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Markets react to Chile cliff hanger

Chile is widely seen as one of the more stable and predictable Latin American democracies, which in recent times has seen peaceful alternations in power between broadly business-friendly governments of the centre-left and of the centre-right. But after the first round of this year's presidential election on 19 November, there is greater than usual uncertainty over who will win on the second round on 17 December. Immediately after the poll, share prices and the Chilean peso weakened.

The markets and pollsters had been expecting the centre right candidate Sebastían Piñera, a former president (2010-2014), to defeat his main contender Alejandro Guiller (an independent supported by the ruling centre-left Nueva Mayoría coalition). While Piñera was expected to fall short of the 50% support needed to win in the first round, he was widely seen as the best positioned to win the run-off. This would then pave the way for him to lead a government pursuing a new set of market-friendly economic reforms, "correcting" some of the current centre-left government's less market-popular innovations, and setting things up for a strong economic recovery.

That script may still prove right. But the markets were rattled by a few surprises. First, Piñera won the first ballot, but by significantly less than expected, taking 36.64% of the vote. Second, although Guiller, somewhat identified with the unpopular outgoing government, put in a relatively weak performance (taking 22.7% of the vote), another candidate on the Left, Beatriz Sánchez of the Frente Amplio (FA) coalition, who, according to the opinion polls was due to get around 14%, surprised everyone by capturing 20.27% of the vote.

Therefore, depending on how voters switch allegiances in the second round, the race is still wide open. Piñera may win, but it is numerically possible for Guiller, supported by a swing from Frente Amplio voters, to snatch that victory away from him.

The first-round vote also throws up another thought. Some analysts are saying that the 2017 elections might not have been about the perennial Left-Right divide, but about something new: the need to rejuvenate Chilean politics. Voters may have been turning away from traditional parties and politicians and looking for new faces. That would potentially play in favour of Guiller and against Piñera. With elections due next year in Brazil and Mexico, Chilean voters could be the pioneers of a wider regional swing in favour of candidates positioning themselves as independents and outsiders.

In the Chilean context, however, what the business community really needs to know is the shape and direction of economic policy under the next government (2018-2022). Until the second round, this is not an easy question to answer.

Piñera has been promising that if elected he will boost investment and double the country's growth rate (from around 2% at present). He also promises to adjust the tax and labour reforms introduced by the incumbent centre-left government led by Michelle Bachelet. Other priorities include modernising the constitution, promoting decentralisation, and taking action to reduce the country's housing deficit.

However, even if victorious in the second ballot, it is expected that Piñera will lack an outright congressional majority, meaning that his reforms may face resistance. In the Chamber of Deputies, current projections are that Piñera's Chile Vamos coalition will have 73 of 155 seats, prompting consultancy Capital Economics to comment that "a new wave of market-friendly reforms now looks less likely". In its view, a Piñera government would be able to attract cross party support for fiscal consolidation measures, but might have greater difficulty getting backing for its plans to cut corporate tax rates and reduce red tape in the mining sector.

Guiller, on the other hand, has said his economic policy priorities are to boost public investment in infrastructure and housing, devolve government spending decisions to the regions, reform mining royalty payments, "consolidate" the current government tax reform, and create one million new jobs.

He too wants constitutional reform. He also promises to guarantee the right to education, health, housing, and pensions. However, if elected, he too will lack a congressional majority. Indeed, he may have to adjust his policies to the Left in order to seek Frente Amplio support. As such, despite the market anxiety for a quick answer, the economic policies of the next government may depend on political deals that have yet to be done.

Economy picking up?

Chile's GDP grew by 2.2% year-on-year in the third quarter, confirming earlier readings pointing to a recovery. Growth picked up pace from +1.0% in Q2 17. On a quarter-on-quarter basis, Q3 growth was up by 1.5%, the sharpest acceleration in almost five years. Exports made the largest contribution to the result (+3.0% year-on-year), reflecting growth in copper production, accentuated by a recovery from strikes earlier in 2017.

Chile and EU to update trade accord

The Chilean government and the European Union (EU) will hold an opening round of negotiations to modernise the existing bilateral economic association agreement from 16 November in Brussels, Belgium.

An EU press release notes that the aim is to update the 14-year-old agreement to bring its "trade provisions in line with the EU's modern agreements".

The EU is currently Chile's second largest trade partner, accounting for 14.9% of the country's total exports in 2016. While bilateral trade has remained stable in recent years, both parties hope it will increase after the updating of their bilateral trade agreement.

REGIONAL ECONOMY REVIEW

VENEZUELA

Keeping bondholders guessing

For months, or even years, Venezuela-watchers have routinely speculated as to whether the government would default on its external debt and, increasingly, as to when that might happen. The general consensus was that a failure to meet a scheduled bond repayment would trigger a series of events, culminating in the seizure of Venezuela's oil assets and the ultimate collapse of the government.

The reality is proving much more complex, mainly reflecting uncertainty about whether Venezuela has actually defaulted and, if it has, on what debt instrument. A related and equally crucial question is what bondholders are likely to do in response.

Promised funds do not materialise

At the time of our November report, President Nicolás Maduro had just confirmed that the government had met a heavy repayment schedule, which involved around US$2.7bn in repayments that fell due in late October and early November. Yet the president's insistence that the government had made these repayments rang increasingly hollow in the weeks that followed, when bondholders money did not materialise in their accounts. It is unclear whether the president genuinely believed that the funds had been transferred, reinforcing his tenuous hold on the leadership, or whether he knew full-well that the authorities lacked the means to repay bondholders and was just playing for time.

In the month since then, a variety of sovereign debt, bonds issued by the state oil company Petroleos de Venezuela (PDVSA) and state power company Electricidad de Caracas (Elecar) has fallen due. Some of the larger scheduled bond repayments had grace periods of just three-days written into the contract small-print, so the government's failure to make these payments tipped the administration into a technical default. Sovereign credit ratings agency Standard & Poor's downgraded Venezuela's credit rating on two sovereign bonds (expiring in 2019 and 2024) from CC to D and changed the long-term foreign currency rating to SD (selective default), from CC.

