countries (and especially so for Brazil) the need for significant new sources of infrastructure funding is acute. So the NDB is likely to be seen as a welcome new source of help.

As for borrowing to overcome balance of payments difficulties and foreign exchange shortages, the CRA is clearly nowhere near to replacing the role of the IMF. For a start, it is being launched as a closed club, with its five members committed only to helping each other, and doing so in a tightly prescribed fashion. In times of difficulty, China will be able to draw down half its contribution to the CRA, while Brazil, India and Russia can call on 100% of their contribution and South Africa will be able to take out double its US$5bn share.

Anything above that will be subject to agreement, and with the five countries following very different economic policies, that won't necessarily be easily granted. Nevertheless, the IMF's managing director, Christine Lagarde, congratulated the BRICS on setting up the reserve arrangement and said the Fund would be "delighted" to work with them on an international safety net to preserve financial stability. And from her perspective, Brazil's President Rousseff said: "We have no interest in giving up the IMF – on the contrary, we are interested in democratising it, making it more representative".

The conclusion, therefore, is that Latin American countries will welcome a potentially important new source of infrastructure investment funding but will not find in the BRICS proposal a comprehensive alternative to the IMF. For the foreseeable future, all lenders can be expected to impose some form of conditionality on their borrowers. Latin American countries that reject the IMF – whether Venezuela, Ecuador or Argentina to name a few – will still have to deal with the fact that 'non-traditional' lenders will demand some kind of guarantees or conditions from their debtors. This was highlighted recently when the Argentine government, in dispute with holdout creditors in the US, refused to acknowledge that it had entered a selective default on its external debt. Government officials furiously criticised US ratings agencies like Standard & Poor's (S&P) for declaring that the country had defaulted. But they failed to highlight the fact that China's equivalent – Dagong Global Credit Rating – had also ruled that Argentina is in default, a decision that could have a negative effect on recently announced Chinese loans to the country, including a US$2bn programme to invest in the Belgrano Cargas freight railway.

ARGENTINA

The software company with global ambitions

Rising inflation, deepening recession, a black market dollar, a country that almost won the World Cup in July, but ended up arguing with 'vulture funds' and defaulting on foreign debt in the same month: no-one can say that Argentina hasn't recently had its share of turbulence and volatility. But what may be more surprising is that out of this rather chaotic background has emerged a hi-tech software company with global ambitions, and which has just launched a successful Initial Public Offering (IPO) on the New York Stock Exchange (NYSE).

On 18 July, Argentina's Globant became the first Latin American software company to list on the NYSE, initially pricing its shares at US$10 each. By the closing bell they had risen to US$11.25, raising US$66m and valuing the 11-year old company at almost US$400m. Globant has developed a blue-chip list of clients for its software services, including the likes of Google, LinkedIn, American Express, Coca-Cola, Disney, Electronic Arts, JWT and Zynga. It has sharply boosted its revenues to US$158m in 2013 (up from US$90m in 2011). Over the same period, profits doubled to US$14m.

"Chief Executive Martín Migoya acknowledged, but did not sound excessively concerned about, the difficulties of operating out of Argentina.... "Argentina is a great place to be, with a deep talent pool", he stressed."

Chief Executive Martín Migoya acknowledged, but did not sound excessively concerned about, the difficulties of operating out of Argentina. "Costs have been pretty stable in recent years in dollar terms" he told the *Wall Street Journal*, noting that the difficulty of an annual 30% inflation rate was offset by currency depreciation. "Argentina is a great place to be, with a deep talent pool", he stressed. The IPO prospectus mentioned Argentina's sovereign debt dispute with some of its creditors, acknowledging that, "our ability to obtain US dollar-denominated financing has been adversely affected by these factors." But Migoya was sanguine, saying the company could still raise credit in the US, emphasising, "we don't see it as a major problem."

This confidence may reflect the company's global focus, and a feeling that it has developed a powerful proposition in the ultra-competitive software world. The company has described what it does as combining "the engineering and technical rigour of IT service providers with the creative approach and culture of digital agencies". Still part-owned by the founders (Migoya, Guibert Englebienne, Martín Umarán and Néstor Nocetti), Globant also relies on the advertising agency WPP and on the Riverwood and FTV investment funds as partners. WPP has a 20% stake. Globant now employs just over 3,000 engineers, developers, marketing specialists and designers, spread across 14 cities in Argentina, Brazil, Colombia, Uruguay, the US and the UK. Globant's largest markets are the US and UK. It is focusing on the opportunities it sees emerging in mobile, cloud computing, social networks and big data. To exploit them, it believes it has to be strongly innovative and visually and design-led.

The chief information officer of one of Globant's clients (who did not wish to be identified) told *IDG Connect*: "They are funky fellows. They are really on top of the latest stuff and they go after stuff that tends to have a big visual impact. They feel like the kind of teams that would work in trendy advertising but they can really code too. I really hoped they wouldn't sell out to one of the big boys and they haven't." Globant also has a kind of Californian feel to it, in contrast with the more conventional and hierarchical engineering-led business process outsourcing (BPO) outfits. It works in loose teams and says it has six 'core values' for its staff (these are: act ethically, be a team player, constantly innovate, aim for excellence, think big and have fun). It could be a test case for the proposition that good and well-executed business ideas can prosper in the global marketplace, despite local difficulties.

BRAZIL

Battle for GVT

A takeover battle developed in August for Global Village Telecom (GVT), the Brazilian telephony and broadband provider majority-controlled by Vivendi of France. The battle looked like a straight contest between Telefónica of Spain and Telecom Italia.

Telefónica made the first move on 4 August, with an offer valued at around EUR 6.7bn (US$9bn), comprising two parts. The Spanish company said it would pay around US$5.3bn in cash and shares for the controlling stake in GVT, and in addition would give Vivendi the right to buy up to an 8% stake in Telecom Italia shares held by Telefónica. Reducing Telefónica's stake in Telecom Italia would help meet Brazilian regulatory concerns, but at the same time gaining control of GVT would give Telefónica an extra edge in Brazil, allowing it to combine its leadership in mobile (through the Vivo brand) with the fast-growing online video streaming market led by GVT. Ralph Szymczak, an analyst at Germany's Landesbank Baden-Wuerttemberg, commented: "This is an absolutely sensible move from Telefónica. They are trying to get out of Italy and would strengthen their Brazilian business through a merger with GVT".

"Reducing Telefónica's stake in Telecom Italia would help meet Brazilian regulatory concerns, but at the same time gaining control of GVT would give Telefónica an extra edge in Brazil, allowing it to combine its leadership in mobile (through the Vivo brand) with the fast-growing online video streaming market led by GVT."

But by 17 August sources quoted by *Bloomberg* were saying that Telecom Italia was preparing a bigger counterbid for GVT worth around EUR7bn (US9.4bn). According to these sources, Telecom Italia's CEO, Marco Patuano, had earlier expressed an interest in GVT and preliminary talks had been held, only to be upstaged by the Spanish bid. Telecom Italia was said to be proposing a merger of its Brazilian mobile holding company Tim Participaçoes and GVT, also as a mobile and broadband convergence play, and offering up to 20% of its own shares to Vivendi. There were also reportedly discussions on bringing in Vivendi's pay-TV company, *Canal Plus*, into a broader multimedia alliance.

Petrobras on the right track, and investors think so too

Recent comment in the mainstream and financial media on Petrobras' level of indebtedness, the unprofitability of its refining and marketing business in Brazil, the technical difficulties of extracting oil and gas from the pre-salt basins and various legal problems miss the point. The company performed well during H114 and is on track towards achieving its planned doubling of production to 4.2m barrels of oil per day (bpd). As production from the pre-salt basins is increased, the company's cash flows should improve.

It is easy to find evidence of the challenges facing Petróleo Brasileiro SA (Petrobras), Brazil's listed (but predominantly state-owned) gigantic oil company. In late July, the ratings agency Moody's Investors Service suggested that the company's credit metrics would deteriorate until 2016, after which time, higher production should boost cash flow. Moody's highlighted how the increase in production will depend on greater output from the massive pre-salt basins off the south-eastern coast Brazil: the oil is at extremely great depths and is difficult and expensive to extract. Financial journalists have long focused on government policies preventing Petrobras from lifting the prices of (significantly imported) diesel and gasoline to bring them in line with international prices. The result is that Petrobras' very substantial refining and marketing (R&M) business segment is unprofitable. Ahead of the October 2014 general election, a congressional inquiry has been examining Petrobras's purchase – apparently at a grossly inflated price – of a refinery in Pasadena, Texas, in 2006 when President Dilma Rousseff, who is seeking re-election in October, was chair of the Petrobras board. There have also been allegations of corruption in relation to the construction of the Abreu e Lima refinery in Northeastern Brazil. Earlier this year, Paulo Roberto Costa, a senior Petrobras executive, was arrested as a result of a major police investigation into money laundering. Without prejudice to the various allegations and police investigations, it is the case that corruption allegations (and congressional investigations) involving Petrobras have become par for the course in general election years in Brazil, when the opposition is on the attack.

> "Moody's Investors Service suggested that the company's credit metrics would deteriorate until 2016, after which time, higher production should boost cash flow."

However, the share price of Petrobras tells another story. The price of the approved depository receipts (ADRs) that are listed on the New York Stock Exchange (NYSE) reached an all-time high of a little over US$70. In the wake of the global financial crisis, the ADR price slipped from around US$40 in early 2010 to a nadir of about US$11 in March 2014. Since then, the price has recovered to US$18. As we explain below, Petrobras and its management have been performing well through H114. The results for the first six months of the year were published on 8 August 2014.

As **chart 1** (*overleaf*) shows, the company's cash holdings (including small positions in government bonds) slipped from US$32.8bn at the end of June 2013 to US$30.1bn at the end of 2013. However, the cash position had slipped to US$19.75bn at the beginning of 2014. Cash generated from operations amounted to US$10.5bn in H114, and the company's net raisings from global bond markets (i.e. proceeds from issues of new bonds less payments for maturing bonds) amounted to US$19.6bn. This amount included the US$5.1bn that Petrobras raised from European investors and the US$8.5bn raised in North America early in 2014. Petrobras also generated US$1.1bn from divestments. Cash from these sources amounted to US$31.1bn. The cash was applied to capital expenditure (US$17.2bn) and dividends (US$3.9bn). As is indicated by Moody's, Petrobras still needs to raise money from bond investors, and particularly those that are based outside Brazil.

Shares up, Silva up

Petrobras shares in New York hit a 52-week high of US$19.32 on 27 August after the company announced it had found more gas and light oil at its second extension well. The ultra-deepwater well, 3-BRSA-1244-SES/3-SES-182, or Moita Bonita-3, is located in the Sergipe-Alagoas Basin, 82kms off the coast of Sergipe. Meanwhile in Brazil, the company's share price rose 4.6% to R$22.8 as polls put Marina Silva ahead of Dilma Rousseff in the presidential race. Silva has promised fiscal reform and less intervention in state companies.

Chart 1: Cash Flows - Summary (US$mn)		
	H113	**H114**
Adjusted cash at beginning of period[1]	**23,732**	**19,746**
Cash generated from operations	15,281	10,394
Capital expenditure[4]	-20,418	-17,185
Divestments[5]	1,542	451
Change in investable securities	-96	604
Net cash flow	**-3,691**	**-5,736**
Proceeds from long-term financing[2]	29,672	27,341
Repayments	-13,993	-7,699
Dividends paid	-1,386	-3,916
Other[3]	-1,494	-394
Adjusted cash at end of period[1]	**32,840**	**30,130**
1. Includes holdings of government bonds		
2. Includes US$5.1bn raised in Europe in January 2014 and US$8.5bn raised in North America in March 2014		
3. Mainly impact of exchange rate changes on cash and cash equivalents		
4. Capex was down for both E&P and R&M relative to H113.		
5. Divestments were boosted in H113 by sale of African assets		
Source: *Petrobras*		

Chart 2: Petrobras Debt Summary (US$mn)			
Maturity	**31-Dec-13**	**30-Jun-14**	**Change**
2014	8,001	7,671	-330
2015	7,266	6,767	-499
2016	12,692	13,162	470
2017	8,679	12,314	3,635
2018	16,051	18,673	2,622
2019 or later	61,547	81,025	19,478
Total	**114,236**	**139,612**	**25,376**
NB US$68,112mn of the debt is floating rate BRL and US$ denominated debt amount to US$28,143mn and US$96,340mn respectively			
Source: *Petrobras*			

And the absolute amount owed by the company to bond investors continues to grow. As **chart 2** shows, total debt rose from US$114.2bn at the end of 2013 to US$139.6bn at the end of June. The latter number is inflated by the general softness of the Brazilian Real through the first half of this year.

However, other data published by Petrobras in its half-year report identifies a number of positive trends. As noted above, the company's paper is seen as an attractive opportunity by global investors: indeed, the vast majority of the debt is denominated in foreign currencies. Over the course of the first six months of the year, Petrobras extended the maturity profile of its debt. The percentage that matures in 2019 or later has increased to 58%. Floating rate securities account for just under half of the outstanding debt. Petrobras should gain a partial benefit from a fall in bond yields over the long term: conversely, it is not fully exposed to a rise in bond yields.

The slippage in capital expenditure from US$21.67bn in H113 to US$18.1bn (i.e. including the cash payment of US$17.2bn plus an increase in amounts payable to suppliers of US$905m) may seem anomalous for a company that is committed to roughly doubling its production from the current level of just over 2.0m bpd to 4.2m bpd in 2020. However, almost all of the reduction is accounted for by a drop in capital expenditure in Petrobras' currently unprofitable R&M business segment and in its operations outside Brazil. The details are shown in **chart 3**.

Chart 3: Capital Expenditure Summary (US$mn)		
	H113	**H114**
Exploration & Production	11,809	11,739
Refining & Marketing[1]	7,106	4,128
Gas & Power	1,189	1,132
All Others[2]	1,561	1,091
Total	**21,665**	**18,090**
1. Including transportation		
2. Drop is mainly due to 47% fall in capex outside Brazil to US$554mn		
Source: *Petrobras*		

“The firm's return on equity in the first six months of this year was around 6%, having been 10% in the previous corresponding period. We would assess that the slippage in profitability is only temporary. Given the payment of the dividend to shareholders, that appears to be the view of the Petrobras management as well.”

Net income slipped from US$6.7bn in H113 to US$4.8bn in H114. This was partly due to the softness of revenues in US$ terms, although they were higher by 12% relative to the earlier period in Real terms. Costs of sales were US$1.22bn higher than they had been in H113, thanks in part to the impact of the slippage in the currency on the costs of imports. Much of the deterioration in profitability was taken by the R&M business segment, which posted an operating loss of US$5.8bn – in part because of the official requirement that it sell imported gasoline and diesel at a loss: the government's cap on retail prices is a measure to protect household budgets from some of the ravages of inflation. However, Petrobras is a vertically integrated operation, and most of its other business segments are profitable. The profits from outside Brazil slipped from US$1.67bn in H113 to US$485m in H114: this was the result of Petrobras having sold foreign assets since the earlier period. Crucially, the exploration and production (E&P) segment, which plays a central role in the company's planned expansion, lifted its operating profit from US$14.2bn in H113 to US$14.25bn in H114. The details are shown in **chart 4** (*overleaf*).