Meanwhile, the International Swaps and Derivatives Association (ISDA) – a trade body that determines whether holders of credit-default swaps (CDSs, a form of insurance against default) are eligible for compensation – met in mid-November, ruling that both Venezuela and PDVSA had defaulted. Discussions are ongoing about how CDS holders will be compensated.

Better late than never?

For the time being at least, bondholders have reacted cautiously. The government has continued to state that it plans to repay the debt that it owes and some payments do seem to be coming through, albeit very late, particularly in terms of the larger capital repayments (interest payments remain delayed).

The government appears to be giving priority to some of the PDVSA bonds that include its US-based refinery arm, Citgo, as collateral. Bondholders have not yet activated "acceleration" clauses on unpaid bonds, a process that would mean creditors demanding a full up-front repayment of public-sector debt. This is potentially because a critical mass of 25% of bondholders have chosen not to begin these legal proceedings, in turn reflecting the underlying belief that the government will make the payments late. Waiting for delayed payments is viewed as preferable to beginning a judicial process in US courts, as these proceedings would not be concluded rapidly.

Yet bondholders' patience is not endless and the reality is that at some point soon, creditors will tire of the government's partial and late payments. Official efforts to restructure the entire public-sector debt stock are unlikely to come to fruition, in the absence of any commitment or capacity to push through market-oriented reforms. Moreover, this spate of late payments is an indication that the government's stock of liquid dollar reserves is entirely depleted. International reserves held at the Banco Central de Venezuela (BCV, the Central Bank) sank below US$9.7bn in mid-November for the first time, but it is likely that this is predominantly comprised of illiquid gold.

A risky strategy

In the short term, continued late and partial debt repayments are likely to continue, including meeting some of the US$300m in arrears accumulated in recent weeks. Little debt falls due in December or January, which will give the government some breathing space, but scheduled repayments pick up from February. Assuming that the government will continue to use grace periods, this implies the next real crunch will come in March, relating to around US$700m in interest payments that fall due in February. Another US$1.4bn falls due in April, with other payment spikes coming in August (US$1.8bn), October (US$1.6bn) and December (US$1bn).

Absent major restructuring or fresh large-scale credit from China and/or Russia, the Venezuelan government will be unable to make these repayments. The authorities will continue with part-payment, in an attempt to stave off court action from discredited creditors, but this strategy is not viable in the long term. The likelihood is that at some point in 2018, bondholders will lodge a case in US courts seeking compensation. Legal action would be protracted, particularly if it related to sovereign or Elecar bonds rather than PDVSA instruments (since the legal case for seizing Citgo assets would be weaker).

By drawing the default process out through part-payments and delayed transfers, the government is gambling that it can retain power. Even if creditors resort to legal action, any ruling would be unlikely before the December 2018 presidential election, which the government still believes that it can win.

In the meantime, the authorities will hope that by reducing the amount spent on servicing external debt, it can redirect some funds towards imports. It will also hope that a moderate increase in international oil prices will help ease the pressure on Venezuela's ailing economy. Brent oil is currently trading at over US$60/barrel for the first time since mid-2015, which will provide some respite, helping to offset the continued fall in oil production volumes. Yet the government may be playing with fire, since failing to meet all of its external liabilities risks provoking bondholders into more concerted and unified action.

BRAZIL

Government proposes new pension bill

The government led by President Michel Temer has now tabled its third, and most diluted version, of its pension reform proposal. There is only a narrow window of opportunity to get the bill approved by congress before the 2018 election campaign gets underway.

The latest pension bill, unveiled by the government on 22 November, is a further watered-down version of earlier proposals. Aware that members of congress are worried about voting through an unpopular belt-tightening measure ahead of next year's general election campaign, government officials have made various changes.

The proposal of a minimum retirement age of 65 years for men and 62 for women is maintained. However, the requirement for a minimum contribution of 25 years to qualify for a pension has been cut back to 15, as it is as present. Also, the existing (more favourable) conditions for rural workers will be maintained (rural workers currently retire at 60 years of age for men and 55 for women). And transition arrangements have been spread out over 20 years to avoid sharp losses for existing pension contributors.

The fiscal savings from the pension reform therefore will be smaller than originally planned. According to Finance Minister Henrique Meirelles, total savings over the next ten years are likely to come to around BRL480bn

(US$146.8bn), about 60% of the BRL800bn (US$244.6bn) envisaged in the original proposal sent down in May.

Meirelles explained that the latest version cuts both minimum contributions and benefits. "The minimum contribution goes from 25 years to 15, but whoever contributes during 15 years and reaches the minimum age will receive 60% of the retirement ceiling. The benefit goes up slowly and only reaches 100% after 40 years of contribution", he explained.

The politics of getting the bill approved are still complicated. Public opinion has consistently opposed the introduction of an obligatory minimum retirement age, although according to one polling group, DataPoder360, the proportion rejecting it had dropped to 52% in November, down from 73% in April.

A three-fifths majority is needed in congress for approval. In the lower house, that means capturing 308 of 513 votes. Deputy Rodrigo Maia, the bill's rapporteur, notes that if it is not approved by 15 December, then there is "no way" that the Senate would vote on it in 2018, a year that will be dominated by the election campaign (ahead of an October ballot).

In advance of the vote, President Temer has announced a major cabinet reshuffle, which he expects to conclude by mid-December. He most likely hopes that he can use the offer of ministerial posts to various centrist political parties to gain their congressional support for the latest pension bill. It is not yet clear how viable this will be, with analysts suggesting that the government may be a sizeable 50-60 votes short of the 308 target.Argentina

Cabinet purge to boost Temer

On 23 November, the ruling Partido do Movimento Democrático Brasileiro (PMDB)'s ethics commission of announced the expulsion from the party of Senator Kátia Abreu. Abreu had long been one of the fiercest in-party critics of Temer and the policies pursued by his administration. Her expulsion from the party looks like an effort by the ruling party to close ranks around the president and the government's unpopular economic reform plans that are currently being debated in the federal congress. However, the move could prove to be counterproductive as it could also galvanise federal legislators' opposition to the Temer executive.