As is the case with the company's discussion of its debt profile, Petrobras's explanation for the rise of expenses is a source of encouragement about the general direction that the company is headed. Other operating costs soared from US$911m in H113 to US$2.7bn in H114. However, the latest figure included US$1.0bn arising from the Voluntary Separation Incentive Plan – a scheme to pare headcount in an orderly way (and one that focuses mainly on older workers). In H114 there were also higher write-offs of dry wells (US$512m) and areas returned to the Agência Nacional do Petróleo, Gás Natural e Biocombustíveis (ANP), the government agency that regulates the energy industry. These are essentially one-off costs. Petrobras noted that cost savings under its long-term program to boost efficiency amounted to US$2.1bn in H114 achieved, or 39% more than expected. In short, the decline in profits could have been a lot worse.

The US$4.78bn in net income that was achieved in H114 needs to be considered in the context of total equity, which rose from US$149.1bn at the end of December 2013 to US$164.5n at the end of June this year. The firm's return on equity in the first six months of this year was around 6%, having been 10% in the previous corresponding period. We would assess that the slippage in profitability is only temporary. Given the payment of the dividend to shareholders, that appears to be the view of the Petrobras management as well.

> “In summary, both equity and bond investors believe that Petrobras is on track to develop its massive pre-salt reserves so that the increase in production of oil and gas easily compensates for declines at its longer-established projects. We agree.”

Chart 4: Income Statement (US$mn)

	H113	H114
Sales revenues[1,2]	**71,914**	**71,404**
Cost of sales[3]	-53,428	-54,647
Gross profits	**18,486**	**16,757**
Selling expenses	-2,383	-2,397
General/admin. Expenses	-2,489	-2,240
Exploration	-1,225	-1,454
R&D	-624	-520
Other taxes	-232	-278
Other operating costs[4]	-911	-2,696
Operating profit[5,6]	**10,622**	**7,172**
Net finance expense	-1,019	-495
Profits from associates	266	343
Profit-sharing	-321	-282
Net income before income tax	**9,548**	**6,738**
Income taxes	-2,879	-1,963
Net income	**6,669**	**4,775**
Minority interests	181	-270
Profits attributable to shareholders	**6,850**	**4,505**
1. Total sales volumes in H114 were 3% higher, overall.		
2. Sales revenues were up 12% in BRL terms.		
3. Cost of sales was 15% higher in BRL terms in part because of higher import costs.		
4. H114 boosted by Voluntary Separation Incentive Plan (US$1,005mn), higher write offs of dry wells (US$512mn), and areas returned to the ANP (US$222mn).		
5. The contribution of the various Business Segments are:		
E&P	14,231	14,255
R&M	-5,009	-5,793
Gas & Power	998	627
Biofuel	-72	-60
Distribution	888	652
International	1,665	485
Corporate/Other	-2,079	-2,994
	10,622	**7,172**
6. Savings in relation to operating costs under the PROCOP program were US$2.1bn, or 39% more than expected in H114.		
Source: *Petrobras*		

Meanwhile, the company’s balance sheet remains reasonably strong. As **chart 5** shows, total debt of US$139.7bnn is less than equity (including shareholders’ funds, retained earnings etc.). Total assets rose during the first six months of the year from US$321.4bn to US$363.4bn. Current assets have risen by US$12.85bn to US$65.5bnn, while current liabilities have slipped by US$1.06bn to US$32.16bn. The growth in trade receivables and inventories over H114 appear reasonable for a company that is lifting its output.

In summary, both equity and bond investors believe that Petrobras is on track to develop its massive pre-salt reserves so that the increase in production of oil and gas easily compensates for declines at its longer-established

projects. We agree. Production from the pre-salt basins now amounts to 0.5m bpd, which is three times the level of 2012 and one quarter of the current total. Cashflow in the short term should be boosted by further divestments of non-core assets: press reports in late July indicated that Petrobras was close to selling its (remaining) 40% stake in gas distributor Gasmig to a partnership comprising the Minas Gerais power utility Cemig and Spain's Gas Natural Fenosa. Profits in the coming six months should benefit from further progress with the management's programme to boost productivity and to cut costs. In her comments to shareholders about the H114 result, Chief Executive Officer Maria das Graças Silva Foster noted that the company "remains committed to adjusting Brazilian prices for oil products with those in the international market in order to achieve the Net Debt/EBITDA and leverage targets within the limits and deadlines" set by the Board in late 2013. It is possible that Petrobras will have greater scope to set retail prices for gasoline and diesel after the forthcoming general election.

"Chief Executive Officer Maria das Graças Silva Foster noted that the company "remains committed to adjusting Brazilian prices for oil products with those in the international market in order to achieve the Net Debt/EBITDA and leverage targets within the limits and deadlines."

Chart 5: Balance Sheet (US$bn)

	31-Dec-13	30-Jun-14
Cash	15,868	26,397
Marketable Securities	3,885	3,739
Trade receivables	9,670	10,630
Inventories	14,225	16,984
Other current assets	9,007	7,752
Investments	6,666	7,114
Property, plant & equipment	227,901	253,955
Intangibles	15,419	16,326
Other non-current assets	18,782	20,495
Total Assets	**321,423**	**363,392**
Trade payables	11,919	12,509
Current debt	8,017	10,685
Taxes payable	4,950	5,020
Other current liabilities	10,340	5,953
Non-current debt	106,308	129,025
Deferred taxes	9,906	12,737
Pension/medical benefits	11,757	13,105
Other non-current liabilities	9,103	9,889
Total liabilities	**172,300**	**198,923**
Equity	**149,123**	**164,469**
Total Equity and Liabilities	**321,423**	**363,392**
Memo Items:		
Retained earnings etc.	*41,156*	*56,389*
Total debt	*114,325*	*139,710*
Current assets	*52,655*	*65,502*
Current liabilities	*35,226*	*34,167*
Source: *Petrobras*		

WTI discount to Brent widens

WTI for October delivery closed at US$93.4/b on the New York Mercantile Exchange on 26 August, the lowest close since 14 January last. Meanwhile Brent crude for October delivery was trading at US$102.65/b on the ICE Futures Europe exchange in London. Spreads between WTI and Brent are widening on expectations of falling fuel prices in the US, thanks to its growing shale supplies. US production hit 8.5m bpd in July, the most since April 1987, according to the EIA's 12 August monthly Short-Term Energy Outlook.

What could go wrong for Petrobras?

The planned growth of Petrobras is based on the assumption that the profits and cashflow from its massive pre-salt reserves of oil and gas are sufficient to offset the impact of declining output from its long-established fields. An obvious question is: what are the main risks to this optimistic view?

In his presentation of the Petrobras second quarter results, Almir Guilherme Barbassa, the company's chief financial officer, noted that the lifting costs for the pre-salt oil is US$9 per barrel – although this figure should fall as production volumes grow. Excluding the cost of the infrastructure, production from the pre-salt reserves should be profitable provided that the price of oil remains above US$45 per barrel. Including additional facilities to evacuate gas, that figure rises to around US$50 per barrel.

The US Energy Information Administration (EIA) released its latest Short-Term Energy Outlook (STEO) on 12 August. The EIA expects that, globally, supply of and demand for oil will remain broadly balanced. It envisages surplus oil production capacity of 2.1m bpd on average in 2014 and 2.7m bpd in 2015. The EIA noted that unplanned disruptions to supply remained at a high level of about 3.2m bpd in July, of which Libya accounted for one third.

The EIA noted that the North Sea Brent crude price slipped by around US$5/barrel (/b) in July to US$107/b. July was the 13th consecutive month in which the price of North Sea Brent crude remained in a fairly narrow band of US$107-US$112/b. The EIA estimates that the average crude oil price, by this yardstick, should be US$108/b in 2014 overall, and US$105/b through 2015. The EIA anticipates that the West Texas Intermediate (WTI) crude oil price in the US will be US$7/b lower than the North Sea Brent crude price through the second half of 2014, and US$9/blower in 2015.

In short, Petrobras' pre-salt oil can be extracted at a cash profit unless a crisis in the global economy (for instance, as a result of dislocations within China's financial system) causes oil prices to fall by more than one half. Of course, if the global price of crude oil were to fall to, say US$60 per barrel, the impact on Petrobras' return on equity would be adverse.

If problems in China's financial system represent one wildcard (albeit an indirect and geographically remote one), another wildcard is much closer. This is the possibility that supply of oil and gas (and other products) in Southern South America increases greatly as a result of the development of the shale deposits at Argentina's Vaca Muerta formation. Obviously, this could have an impact on prices across the sub-region.

For now, we would suggest that the unknowns associated with the development of Vaca Muerta are considerable. One is the likely output. Press reports indicate that the second phase of the project, which began in April 2014 and may require total investments of US$16bn by YPF and Chevron, will result in production of 50,000 bpd of oil and 3.0m cubic metres per day of gas. With output from Petrobras pre-salt reserves rising to a new record of 546,000 bpd on 13 July, we would conclude that the Brazilian company will remain the pre-eminent supplier in the region.

A separate question is: to what extent will the oil and gas produced from the Vaca Muerta formation actually reach customers outside Argentina? There are early indications that it will be sold mainly to producers of petrochemicals and other products within the country: in essence, the various protagonists see import substitution as a major objective of the development of shale oil and gas in Argentina.

The bottom line is that a precipitous slide in the market price of the oil and gas extracted by Petrobras from the pre-salt reserves is a possibility, but not a probability. Given the performance of the company's share price in 2014, and investment appetite for the bonds that Petrobras has issued, we would conclude that many other observers are sanguine about the company's plans. We are confident that the development of Vaca Muerta will not pose problems for the Brazilian company.

MEXICO

Peña Nieto steps on the gas

Almost a year exactly after unveiling his ambitious energy reform proposals, on 11 August Mexico's President Enrique Peña Nieto was able to sign them into effect: a total of 21 new or amended laws were promulgated on that day. Just two days later, he was announcing the results of the 'Round Zero' allocation of oil and gas rights, and outlining plans for 'Round One' due to be held next year.

The president is in a hurry, and it is not hard to see why. Petróleos Mexicanos (Pemex), the state oil company, is on a downward trend. Its oil production has dropped steadily in the last decade, from a peak of 3.38m barrels per day (bpd) in 2014, to 2.52m bpd last year and an expected 2.44m bpd this year, as some of its bigger fields become depleted. Constantly squeezed for tax revenue by a cash hungry government, Pemex is now making a loss and simply can't afford the more capital-intensive development of deep-sea deposits in the Gulf of Mexico and non-conventional onshore resources such as shale oil and gas. A high-cost, low-profit energy sector seems to be holding the rest of the economy back: GDP growth has been disappointingly sluggish. High electricity costs blunt the competitive edge of Mexican manufacturing. Politically, Peña Nieto desperately needs to inject some dynamism into the economy and get some concrete results to show the electorate before his term in office runs out in 2018.

> "Although Pemex loses its monopoly status under the reforms, the government intends it to remain the major player."

Step in Round Zero and Round One. Although Pemex loses its monopoly status under the reforms, the government intends it to remain the major player. So in Round Zero it was given an exclusive prior chance to keep its best oil and gas fields. The regulator (Comisión Nacional de Hidrocarburos [CNH]) gave the company almost everything it asked for in terms of proven and probable reserves (83% of the total), but awarded a much smaller proportion of prospective resources (21% of the total, less than the 31% it had requested). The energy ministry says that what Pemex was given will allow it to have a production 'floor' of around 2.5m bpd for the next two decades. By associating directly with foreign companies on some projects it may deliver more. But is hoped that the big boost to output will come from Round One, to be held next year, when international oil companies will be able to bid for some of the remaining 17% of proven and probable resources, and some of the 79% of prospective resources (including potentially significant deep sea and non conventional fields). The government is hoping that opening up the sector will trigger a major inflow of investment. Deputy Finance Minister Miguel Messmacher says he expects total hydrocarbons investments to double from around US$30bn a year now to US$60bn by 2018.

Will it work? Speaking to *Latin American Economy & Business*, the Mexican energy specialist David Shields (who edits *Energía a Debate*) thinks it is possible, but warns that the plan is extremely ambitious and that the timeline is very tight. The plan to start Round One early next year (and to complete it by September 2015) is challenging. CNH is short of trained staff. Detailed geological survey and scientific data is "dispersed and heterogeneous" and not in a consistent format. There are worries about transparency and corruption. "It is not just the government, the companies need time too," he says. "A company might need to get a semi-submersible rig into the Gulf of Mexico, a giant piece of equipment that might be in use in Norway right now. These kinds of things need to be planned well in advance and managed as major projects". In his view, the problem is that the information needed for a company to decide whether to bid for Round One, and whether it will stand a reasonable chance of making a commercial return, is not yet available and will only emerge gradually. The CNH, however, will open prior consultations with potential bidders, "which is standard procedure on a number of

Mexican tenders". Another specialist, George Baker of *Mexico Energy Intelligence*, said he had detected a degree of "wait and see" among the big Houston-based energy companies. On the other hand, he noted one big plus point: "The Mexican side of the Gulf of Mexico is the largest unexplored petroleum province on the planet, perhaps outside the North Pole".

CENTRAL AMERICA & MEXICO

The economics of La Bestia

La Bestia ('the beast') is the generic name given to a number of slow freight trains that work their way through Mexico and have become notorious for carrying mainly Central American migrants and refugees northwards, as they attempt to get into the US. The large number of under-age children taking this perilous journey, coupled with US concerns over border security and immigration in an election year, has catapulted La Bestia into the headlines. As we try to show here, it is part of an interrelated multi-billion dollar ecosystem of legal and illegal businesses.

Hundreds of thousands of Central Americans (mainly from Guatemala, El Salvador, and Honduras) try every year to get across Mexico and into the US as illegal immigrants. This human tide – according to some estimates half a million people a year – is caused by a combination of pull and push factors. Among the former, the desire for a better life and to attain the 'American dream'. Among the latter, the need to escape gang violence, poverty and extortion. The flow of people from South to North has created a complex economy if its own, linking different types of otherwise unrelated businesses.

"According to a report by the United Nations (UN) in 2010, people-smuggling from Latin America into the US is a US$6.6bn per year business."

At its centre is the people-trafficking or 'coyote' business. The coyote is the middleman paid by travellers to arrange the trip. According to a report by the United Nations (UN) in 2010, people-smuggling from Latin America into the US is a US$6.6bn per year business. Migration experts and other sources say that the price each immigrant pays for the service is somewhere between US$5,000 and US$10,000, which is broadly consistent with the UN estimate, considering that many also face additional forms of extortion and ransom demands along the way. The profit per migrant has been loosely estimated at US$3,500-US$4,000, with the proviso, made by Rodolfo Casillas of the research group FLACSO in Mexico, that "we're talking about a market where chaos reigns".

Estimated costs of people trafficking

Item:	Cost in US$
Boatmen at Mexico's southern border: cost of crossing the Suchiate River from Guatemala.	1.5
Lodging: cost per room, which can hold many migrants.	11.50 per night
Central American gang (e.g. El Salvador's Mara Salvatrucha or MS). Cost per migrant to be allowed to board *La Bestia*.	100
Mexican police and immigration officials bribe.	230.00 to 540.00
Release fee per detained immigrant.	40
Northern Mexico drug cartels: cost per Central American immigrant (note Mexican immigrants pay less, European or Asians more).	500.00-700.00, plus 10% flat fee per smuggler crossing into US
Boatmen on northern Mexico border with US: fee for crossing the Rio Grande per immigrant.	100
Drivers: cost of ride from Rio Grande to stash house, or from any point north of US Border Patrol to Houston.	150.00- 200.00
Caretaker at stash house, per immigrant per day.	US$20

Source: *Associated Press*

The structure of the coyote business is not unlike that of tour operators and guides in the legal tourism business. Many coyotes appear to be independent contractors putting together 'package deals' and negotiating the necessary arrangements with different parties along the way. A number have lived in the US and speak good English. Today's coyotes use *Facebook* and *Skype* as essential tools of the trade. Alan Villeda, a people-trafficker operating out of San Pedro Sula in Honduras, told the *Reuters* news agency that when he started in 1998 he had to contact his clients on bad telephone lines. Nowadays, people contact him directly through *Facebook*; they use social media to keep in touch with friends and family who have made it into the US. In contrast to the drug smuggling business, where the drug cartels keep absolute and watertight control of the merchandise at every step, coyotes sub-contract different parts of the process and may cover only a section of the trip. In Southern Mexico, they know they have to pay a flat fee per migrant to the Central American gangs. In Northern Mexico, they know they instead have to adapt to the business rules of the Mexican drug cartels, which insist on payment of a 10% flat fee commission on anyone crossing their territory or *plaza* (the same rate applied to retail drug sellers).