Abreu, who served as agriculture minister (2015-2016) under the previous Partido dos Trabalhadores (PT) administration led by Dilma Rousseff (2011-2016), was subjected to a disciplinary process by the PMDB ethics commission back in September 2016, after she disobeyed party orders and voted against the impeachment of Rousseff, which Abreu described as an coup d'état. Following Rousseff's impeachment and his assumption to the presidency, Temer wasted no time in sacking Abreu from the cabinet.

But Abreu remained a thorn in side of the Temer administration in congress, where she joined the opposition calls for Temer to face impeachment himself over the various corruption allegations that have been levelled against him. More problematically, Abreu has also repeatedly voted in line with the opposition against some of the government's economic reform initiatives.

With Temer struggling to retain the necessary congressional support to pass some of its pending reform proposals, including the key pensions reform, the PMDB appears to have decided to make an example out of Abreu and ostensibly send a message to other dissident party members.

The PMDB's ethics commission president, Eduardo Krause, said that the commission had unanimously voted in favour of expelling Abreu for the party after finding that she had violated the party's ethics code and openly disobeyed party orders.

Abreu reacted to her expulsion by stating that this would not affect her decision to continue opposing the government's reforms in congress. Indeed, she said that as an independent senator she would now look to join forces with other leaders in congress to defend the interests of the Brazilian people. The concern for the PMDB and the Temer administration is that other dissident party members might be tempted to join her.

ARGENTINA

Fiscal deal with the provinces

Strengthened by his coalition's good showing in the October mid-term congressional elections, President Mauricio Macri has signed a new financial agreement with 23 of the country's 24 provinces, designed to help correct the country's fiscal imbalances.

Under the deal signed on 16 November, the provinces agreed to drop long standing legal claims in various tax-sharing disputes with the federal government totalling ARS740bn (US$42bn) in claims. No less than 56 legal disputes will be abandoned. In exchange, the provinces will receive the income stream from a 10-year ARS80bn (US$4.6bn) federal government bond. The provinces have also signed up to cut local sales taxes by an amount equivalent to 1.5 percentage points of GDP over the next five years, to limit total spending, and to support pension reform. From the federal government's point of view, these commitments are necessary to achieve a reduction in next year's fiscal deficit equivalent to one percentage point of GDP.

Particularly important was the resolution of a long-standing dispute between the federal government and the province of Buenos Aires. The province, the most densely populated in the country (with 15m inhabitants), argued that it had not received its due share of federal income taxes, as agreed back in 1993, and had an outstanding claim for around US$22bn. Clearing this issue will be a big relief for the federal government. Overall, the deal with the provinces means that President Macri will be able to move forward with his reform agenda, and with plans to reduce costs and increase competitiveness.

Inflation overshoot?

Inflation in calendar 2017 will probably exceed the government target of 21%, Treasury Minister Nicolás Dujovne said on 23 November. The minister insisted, however, that inflation was falling. It has come down from 37% last year (2016), the first year of the Macri government, when it accelerated amid the devaluation of the currency and the end of long-standing freezes on public utility tariffs.

Dujovne also sought to reassure those worried about the country's heavy borrowing in 2016-2017, emphasising that 2018 would be the last year in which the government would need to issue "significant amounts" of foreign debt. He pointed out that as long as the fiscal deficit was falling, the government's borrowing requirements would also be coming down. The Macri government calculates that the overall fiscal deficit this year will be the equivalent of 4 percentage points of GDP, falling to 3.2% in 2018, 2.2% in 2019, and 1.2% in 2020.

URUGUAY

Still decoupled?

Uruguay seems to have decoupled itself from the recent economic bad times in neighbouring Argentina and Brazil. With those two regional behemoths now on the mend, the small country is set to consolidate its moderate growth path. But the Montevideo government still faces a big fiscal challenge.

In its monetary policy report published in November, the Uruguayan Central Bank (BCU) reported that third quarter external demand for Uruguayan exports was slightly stronger than expected, largely due to the recovery in Brazil. The external environment was described as slightly more auspicious than had been anticipated, despite some continuing points of uncertainty. Moderate economic growth is expected to continue, with underlying inflation within the target range. Year-on-year GDP growth was 2.8% in the second quarter. Annual inflation was 6% in September, within the 3%-7% target band.

Speaking at a meeting of academic economists at the Facultad de Economía y Ciencias de Administración (FECA), Economy Minister Danilo Astori was relatively upbeat. He argued that in recent years Uruguay has been able to decouple itself from its immediate economic neighbourhood, which has been marked by the difficulties in Argentina and Brazil. Looking at all three economies in 2011-2017, Uruguay in that period achieved total GDP growth that was 16 percentage points ahead of its two large neighbours. Now, Astori noted, the smaller country was positioned to benefit from the expected consolidation of the recovery in Argentina, and from the initial signs of improvement in Brazil.

Astori argued that an important feature of Uruguay's decoupling success had been its ability, over the last 15 years, to diversify its export markets away from previous heavy reliance on its partners in the Southern Common Market (Mercosur, comprising also Argentina, Brazil, Uruguay and Paraguay) and towards important new markets such as China. In product terms, the country had also benefited by developing its ability to trade in services, particularly inward tourism and information and communication technologies (ICT). As a result, Uruguay was able to attract investment from many different countries. Bringing inflation down to the target band, after many years of over-shooting, was also important, he noted.

But within this generally benign outlook, Astori recognised that his team was still struggling with some issues. He noted that public sector finances remained in 'a state of tension'. In the 12 months to September 2017, the fiscal deficit was 3.6% of GDP, and bringing that down was the government's single most important challenge, according to Astori. The official target is to reduce the deficit to 3.3% of GDP by the end of this year, and to 2.5% by 2019, the last full year of the current administration's five-year term. Other challenges included pushing ahead with an ambitious US$12bn infrastructure investment programme.

Meanwhile, a report by Spanish bank BBVA on the macroeconomic outlook for Uruguay in the second half of 2017 observed that a private consumption-led recovery is underway, with purchasing power boosted by falling inflation, despite some volatility in the index of consumer confidence. This improvement has not yet reduced unemployment, however, which remains relatively high at 7.5%-8.0%. There are also signs of an investment recovery, and of a reduction in the current account deficit as Uruguay reduces its energy dependence on imported oil and boosts tourism receipts (spending by inward-bound tourists reached a record US$1.8bn in the first nine months of this year).