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'Antonio Martínez' (most probably a false name), a coyote who spoke to the *Associated Press* in July, said he charged US$2,500 a head for moving people from the Guatemalan to the US border, where he gave them fake Mexican identity cards and made them learn the first stanza of the Mexican national anthem before passing them off to another coyote (that meant that if caught they'd be deported to Mexico, not their country of origin, allowing them to try again).

Another smuggler said the all-in rate was US$10,000, and that covered everything from hotel and train payments to official bribes and 'cartel taxes'. This man said that a drug cartel could occasionally demand an extra US$5,000 on threat of death. "You have to be careful with the Zetas. They cut you in pieces and videotape it", he said.

The Mexican-Guatemalan border is widely described as 'porous', meaning that there are few effective border controls. However, there are rather more Mexican police and immigration posts dotted around the road network in a fairly wide area to the north of the border, particularly in Chiapas state. For this reason, immigrants have preferred to use the freight trains as a better way to avoid officials and travel northwards during the Mexican section of their journey.

There are two freight tracks. One starts in the north of the isthmus at Tenosique, running into Veracruz and from there onwards to Lechería in Estado de México, to the north of Mexico City. The southern route also goes through Veracruz and then it too leads on up to Lechería. From here further routes to the US border are available. The shortest and therefore most popular of them lead to Reynosa and Nuevo Laredo, on the border with Texas. This is why the Texas border is under most pressure. The southern track used to start in Tapachula, near the border with Guatemala, but the line was damaged by Hurricane Stan in 2005 and remains largely abandoned. Instead trains now start from Arriaga some 240kms further on. Many immigrants walk to Arriaga along the unused rail tracks. A report by the Washington Office on Latin America (WOLA), published earlier this year, says "for years migrants on this journey have been robbed, beaten, sexually assaulted, and even killed, particularly in an area commonly known as La Arrocera in Huixtla municipality".

The operation of the freight trains is of course a legal business, which since the privatisation of the Mexican rail system in 1996 is largely run by four private companies (although the state remains responsible for the track in a number of

areas). Three of the freight companies are Ferromex, Ferrosur and Kansas City Southern de México (KCSM). The fourth is Ferrocarril Chiapas Mayab (FCCM), which works with Ferrocarril Istmo de Tehuantepec (FIT). The main business is hauling cargo like cement, construction steel, scrap, sand, corn, wheat, diesel fuels and industrial detergents. These are freight trains, but hundreds of migrants ride illegally and dangerously on the roofs of each wagon.

Univisión, the US-based Hispanic TV news network, has pointed out that these companies are wholly or part-owned by high profile Mexican and US businesspeople. Mexico's Carlos Slim, one of the world's richest men and owner of telephony giant América Móvil, has a stake in Ferromex, as does the mining impresario Germán Larrea, known as 'The King of Copper', and the US rail group Union Pacific. KCSM shareholders include Rodney Slater (the former US secretary of transportation under President Bill Clinton [1993-2001]), and the former US ambassador to Mexico, Antonio Garza. Another shareholder is the Republican congressman Kenny Marchant, who has opposed President Barrack Obama's recently submitted emergency bill to respond to the unaccompanied minors crisis on the border.

The rail companies stand accused of doing little to protect the safety of the migrants – who admittedly use their trains illegally – but who are exposed to accidents, derailments and threats of violence from the gangs. It is also frequently claimed that railway staff themselves are guilty of abusing and extorting those riding illegally on top of the freight wagons. Responding to some of these criticisms, FCCM recently said it was planning to invest US$150m to upgrade the track on its section and increase train speeds from 10 to 30kms per hour, which it said would make it more difficult for illegal riders to board them. The company's deputy director general, Maria Isabel Pons, said "the moment you increase the speed you make the tracks safer, because these people aren't going to be able to climb aboard. People are climbing aboard because the quality of the operation has fallen and the trains are slow". She added that the company aimed to use a new technique to solder rail lines together, replacing the current system whereby they are bolted together with steel plates. As it is easy to unbolt the plates, allowing gangs to force the trains to stop on pain of derailment, this too would improve security.

Kansas City Southern de México, on the other hand, has warned of legal action against various media outlets. The company says it does not "own or operate La Bestia" and that the number of illegal immigrants boarding trains on the routes it does operate is "minimal". A lawyer for the company noted that "KCSM has a robust security system aimed at preventing illegal migrant trespassing, protecting cargo, and preventing vandalism and accidents, and complies strictly with the security rules and regulations in close coordination with public security authorities at three government levels in Mexico". Various journalists acknowledge on this point that La Bestia is a generic term, and does not refer to any specific freight train or operating company used by the migrants; but some insist that they have evidence of migrants riding KCSM trains at various points in the network.

One person evidently not convinced of the companies' record is Veracruz State Governor Javier Duarte de Ochoa, who in March this year filed a formal complaint against KCSM and Ferrosur with the federal prosecutor's office, charging them with "presumed responsibility by action or omission in the violation of the human rights of migrants". The case says the companies were complicit in various crimes against the migrants, including robbery, human trafficking, kidnapping, murder and extortion. The Veracruz state prosecutor, Luis Angel Bravo Contreras, said there was evidence of "strange or suspicious stops and decreasing speeds just before robberies occur". In press statements at the time, KCSM said it would cooperate with the investigation.

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REGION

ECLAC reduces growth forecast

In August the Economic Commission for Latin America and the Caribbean (ECLAC, also known under its Spanish acronym, CEPAL) became the latest multilateral institution to cut back its regional growth forecast.

The UN commission now says regional GDP growth this year will be only 2.2%, down from its earlier 2.7% projection, made in April, and down from the 2.5% result achieved in 2013. The ECLAC reduction had been preceded by a similar revision by the IMF, which in its World Economic Outlook, published in July, reduced its growth forecast for Latin America to 2.0%, down from its earlier forecast of 2.56% in April of this year. ECLAC attributed the change to weaker external demand, something of a slowdown in domestic consumption growth, insufficient investment, and a lack of new economic policy initiatives. For the region as a whole, ECLAC said the most important downside risk was slower growth in China. Key Latin American commodity exporters could suffer if the Chinese growth rate slips under 7%. On the plus side, however, some of the world's other leading economic areas, such as the US (and to a lesser degree the European Union [EU]), seemed set to strengthen their recovery towards the end of this year, boosting demand for Latin American exports.

"For the region as a whole, ECLAC said the most important downside risk was slower growth in China."

The various regional economies are showing quite wide variations in expected performance. The more pessimistic outlook for the region as a whole in part can be explained because some of the bigger economies are lagging behind the average. These include Brazil (only 1.4% growth predicted for this year), Argentina (0.2%), and Venezuela (-0.5%). Mexico, the number two economy, is expected to do a little (but not much) better than the average (+2.5%), as manufacturing exports to the recovering US economy begin to rise. The fastest-growing Latin American economies this year tend to be small- to medium-sized. The ranking is led by Panama (6.7%) and Bolivia (5.5%), followed by Colombia, the Dominican Republic, Ecuador and Nicaragua (all forecast to post annual GDP growth of 5.0%).

While noting the need for short-term business cycle management, ECLAC in its report stresses the importance of planning for the long term, investing in infrastructure, and raising productivity. "Macroeconomic policy must be reoriented, seeking to create the conditions for sustained growth and increased productivity. For that to happen, it is necessary to foster greater investment (public and private) in infrastructure and innovation and to boost the diversification of production," the report said.

ECUADOR

The new monetary and financial code: not a roadmap to ruin

Ecuador's new Monetary and Financial Code (Código Monetario y Financiero), due for final approval as we went to press in late August, has been widely criticised in the mainstream and financial press, on fears that it effectively formalises the ability of the left-wing government and the (government-controlled) Banco Central del Ecuador (BCE) to direct banks and other private sector actors. In reality, the new Code confirms powers that are available to governments in many other countries, and it will not necessarily result in outcomes that are detrimental to Ecuadorean financial institutions or their customers.

In mid-August, President Rafael Correa asked the unicameral National Assembly controlled by his ruling political vehicle, Alianza País (AP), to consider some amendments to the new Code, notwithstanding that he is happy with the general thrust of the Code. A central feature is the creation of a new Monetary and Financial Regulatory Council (to replace the existing regulator), which will be appointed by the executive. This new Council will have the ability to direct lending to particular sectors of the economy. It also will have the ability to quantify the amount of lending and the price (i.e. the interest rate). The Code also confirms that the BCE has the exclusive right within Ecuador to issue currency. Ecuador has been dollarised since 2000, after a major banking crisis in 1998-1999. The BCE already issues some small coinage and will shortly begin to issue an 'electronic dollar' to facilitate electronic payments in the country (via mobile phones), which also has caused some concern.

Widespread commentary in the main opposition and financial press has suggested that the new Code makes it likely that Ecuador's banks will be required to lend on non-commercial terms, in order to support sectors that the new Council considers in need of additional credit (like micro, small- and medium-sized companies). The assumption is that the interests of bank shareholders will be subordinated to government policy.

Discussion of the new Code has been complicated by associated developments. The first was the announcement in mid-August that the BCE had reached an agreement with the local mobile telephone company, Movistar (owned by Spain's Telefónica), to set up a new mobile payments system to use the electronic dollar. This payments system is similar to existing schemes in other developing countries: the overall aim is to boost access to basic financial services for people that may have a mobile phone but not a bank account. Some critics suggest that having the BCE manage such a payments system (in other countries such schemes tend to be privately managed) would facilitate its ability to boost the level of US dollars circulating within Ecuador's financial system. Indeed, one key aim of the new monetary code is to boost domestic liquidity in the country. (Notably, the electronic dollar will be entered as a liability on the BCE's balance sheet).

> "Unless abused wholesale, the new Monetary and Financial Code is not a roadmap to financial ruin."

The second development is a proposal by the ruling AP that Ecuador's private pension funds should be placed under the control of the Banco del IESSS (BIESS – the financial arm of the state owned social security agency). Holger Chávez, who oversees the National Assembly's commission for labour rights, has advocated that any of the 64 private pension funds in the country that have ever received support from the state should come under the aegis of BIESS. If his proposal is implemented, control of 54 of the funds would pass to BIESS. By far the most important of the 54 is the Fondo de Cesantía del Magisterio Ecuadoriano (FCME – the fund that serves the country's teachers), which has around 150,000 members and whose assets under management (AUM) account for nearly half of the US$928m held by the 54 funds. Critics, including the Unión Nacional de Educadores (UNE – the main teachers' union) argue that the proposal is illegal and discriminatory. Ecuador's centre-right opposition Partido Social Cristiano objects to the fact that the proposed reform is retroactive, and suggests it should instead only apply to new funds established after the reform takes effect.

Arguably, critics of the new monetary and financial code and associated reforms are alarmist. Greater formal control of a financial system by a government and/or a central bank is only negative if that control is abused, with the result that resources are allocated in a way that completely fails to recognise economic and financial realities. The discussion of the Monetary and Financial Code and the two other proposals has generally overlooked the late May agreement between the Correa government and the International Monetary Fund (IMF) in late May 2014, whereby both parties would resume Article IV negotiations for the first time since 2008. This was a necessary step ahead of Ecuador's recent return to international capital markets for the first

time since its selective default on US$3.2bn of external debt in 2008-2009. Although it seems that the negotiations will take place as a one-off exercise, Ecuador's government appears more, rather than less, committed to orthodox economics than it has been in the past (not least for financing reasons, and notwithstanding its sizeable accrued loans with China). (Relatedly, Ecuador has also recently restored relations with the World Bank.)

In the meantime, Ecuador's macroeconomic fundamentals are no longer a source of alarm. The IMF is looking for economic growth to remain at 3.5%-4.0% over the coming years. In part because of dollarisation, inflation is expected to remain steady at 2.5%-3.0%. Unemployment is stable at about 5%. The current account deficit is growing, but should, according to the IMF, peak at 3.8% in 2016. The budget deficit is expected to be of a similar scale – in a country where central government debt amounts to 25%. Per capita incomes, at US$4,300 or so, are low, but are rising.

"Those critics of Code that deplore the formalisation of the government's ability to direct the flow and pricing of credit in Ecuador ignore several important facts. One is that governments that wish to direct the flow of credit often do so without being empowered by a formal Code. Another is that the direction of credit, at controlled prices, by central banks has become the norm and not the exception."

Although we recognise that the proposal to bring the private funds under the control of BIESS has some similarities to the nationalisation by Argentina's government of private pension funds in that country in late 2008, we would stress that Ecuador's economic and fiscal situation is quite different to that of Argentina nearly six years ago. How the Ecuadorean pension funds are run over the coming years matters much more than the formal system of governance. As the figures cited above indicate, Ecuador's government does not face a fiscal crisis.

Attempts by the government and the BCE to promote financial services to first time users who have mobile phones are, in principle, admirable. However, these attempts are unlikely to come to much unless they involve Claro, the dominant mobile telephone services company that is owned by Mexico's América Móvil: Claro has a 66% market share. The agreement with Movistar is a necessary but not sufficient condition for the new system to flourish.

In general, there is no reason why a central bank should not run a payments system for which the infrastructure is provided by mobile phone companies. In Kenya and other developing countries that have pioneered mobile phone-based payments systems, the amount of money within the system has been boosted by the purchase of deposits with physical notes and coins, and by the normal growth of the economy.

There is no reason why this should not be the case in Ecuador. Although it might be possible for the central bank to irresponsibly expand the money supply using a new payments system as a vehicle, it does not mean that the BCE will actually do this – regardless of what the new Code may say or imply.

Those critics of the Code that deplore the formalisation of the government's ability to direct the flow and pricing of credit in Ecuador ignore several important facts. One is that governments that wish to direct the flow of credit often do so without being empowered by a formal Code. Through the modus operandi of the enormous Banco Nacional de Desenvolvimento Econômico e Social (BNDES), Brazil's government has considerable control over the flow of credit in that country, but is not subject to opprobrium as a result. Further afield, it is taken for granted that the authorities in China will at least try to direct the pricing and destination of credit within that highly monetised economy.

Another is that the direction of credit, at controlled prices, by central banks has become the norm and not the exception. In different ways, the asset purchase programs operated by the US Federal Reserve and the Bank of Japan in recent years have involved aggressive expansion of credit and the direction of that credit to particular sectors of the economy. So too has the Bank of England's Funding for Lending Scheme (FLS) and the European Central Bank (ECB)'s targeted longer-term refinancing operations (TLTROs).

None of these institutions, or the governments with which they are associated, have been exposed to derision because of these policies. It seems a little unjust that Ecuador's government and the BCE should be overly criticised for the legislative adoption of the new Monetary and Financial Code, although President Correa's fiery language – he says that the new Code will obliterate the vestiges of the 'neo-liberal' banking system that led the country into crisis in 1998-1999 – inevitably raises hackles.