That said, the trade surplus is expected to narrow in 2018 as domestic growth and investment boosts import demand. BBVA says the government's fiscal correction is heading in the right direction, albeit moving more slowly than hoped. It thinks the deficit will be cut to 3.5% this year and to 3.3% in 2018. BBVA expects end-year inflation of 6.3% in 2017. GDP growth is forecast at 3.2% in calendar 2017, and at 3.1% in 2018.

Prospects for UPM2

A key factor affecting Uruguay's future medium term growth prospects is whether the Finnish pulp and paper company UPM goes ahead with plans to build a second major processing plant in the country. The proposal is to build the second plant close to the city of Paso de los Toros, which would boost both local employment and the regional economy.

In early November, UPM and the Uruguayan government signed an investment agreement on the project, known as UPM2. The plant is expected to require direct investment of EUR2bn (US$2.32bn) and is part of the company's strategy to focus more on pulp (where global demand for tissues and packaging board is growing) rather than on paper (where global demand is weakening). UPM says it will not make a final investment decision until

2019, and that the decision will be linked to progress on the Uruguayan government's commitment to invest around US$1bn in developing rail, road, and port infrastructure to allow UPM2's output to be shipped for export.

Markku Jarvinen, an analyst at brokers Evli, said the project would probably start around 2021. With few similar investments announced at a global level, he suggested a tightening global market could lead to higher hardwood pulp prices in future.

COLOMBIA

Slow recovery on the way

Colombia's GDP grew by 2.0% year-on-year in the third quarter, according to the national statistics agency (DANE). Although this was below government expectations, Finance Minister Mauricio Cárdenas nevertheless welcomed it as part of a first phase of economic recovery.

The economic team expects growth to pick up to 2.5% in the fourth quarter, which would imply that growth for calendar 2017 as a whole will come in at 1.8%, a little below the earlier official target of 2.0%. The government continues to project 3.0% GDP growth for 2018. A range of analysts say there are questions about the pace of recovery.

Mauricio Hernández of BBVA Research notes that the Q317 results are mixed, with agriculture leading the field, partly because of a good coffee harvest. Manufacturing, on the other hand, has been weak. Stripping out agriculture's contribution, growth would have been a lower 1.6%. However, Hernández adds that the beginnings of a positive turn-around in housing and construction are evident. While he believes that the economy is now turning onto a growth path, he warns that recovery will be slow and market sentiment volatile. The Central Bank, meanwhile, has warned that the recovery is subject to ongoing risks over the availability of foreign finance, possible export commodity price falls, and any downside movements in consumer or business confidence.

Trade with EU

The European Commission (EC) report on 9 November released a report which found that its free trade agreements (FTAs) signed with Peru and Colombia have helped stabilise two-way trade.

According to the report, since the FTAs with Peru and Colombia came into full effect in 2013, bilateral trade between the EU and Peru has fallen by 11% and bilateral trade between the EU and Colombia has fallen by 23.5%.

However, the report attributes this to the "economic slowdown in Latin America and the fall in commodity prices on the global market, which has affected exports of both countries", and it notes that the FTAs with Colombia and Peru had a stabilising effect on international trade in these two countries, as their trade with the rest of the world has fallen by 36% and 18% respectively since 2013. In both cases, the fall in trade with the rest of the world was higher than the fall in trade with the EU.

The report goes on to suggest that without the FTAs Colombia and Peru's fall in trade with the EU between 2013 and 2016 is likely to have been even greater. The FTAs with the EU were resisted by some quarters in both Peru and Colombia, which argued that they would prove to be detrimental for some local economic sectors and more beneficial to the EU.

Significantly, the EC report provides some evidence in support of that view, noting that EU exports to Colombia increased by 18% during the first two years of the FTA coming into force and declined by 17% in 2016. Meanwhile, EU imports from Colombia fell by 37.5% since the implementation of the FTA. Similarly, EU exports to Peru increased by 4% since the FTA came into effect, whereas imports from Peru fell by 4% over this period.

Despite rising gas output, outlook remains weak

Trinidad & Tobago has the unenviable reputation of registering one of the worst economic performances in the Latin America and Caribbean region in recent years, with only Venezuela faring worse in 2016. The International Monetary Fund (IMF) estimates that Trinidad & Tobago's economy shrank by 6% in 2016, following very weak growth in 2015 and a slight contraction in 2014. A combination of low energy prices and falling energy production are the main factors behind this weak performance, with energy-GDP slumping by just over 11% alone in 2016. Although 2017 is also expected to remain weak, prospects for 2018 are stronger, with additional natural gas capacity expected to come on stream. However, in the absence of significant fiscal and external consolidation, the country's already-large twin deficits are set to remain extremely large.

Trinidad & Tobago has been hit hard by the slump in energy prices in recent years. At its peak in 2010-11, the energy sector accounted for around 50% of GDP and fiscal revenue, as well as 75% of export earnings. A decline in both average prices and output volumes has hit the ratios hard, but the non-energy economy has struggled to compensate for the loss of support from weaker oil and gas dynamics. These developments have also generated large fiscal and current-account deficits of 12.1% and 10.7% respectively in 2016.

New gas capacity set to come on stream

In the conclusions of its Article IV consultation published in late November, the IMF was somewhat more positive about the country's medium-term prospects. Although it is projecting another contraction in 2017, of 3.2%, it expects the economy to return to growth from 2018, expanding by a reasonably firm 1.9%.

The main reason is an expansion of natural gas production, which is expected to have spill-over effects elsewhere in the economy, boosting downstream petrochemicals production, as well as supporting a recovery in fiscal receipts, which in turn will aid a broader recovery in government consumption.

After exceeding 4bn cubic feet per day (cf/d) during 2007-14, peaking at 4.3bn cf/d in 2010, natural gas production has been falling. According to Central Bank data, production volumes fell to 3.8bn cf/d in 2015 and 3.3bn cf/d in 2016, before stabilising around this level in the first three quarters of 2017.