It is theoretically possible that the Ecuadorean government and the BCE will embark on disastrous economic and monetary policies under the new Code. However, the evidence suggests otherwise. President Correa – a US-trained development economist – is nothing if not a micro manager. The new Code will generate a lot of headlines and commentary. But unless abused wholesale, it is not a roadmap to financial ruin.

ECUADOR

Correa govt optimistic about EU trade deal benefits

"We have closed the negotiations and closed them well," Ecuador's foreign trade minister, Francisco Rivadeneira, said on 11 August in reference to the trade agreement struck with the European Union (EU) in July. A long legislative journey awaits before the trade accord can take effect but Rivadeneira was keen to stress that it had been "a very positive negotiation for Ecuador", with widespread benefits for exporters and "extremely small" costs which were "difficult to identify". He argued that the repercussions of failing to reach an accord would have been very negative, with "enormous unemployment in the country".

Ecuador completed its association agreement, to use the preferred nomenclature, with the EU on 17 July in Brussels. It will be at least two years before the accord actually takes effect though, as it now has to endure a laborious and labyrinthine passage through the European parliament, the parliaments of all 28 EU member states, and Ecuador's national assembly. In the meantime, Rivadeneira said Ecuador had won a promise from EU negotiators to use "all their political will in order to ensure that the products that don't [presently] pay a tariff continue exempt until the accord takes effect."

EU response
"It [the association agreement] will provide for a solid and predictable framework for Ecuadorean and European traders and investors and will also contribute to regional integration in one of the fastest-growing markets for European firms in Latin America," the EU trade commissioner, Karel de Gucht, said. "We now have to take the necessary steps to make sure the agreement is applied as quickly as possible."

The trade benefits that Ecuador enjoys with the EU under the General System of Preferences (GSP Plus) expire in December 2014, when its exporters would technically stand to lose significant ground to Colombian and Peruvian counterparts because of higher tariffs. Peru and Colombia signed a free trade-deal with the EU in 2012 as part of the Andean Community (CAN) trade bloc, which was provisionally applied with Peru in March 2013 and with Colombia in August last year.

Ecuador's export federation, Fedexport, says that Ecuadorean exports would face tariffs of between 2% and 40% to enter the European market without the GSP in place, costing exporters about US$375m annually. Currently, 60% of Ecuador's total exports benefit from the GSP.

The EU is Ecuador's biggest market for non-oil exports. Ecuador had a very small trade surplus with the EU in 2013, with its exports to the bloc totalling €2.5bn (US$3.4bn), and its imports from the EU amounting to €2.4bn. Ecuador's export sector is optimistic that exports to the EU could rise by around US$500m under the association agreement.

Banana boost

Ecuador is the biggest supplier of bananas to the EU. Almost one in four bananas traded in the EU last year came from Ecuador. Failure to secure a trade agreement with the EU would have seen Colombia muscle in and ultimately usurp Ecuador's position of pre-eminence. Eduardo Ledesma, the

Mayor Jaime Nebot accused President Correa of trying to strip the port of Guayaquil of its pre-eminence, leaving it with "tourism, coasting trade or the crumbs of freight to the Galápagos islands". He said the government had refused to dredge to 15m at the port even though it was "technically possible" and said Correa was not watching over the port of Guayaquil's interests but wanted to "attend its burial". He also accused Correa of conspiring to isolate private ports and cast doubt on his intention to construct the deepwater port in Posorja, claiming that he intended to build one "with public money in Manta" instead. Manta, located in the northern coastal province of Manabí, is the terminus for the 'multi-modal corridor' between Manta and the Brazilian city of Manaus, which aims to improve imports and exports between Asian markets and the Amazon.

president of the association of banana exporters of Ecuador (AEBE), described the agreement as "tremendously positive for the banana sector, since we had a fairly high tariff differential with Colombia."

Under the EU deal with Colombia, the banana tariff will fall each year to reach €75 (US$101)/t by 2020. Under the new structure, Ecuador's banana exporters will only pay €1 (US$1.35) per tonne extra compared to Colombia and Costa Rica from 2016-2019; and the same from 2020 onwards.

The current tariff of €132 (US$178) for Ecuador was set to fall to €122 (US$164) for 2015, but without a free trade deal in place with the EU, Ecuador would have had to pay on average up to €32 (US$43) per tonne extra over the same period. Based on last year's volume of banana exports, this equates to some €45m (US$60m) in savings. Ecuador's banana exports to the EU totalled US$667m in 2013, down 7% from US$715m in 2012; but they stand at US$359m for the first five months of 2014 compared with US$308m in the same period last year. Ecuador's banana exports to the EU in 2013 were more than double the amount produced within the EU, such as Spain's Canary Islands and the French departments of Guadeloupe and Martinique, which will now seek more protection via subsidies.

Other exports to gain

Other Ecuadorean exports that stand to benefit from the improved access to EU markets are shrimp, cacao, coffee, fruits, nuts and cut flowers. Shrimp exports to the EU totalled US$625m in 2013, up 27% from US$492m in 2012. Shrimp exports were also up by a whopping 45% in the first five months of 2014 to US$356m, compared with the US$245m of exports in the same period last year. Cacao exports reached US$139m in 2013, up 38% from US$101m in 2012. They are also up 39% in the first five months of 2014 to US$71m compared with US$51m of exports in the same period last year. Coffee and tea exports stood at US$138m in 2013, up slightly from US$132m in 2012.

Rivadeneira said 76% of Ecuador's exports would immediately enter the EU tariff-free. He also expressed the hope that the EU would also eliminate the requirement for visas, as it did with Colombia and Peru, although this was not included in the deal. He said that the government would implement "an arsenal of tools to reduce the negative effects" for certain sectors, including sensitive products like milk, meat, cereals and vegetables.

This is crucial, because the Ecuadorean government made a big song and dance about not signing up to the original trade deal along with Colombia and Peru in 2012. Fundamentally this was because of a pathological aversion to the concept of free trade (hence the insistence on the term 'association agreement'). It is not clear that Ecuador has negotiated a deal which is really any different in substance to other trade deals or exactly what the "arsenal of tools" Rivadeneira has at his disposal to protect sensitive products are; presumably it will mean subsidies of some sort.

Ecuador will receive zero-duty access to the EU market for industrial goods, which could assist Ecuador's agro-industrial industry. The EU will get better access to the country's public procurement, as well as Ecuador's adherence to the World Trade Organization (WTO) regulations regarding the protection of intellectual property rights. "I'm delighted we've been able to conclude this ambitious and comprehensive agreement with Ecuador," the EU trade commissioner Karel de Gucht said. "It will boost our bilateral trade and investment, and act as an important driver for development in Ecuador."

Deepwater port gets presidential go-ahead

Ecuador will seek investment to go ahead with the construction of a deepwater port in Posorja, a small fishing town at the delta of the Guayas River about 120km from the coastal city of Guayaquil, President Correa announced in mid-August.

In November 2013, the government contracted the Spanish state-owned consulting and engineering advisory firm Ingeniería de Sistemas para la Defensa de España (Isdefe) to find the ideal location for a 15-metre-deep-water port in the province of Guayas. Isdefe settled on Posorja. It is worth noting that in 2006, a US$450m concession to build and operate a deepwater port in Posorja was awarded to Spain's Alianza Internacional Portuaria (Alinport), but work never began and authorisation for it was later revoked. President Correa said there were three international companies interested in investing in the deepwater port now (he did not reveal which), adding that he had "no problem if it is private investment, mixed investment or public investment as long as it's quick".