Yet data from the coming months is likely to be slightly more positive, on the back of new capacity from BP Trinidad & Tobago's (BPTT) new Juniper facility, which is the largest new production in the country in recent years.

The US$2bn investment began producing gas in August 2017 and is expected to produce up to 590m cf/d at full capacity next year. The platform produces gas from the Corallita and Lantana fields, located 80kms off the south-east coast of Trinidad.

In addition, BPTT's Trinidad Regional Onshore Compression Project has started operations, which will lift yields from existing wells. Indeed, the Juniper and Onshore Compression Project represent two of BP's "7 in 2017" – seven of BP's most important major worldwide projects that the company is launching this year.

The next major gas project is BPTT's development of the Angelin field, which is located around 60km off the east coast of Trinidad and received the green light to go ahead in mid-2017. The facility will draw gas from four wells to the

Serrette platform through a new pipeline and is expected to have a total production capacity of 600m cf/d. BPTT expects to start drilling in the third quarter of 2018, with the first gas set to be produced in the first quarter of 2019.

As production from the facility increases over the course of 2019, total gas production is expected to rise again in that year, helping to explain the IMF's projection of firming GDP growth (2.2%). As well as increased upstream output, the construction of a methanol and dimethyl ether plant in southern Trinidad in late 2018 or early 2019 will lift downstream production.

IMF remains gloomy over reform prospects

Although these developments will help reduce the external and fiscal deficits from the highs registered in 2016, in its November Article IV consultation the IMF was fairly negative about the prospects of significant and structural improvements in both areas. It stated that staff expect the current-account deficit to remain large, averaging 8% of GDP in the medium term, in the absence of measures to address the fiscal imbalance and structural reforms.

Similarly, the Fund is not pencilling in any significant public-sector consolidation into their baseline forecasts, with the fiscal deficit projected to average 12% of GDP over 2018-22.

Fund officials state very specifically that current government policies put public debt on an unsustainable trajectory, reaching an eye-watering 109% of GDP by 2022 (similar to levels in Jamaica, where heavy interest payments account for a significant portion of government expenditure, placing significant constraints on the economy). Not only that, but the IMF regards risks as tilted to the downside, with an even-more gloomy outlook likely in the event of further disruptions to energy supply.

Even though gas supply is expected to pick up in the coming years, the government recognises the need to diversify the economy in order to develop non-energy sectors. To this end, the IMF has urged the authorities to allow the heavily-managed exchange rate to depreciate, pointing to recent shortages of foreign exchange as evidence that the local currency is overvalued. The government will be reluctant to do so, on the basis that currency depreciation would be likely to feed through to higher inflation.

Pre-empting these concerns, the Fund stated that if the currency changes were made at the same time as a broader fiscal consolidation package, it would contain the impact on inflation, but it is doubtful whether the government has the political capital to push through measures that would be unpopular with the public at a time of heightened public discontent. As a result, an economy that five years ago seemed in fairly solid structural shape looks set to remain weak, highlighting just how quickly large fiscal and external deficits can accumulate, and reinforcing just how difficult it is to subsequently restore balance.

Leadership vote

The United National Congress (UNC), currently led by former prime minister Kamla Persad-Bissessar (2010-2015), was due to hold a leadership election on 26 November.

Dr Roodal Moonilal, who challenged Persad-Bissessar in the 2015 internal elections, said he would not stand for election this time because he has "quite a few other matters on his table". Moonilal is facing a corruption investigation.

Another potential challenger, Dr Surujrattan Rambachan, said he would support the current leader but that he wants to see a "more vibrant" national executive (Natex). "I am supporting her but will have reservations about the quality of the people on Natex, we need a mix of professional people and political activists", he stated.

Export recovery brings opportunities and challenges

At last, Latin American and the Caribbean (LAC) exports are growing again. In a new report the Economic Commission for Latin America and the Caribbean (ECLAC) says that exports are set to grow by around 10% in 2017, after four years of negative performance in 2012-2016. ECLAC highlights three main points, however. It says that the recovery remains uncertain still. It notes the LAC region is lagging in the development of trade in modern services, and finally it stresses that the region needs to do more to diversify and increase-value added in the agricultural sector.

The export recovery in Latin American and the Caribbean is a fact. In the first half of 2017, the region's exports of merchandise goods rose by 12.1% year on year (after a contraction of 9% in the first half of 2016). Services exports grew by 8.9% (compared to a 0.4% fall in the comparable year-earlier period). Overall, exports are expected to grow by10% in 2017, thanks to a 6.5% rise in export prices and a rise of 3.5% in volumes shipped.

Imports also rose in the first half, indicative of recovering demand within the region. Goods imports were up by 7.4%, with imports of services up by 2.8%.

The export recovery has been particularly marked in the mining and oil sectors. Mining growth is being driven by increased shipments to China and the rest of Asia, which is strongly linked to higher metal and mineral prices.

Meanwhile, exports to the US – and within the LAC region itself – have been growing at roughly historical averages in 2017, with exports to the European Union (EU) the least dynamic. Within LAC, the greatest increase in exports this year is accruing to Central America (+15.8%) and the Caribbean (+12.5%). In Mexico, exports will gain 8.7%, led by volume. South America will experience export growth of 8.2%, based on higher prices, ECLAC estimates.

But the Commission also makes it clear that there are questions about the sustainability of this recovery. It notes, for example, that the medium-term outlook for the world economy remains uncertain, and that there are challenges posed to traditional trade by the digital revolution, and by "the emergence of populist political movements in some developed countries".

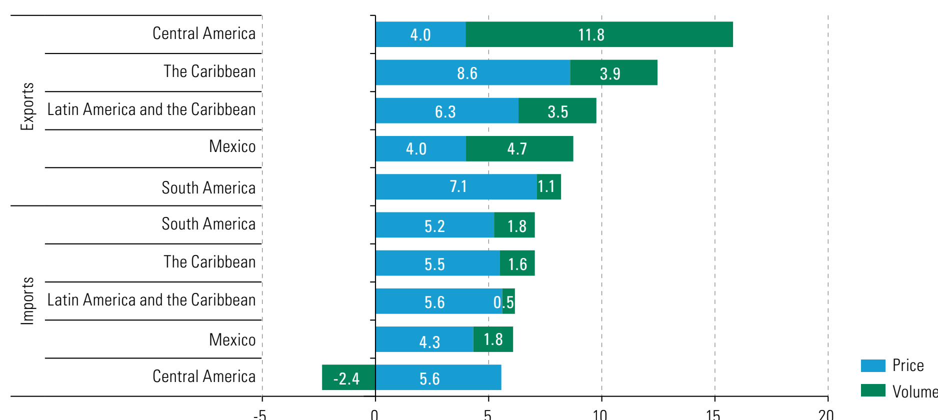
Globally, investment has still not recovered to pre-2008/2009 levels, before the global financial crisis. Productivity growth remains low, and nominal wages are stagnant. In this context, there is much to be said for boosting intra-regional trade within LAC, which tends to favour a model based on product diversification and the inclusion of greater value-added items such as manufactures. The LAC is also the natural market for the internationalisation of home-grown small and medium-sized enterprises (SMEs).

Yet, despite the growth of free trade agreements with third countries and trade blocs beyond the region, Latin America remains quite protectionist internally. The ECLAC report notes that some severe non-tariff barriers remain in place within the region, including quotas, non-automatic import licences, informal barriers and anti-dumping duties. Taken together, these barriers equate to an overall import tariff of 23.5%. Slow-moving customs processes, ECLAC calculates, are the equivalent of an additional 20% ad valorem tariff.

Therefore, the report says, there is "an urgent need for deeper integration, especially with the recent shift in the United States' trade policy and the uncertainty surrounding the renegotiation of the North American Free Trade Agreement (NAFTA)."

Latin America and the Caribbean (selected subregions and countries): projected year-on-year variation in trade in goods, by price and volume, 2017

(Percentages)



Source: *Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official information from central banks, customs offices and national statistics institutes.*

Services Exports

There is a particularly interesting chapter in the report on trade in services. ECLAC now breaks this down into two categories – traditional services (including travel, transport and others) and what it terms 'modern services'. Modern services comprise telecoms, IT services, financial services, insurance and pensions, royalties, and other business services. As the process of technological change ripples through the world economy, growth in modern services has become more dynamic. For example, in 2005-2016 global growth in merchandise exports averaged 3.9% per annum. Growth in traditional services was stronger, at 4.5%, but growth in modern services was strongest of all at 6.7%. The LAC region has not yet really grasped this opportunity. In 2016, its share of global merchandise exports was just under 6%; its share of global traditional services exports was a lower 4.4%, and its share of global modern services exports was the lowest, at just 1.8%.

Within LAC, South America is the largest exporter of services, accounting for three quarters of the total in 2016. Central America and the Caribbean contribute about one-fifth of total service exports, with a particularly strong presence in travel and tourism, transport and telecoms.

Only two countries in the region – Costa Rica and Panama – have a trade surplus in modern services. This is because Costa Rica specialises heavily in the export of computer and other business services that have an intensive need for skilled labour and foreign direct investment (FDI). Panama in turn has specialised in the provision of financial services. At the other end of the spectrum, Bolivia runs a large deficit in services (both traditional and modern) equivalent to almost 5% of its GDP. Chile and Brazil have smaller services deficits (mainly concentrated in modern services), while Argentina's services deficit owes mainly to modern services.

ECLAC points out that the indirect trade in services – because services may be 'embedded' as intermediate inputs in the export of physical goods – is also important. In fact, using new data from the World Trade Organisation (WTO) and the Organisation for Economic Cooperation and Development (OECD), it says that indirectly exported services are on average similar in value to those directly exported. By countries, indirect services exports represent between 65% of direct exports, as in the case of Chile, and 160%, as in the case of Mexico. Chile's low proportion of embedded service exports reflects the weight of its commodity exports, which have a relatively low services component. By contrast, Mexico's exports of manufactures have a high service content.

Brazil and Costa Rica were the countries with the largest share of domestically -supplied intermediate services in the value of their manufacturing exports in 2011. While this may be desirable in terms of maximising value added and economic diversification within a given country, it can also have a downside.

ECLAC comments that "the high domestic services content in Brazil contributes little to the international competitiveness of its manufacturing sector, as it mostly reflects the high prices of key services such as finance, logistics, and telecoms."

The UN Commission concludes that to compete in modern services, countries in the region will need to develop public-private strategies to support and develop the sector. It highlights Colombia's ten-year Productive Transformation Programme (launched in 2009), which set targets for software and IT exports, business process outsourcing (BPO) and knowledge process outsourcing (KPO).

Finally, the report dedicates a chapter to one of LAC's traditional exporting strengths – the agricultural sector. It notes that despite global price fluctuations, agricultural exports have tended to be more resilient and less volatile than total exports. In 2012-2016, the value of the region's total exports slumped by 21%, but the value of its agricultural exports slipped by only 1%.

LAC has an agricultural trade surplus with all its partners. But although the region remains a significant global supplier of a range of agricultural products, most of them are still primary commodities, with a low presence of agro-industrial products. This concentration of exports in a few raw commodities is particularly evident in exports to Asia. Yet by contrast, intra-regional trade in agricultural products is much more diversified. ECLAC recommends that the region should follow a policy of "de-commoditising" its agricultural exports, increasing their diversification and raising value-added by processing and expanding the agro-industrial sector.

The China connection: An ECLAC delegation visited China in November to further cooperation, and to present some of the more-regionally relevant findings of its 2017 LAC trade report.

Officials noted that regional exports to China will show the highest growth rate in 2017, at 23%, surpassing the growth of exports to the rest of Asia, Europe and the US, or within the region itself. Mario Cimoli, an ECLAC official, noted that "relations between Latin America and the Caribbean and China must be understood in a new global context. The region and China have to have a joint response to confront the macroeconomic, technological, and geopolitical uncertainties". This, he suggested, could be done through strengthening multilateralism and the mutual recognition of diverse development goals.

REGIONAL BUSINESS REVIEW

MEXICO

NAFTA deadlock

The fifth round of talks between the US, Canada, and Mexico about the renegotiation of the North American Free Trade Agreement (NAFTA) appear to have made little progress. As a result, the future of the agreement remains uncertain. The talks now will continue into 2018, and are set to overlap with the start of Mexico's July 2018 presidential election campaign.