The race is on because when the third set of locks in the Panama Canal open in 2015, it will mean that ships with up to a 15m draft will be able to pass through. The 'Simón Bolívar' port of Guayaquil currently only has a depth of 9m. At present 58% of national freight goes through the state-owned, independently managed port of Guayaquil, rising to 82% if the 22 private ports located on the access channel into this port are included. The president fired a broadside at these private ports, which he described as parasitic, contributing just 5% of their profits to the State. He also said that the government had looked into dredging to 15m metres at the 'Simón Bolívar' port but it was "technically and economically unviable", otherwise it would have done. The opposition mayor of Guayaquil, Jaime Nebot, begged to differ, and accused the Correa government of trying to undermine the country's main business hub, long opposition administered. Correa said this was nonsense, insisting that the Simón Bolívar port would continue operating, with the government seeking to make it a specialist destination for cruise ships which would be "extremely beneficial for Guayaquil".

> "The president fired a broadside at these private ports, which he described as parasitic, contributing just 5% of their profits to the State."

Posorja

Posorja has a population of around 28,000. The new deepwater port would not only allow bigger ships to dock but speed up the loading and unloading of containers. The transport and public works minister, María de los Ángeles Duarte, said that one of the drawbacks of the port of Guayaquil was that it was very slow for freight ships, dependent, among other things, on the tide. Posorja, currently a private port, would be transformed with renovated piers and docks, and the town would undergo a major facelift, with myriad infrastructure projects, including perimeter roads, a seafood distribution centre and housing programmes. President Correa promised to step in if 'speculation' pushed house prices up quickly.

VENEZUELA

Selling the family silver

Several developments since mid-July point to intensifying cash flow problems at the state oil company Petróleos de Venezuela (Pdvsa) and, by extension, in the central government.

In last month's edition, we noted that Pdvsa's annual accounts for 2013 indicated that both the company (and the government) were short of ready cash. Pdvsa made a profit of US$9.5bn from the sale of a 40% stake in a company called Entidad Nacional Aurífera (ENA) to the government: this was shortly after the government had essentially given ENA, with a notional value of US$30bn, to Pdvsa. Pdvsa had earlier made a one-off profit of US$7.8bn because of the impact of the February 2013 devaluation on its monetary liabilities in local currency Bolívares. Without these two items, the company's pre-tax profits would have been just US$6.3bn. In spite of this, Pdvsa paid the government a dividend of US$10bn.

Significantly, very little cash actually changed hands as a result of these transactions. When Pdvsa sold 40% of ENA to the government for US$12bn, it simply made a corresponding reduction to its accounts payable. When it paid the dividend, the reduction was made to accounts payable. The US$2bn difference between the payment for the stake in ENA and the (slightly smaller) dividend is immaterial for a company whose sales of oil and products last year amounted to US$114bn. All these transactions are in the context of a difficult operating environment. Stagnant production volumes and falling prices have caused revenues from oil and products to slip in each of 2011 and 2012. Capital expenditure of around US$65bn over the three years to the end of 2013 has not had a positive impact on production volumes. Meanwhile, rising operating costs have been eating into Pdvsa's cashflow. Pdvsa has cut back its contributions to the (off-budget) National Development Fund (Fonden) and other official social programs. Pdvsa also has been squeezing its suppliers and joint venture partners by delaying payments.

For a long time, Pdvsa had sufficient financial strength and cashflow to protect the government (via payments of royalties, taxes, contributions to social programs and dividends) from the generally downwards move in energy prices. Latest data suggests that this is no longer the case; and the positions of both the company and the government now look a lot more fragile than one or two years ago.

"In mid-August 2014, Dagong Global Credit, a major Chinese ratings agency, lowered its sovereign rating for Venezuela from BB+ to BB-. Among much else, Dagong commented on the likely weakness in the Venezuelan economy in the coming year."

We are not alone in this view. In mid-August 2014, Dagong Global Credit, a major Chinese ratings agency, lowered its sovereign rating for Venezuela from BB+ to BB-. Among much else, Dagong commented on the likely weakness in the Venezuelan economy in the coming year. Dagong is looking for real annual GDP to contract by 2.3% in calendar 2014, before growing slowly over the medium term. Dagong also pointed out that Venezuela's international reserves fell to 5.7% of GDP at the end of 2013 and covered only about one fifth of the country's (growing) external debt.

Two other recent developments suggest that the cashflow crisis is becoming acute. In late July, Venezuela's President Nicolás Maduro and his Chinese counterpart, Xi Jinping, signed 38 accords, including US$14bn in Chinese financing for development projects across a broad range of Venezuelan economic sectors, and not just in the extractive industries that have generally been the focus of Chinese foreign direct investment (FDI) into Latin America. The accords also included a US$4.0bn direct loan to the Venezuelan government.

In early August, Rafael Ramírez Carreño, who is Pdvsa president, oil minister and vice-president of economic affairs in the Maduro government, announced that Pdvsa is looking to sell its North American refinery business, Citgo Petroleum. Pdvsa bought a 50% stake in Citgo in 1986 from Southland Corporation, owner of the 7-Eleven retail chain. Pdvsa purchased the remaining 50% from Southland in early 1990. Citgo's three refineries – in Lemont, Illinois, Lake Charles, Louisiana and Corpus Christi, Texas – have a total refining capacity of 750,000 barrels per day (bpd). Exxon Mobil is a 50% shareholder in the Chalmette refinery in Lake Charles. The Lemont refinery is the only one of the three geared towards handling the light crudes produced in North America, as opposed to the heavy crudes extracted by Pdvsa in Venezuela. Citgo also owns a network of pipelines and 48 terminals. Press reports indicate that any sale of Citgo would not include some 5,600 independently owned, but Citgo-branded, retail outlets.

Citgo had raised US$650m through the sale of 6.25% bonds in July. The bond prospectus said that Citgo had sales of around US$43bn in 2013 and earnings before interest, taxes, depreciation and amortisation (EBITDA) of US$1.8bn.

"To put it in context, US$20bn is less than Pdvsa's annual capital expenditure, less than the amount that it pays each year to the government in taxes and royalties and less than the growth in accounts receivable last year."

Comments in the mainstream financial press have, quite reasonably, focused on price. Ramírez has been quoted as saying that Citgo is worth more than the US$10-US$15bn widely cited. However, the discussion has missed several key issues.

The first is that Citgo has a strategic value to Pdvsa that it would not necessarily have to another owner: Citgo's total capacity is equivalent to about one quarter of Pdvsa's total production. Even allowing for the fact that a significant portion of Pdvsa's output is committed to servicing loans and the government's obligations to partners in the Petrocaribe regional oil alliance – and for the fact that not all of Citgo's capacity is suited to heavy Venezuelan crudes – the refining company represents a reliable client that is geographically close to Venezuela. In essence, the proposed disposal of Citgo looks like a 'sale of the family silver' transaction that is yet another indication of the plight that the Pdvsa/the Caracas government finds itself in.

The second is that the Chinese government sees support of, or at least stability in, Venezuela as a significant geopolitical objective – even though one of China's leading ratings agencies has publicly drawn attention to Venezuela's growing risk profile.

Most important, though, is that a sale of Citgo for even US$20bn would buy only a brief respite for Pdvsa/the Caracas government. The oil company is suffering from falling energy prices, rising operating costs and a demanding shareholder. For its part, the government has not made any significant changes that would address the massive, and widely documented, distortions in Venezuela's economy. To put it in context, US$20bn is less than Pdvsa's annual capital expenditure, less than the amount that it pays each year to the government in taxes and royalties and less than the growth in accounts receivable last year. The cash flow crisis is set to continue.

LATIN AMERICAN ECONOMY & BUSINESS is published monthly (12 issues a year) by **Latin American Newsletters**, 61 Old Street, London EC1V 9HW, England. Telephone +44 (0)20 7251 0012, Fax +44 (0)20 7253 8193 Email: subs@latinnews.com or visit our website at: **http://www.latinnews.com**. Subscription rates will be sent on request. Overseas subscription sent by airmail. **EDITOR: EILEEN GAVIN**. **CONTRIBUTORS: ANDREW THOMPSON, ANDREW HUTCHINGS.** Printed by Quorum Print Services Limited, Units 3&4, Lansdown Industrial Estate, Gloucester Road, Cheltenham, Glos. GL51 8P.

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