The fifth round of talks, held in Mexico City in November, failed to make significant progress on some of the main issues dividing the US from Mexico and Canada. These include US proposals for much higher local content rules for the NAFTA automotive sector; changes to the NAFTA disputes procedure; 'Buy American' provisions on government contracts; and a five-year 'sunset clause' under which NAFTA would automatically expire unless actively renewed. All the main US proposals seek to achieve a rebalancing of North American trade – the code word for eliminating the country's large deficit in its trade with Mexico, and to a lesser extent, with Canada. Although an official statement highlighted some progress on technical issues and data collection, US Trade Representative Robert Lighthizer commented, "Thus far, we have seen no evidence that Canada or Mexico are willing to seriously engage on provisions that will lead to a rebalanced agreement. Absent rebalancing, we will not reach a satisfactory result."

Some discussion does seem to have happened. No formal counter-proposals have yet been tabled on automobile local content, one of the most contentious issues. Mexico's Economy Minister Idelfonso Guajardo has stated that his country is ready to consider rebalancing trade with the US, but only in the context of proposals to expand existing trade, rather than cutting it back. Mexico had also put in a counter-proposal to the US 'Buy American' request, suggesting that there could be equivalent 'Buy Mexican' and 'Buy Canadian' provisions limiting the ability of US companies to compete for government contracts. And instead of an automatic five-year sunset clause (which is seen as generating uncertainty for business), the Mexican delegation has suggested that there should be a 5-yearly review of NAFTA. A US official said there had been some progress in other areas including anti-corruption measures, telecoms, and sanitary and food safety measures.

Yet the fact remains that the talks are largely deadlocked. There will be further intense negotiations between the teams before the sixth formal round of talks in Montreal on 23-28 January. But reaching a full agreement as planned, before the end of March 2018, is looking increasingly difficult.

The AMLO perspective

Barring a US walk-out (a possibility, since President Donald Trump has threatened to terminate the agreement entirely), the NAFTA talks now look likely to overlap with Mexico's July 2018 presidential campaign. For the moment, and ahead of the nomination of other candidates, the front-runner in that campaign is Andrés Manuel López Obrador of the left-wing Movimiento de Renovación Nacional (Morena).

AMLO, as Obrador is known, has been giving further details of his likely economic policies. In November, he stressed that he would not seek to import foreign political models, and that he would not seek to emulate the policies of either President Nicolás Maduro of Venezuela or Donald Trump. His key point is that the current NAFTA talks should be scrapped, because, in the words of one of his advisers, the current and outgoing Mexican administration lacks the necessary legitimacy to conduct them.

On other issues, AMLO said he would lead an austere government dedicated to rooting out corruption, with public spending redirected without raising taxes or the country's debt-to-GDP ratio. Spending equivalent to 4.1% of GDP would be redirected to infrastructure and priority social programmes, for example.

Significantly, AMLO indicated that the US$13bn plan to build a new Mexico City airport was not viable and that if elected his government would seek an alternative plan to improve air transportation. Other proposals include universal access to public or private universities, better pensions and health care.

On security, ALMO promises a gradual withdrawal of the army from the campaign against the drug cartels. Government spending would be controlled, private property rights would be upheld, and the independence of the central bank would be respected. It is clear that AMLO candidate wants to play down his reputation for being anti-business. “We are not opposed to businesses, they are necessary. We are against corrupt politicians and influence traffickers,” he stated.

TPP back from death’s door

The Trans Pacific Partnership (TPP), a 12-nation free trade agreement, has not quite died a death since the US decision to withdraw from it, announced by Donald Trump in January 2017. Meeting in Danang, Vietnam, in November, the remaining 11 countries (including Latin American members Chile, Peru and Mexico) agreed to soldier on, under a slightly different name – The Comprehensive and Progressive Agreement for the Trans Pacific Partnership (CPTPP). It is hoped that all signatories will ratify the CPTPP by 2019.

The current version of the agreement includes tariff-free trade, coupled with labour and environmental protection clauses. Since the US departure, some 20 clauses have been dropped and around four remain to be negotiated. The 11 members of CPTPP represent around 13.5% of global GDP (down from around 35% when the US was involved).

Japan has emerged as an important promoter of the CPTPP. China for the moment backs a different grouping – the Regional Comprehensive Economic Partnership (RCEP). As the US pursues a more isolationist and protectionist agenda, a key question for Mexico and other Pacific Rim Latin American countries is what trade and investment opportunities it may be able to find among these shifting globalisation alliances.

ARGENTINA

Awaiting the lithium boom?

Lithium mining activity is growing in north-western Argentina. Demand is rising and expected to surge further as the world begins to convert to electric vehicles using lithium batteries. Could this help kick-start the country’s mining sector?

Companies extract lithium carbonate from ore by an evaporation process using large pools of brine. This produces lithium carbonate, for which the price on international markers has soared by 30% so far in 2017 to reach US$12,000 a tonne. Half of the world’s known lithium reserves are located in an area known as the ‘lithium triangle, which straddles Argentina, Chile, and Bolivia. One of the questions now is which of the three countries will attract most new investment and production. Chile remains ahead, but some analysts argue that Argentina may overtake it by offering new incentives to mining companies.

According to Richard Seville of Orocobre, an Australia-based mining company, “There is a real potential that Argentina will leapfrog Chile in terms of production in five years’ time. It is going to be a very important player.” Orocobre currently produces 14,500 tonnes a year of lithium carbonate, and the company says that in partnership with Toyota Tsusho Corp it intends to more than double its production in Argentina to 35,000 tonnes by 2019. Australia is currently the world’s largest lithium miner, producing some 76,000 tonnes per annum, followed by Chile with 70,000 tonnes. Argentina is in third place with around 30,000 tonnes per annum.

Various analysts suggest that the more market-friendly stance taken by the Mauricio Macri government, which took office two years ago in Argentina

(December 2015), will help boost investment and production. Already, there are at least five lithium mining projects in development in Argentina that could add some 45,000 tonnes of production annually by 2019, with more due after that.

"The shift in mindset around looking at Argentina more favourably has happened very quickly over the last couple of years and obviously has a lot to with politics" says Chris Berry, an executive at Canadian-owned Lithium Americas, which is investing US$425m in the Cauchari-Olaroz mine, near Orocobre.

Changes introduced by Macri include eliminating a mining export tax and ending a ban on profit repatriation. In June this year, Macri signed a federal mining agreement with 12 of the country's 23 provinces to apply a uniform policy on royalties and minimum environmental standards. The government says it expects lithium exports to grow from US$191m last year to US$800m over the next few years.

Over many years, there have been attempts to expand Argentine mining on the eastern side of the Andes, to emulate the size of the industry on the Chilean or western side of the mountain range, usually with limited success. But the Macri government thinks it can now make real progress. The president has set a target of attracting US$30bn in new mining investment into the country. There are still obstacles to overcome.

For example, there is still little consensus on the right balance between mining development and environmental protection, an issue which has held up a number of big projects in the more mature industry in Chile. Seven Argentine provinces ban open-pit mining or the use of cyanide or other hazardous substances. Enrique Viale of the Argentine Association of Environmentalist Lawyers notes that "the social movement against mining is one of the best organised and most powerful in Latin America". The 2010 Glacier Protection Law bans mining in glacier areas and calls for the creation of a national inventory of glaciers. Neither the former nor the current government have created the inventory, meaning that the law cannot yet be practically applied, something that creates uncertainty the precise location of any 'no-go areas'.

In the meantime, the industry as a whole is growing at relatively modest rates. Mining exports rose by 6% to US$3.62bn in 2016. In the first eight months of 2017, they contracted by 0.8% to US$2.186bn. However, Javier Cao of consultancy Abeceb says with some big mines coming to the end of their lifetime, the numbers are not that bad, and show that the government has had some success in preventing a sharper fall, for example by helping extend the life of the Alumbrera copper mine.

Argentine officials also have high hopes that they may be able to attract significant Chinese mining investment. Earlier this year, China's Shandon Gold bought a 50% stake in the Veladero gold and silver mine in San Juan province for US$960m. Veladero, operated by Barrick Gold of Canada, has been criticised for repeated cyanide spills.

MEXICO

Peso nerves

A string of factors including the uncertainty around the NAFTA renegotiations and the upcoming 2018 presidential election are weighing down on the Mexican Peso – the most traded emerging market currency. But comparisons with the Peso crisis of 1994 are not justified, Mexican authorities insist.

In the central bank (Banxico's) November monthly survey of economists, the consensus forecast was for a fall in the peso-dollar exchange rate to around MXN20/US$1 in the run-up to the July presidential election, reflecting heightened political uncertainty ahead of the ballot.

Economists forecast an average rate of MXN18.97/US$1 at end-March, falling to MXN19.31/US$1 by end-June. Within that June average, the lowest forecast was MXN21.28/US$1.

With the technocratic independent former finance minister José Antonio Meade looking almost certain to secure the presidential candidacy for the ruling PRI, the 2018 election is coalescing into a straight two-horse race between the Partido Revolucionario Institucional (PRI) and the leftist Andre Manuel López Obrador (AMLO). This also comes in the absence, as yet, of any candidate from the other main traditional Partido Accion Nacional (PAN), whose Frente Ciudadano por Méxicoelectoral alliance with the left-wing Partido de la Revolución Democratica (PRD) and the smaller Movimiento Ciudadano is struggling to settle on a consensus candidate.

In this situation, the politically-independent Meade will be seen as a safe pair of hands by markets, investors and moderate voters alike, especially in the event that AMLO reverts back to his radical comfort zone, in which case the race will be polarised between two starkly different options, which could further play to Meade's advantage.

For the second consecutive month, the economists surveyed by Banxico identified political uncertainty as the main risk to domestic economic growth moving forward, with 19% ranking it as the principal risk, up from 17% in October. This was followed on the domestic front by public insecurity (15%), deteriorating oil production (11%), international political instability (9%) and inflationary pressures (6%).

Also weighing on the exchange rate forecasts in particular are the NAFTA renegotiation talks. Bearish sentiment on the renegotiations provoked renewed volatility in the peso in November. At one point mid-month, the peso fell to M$19.3/US$1, before recovering to trade at around M$18.6/US$1 later in the month.

Political uncertainty loses its dominance in the risk equation post July, when the election result will be known either way. This may also reflect the consensus expectation among Mexican economists that AMLO would be more moderate as president than as candidate. This is based not only on the assumption that AMLO and his leftist party Morena would not have a congressional majority (or majority support at the state level), but also on the fact that AMLO proved to be pragmatic governor of Mexico City (2000-2005), who dealt on the level with businesses and the private sector in general.

As such, economists forecast a year-end 2018 exchange rate of MXN18.86/US$1, from MXN18.70/US$1 previously. Meanwhile, the consensus real annual GDP growth forecast for 2017 was stable at 2.1%, rising to 2.28% in 2018 (up marginally from 2.25% previously).

In one of his first statements as new Banxico governor, Alejandro Díaz de León also agreed that the 2018 election was one of the main risks the peso, adding that this could also affect inflation. Díaz de León insisted that if the exchange rate remained within a stable range and without sudden movements, and with core inflation set to fall from early 2018 (as the impact of the January 2017 'gasolinazo' falls out of the equation), the inflation should converge over the course of 2018 to the central 3% target.

With inflation still stubbornly high in the first half of November, at 6.49% year on year, economists lifted their latest consensus inflation forecast to 6.5% at year-end, from 6.25% in the October survey. For end-2018, the consensus inflation forecast was 3.84%, up slightly from 3.8% previously and above what Díaz de León might like to see – as inflation expectations feed into price setting.

There are other risks to the exchange rate aside from the NAFTA talks, chief among which are the latest US tax reform and the normalistation of US monetary policy – via an expected further increase in US Federal Reserve rate in December.

In both cases, the concern is that capital and investment flows would flow out of Mexico (and other markets) and back towards the US, which of course would also affect the Peso. Indeed, the US dollar has already been strengthening in anticipation of the much-touted increase in US interest rates.

In early December, in the days immediately after the White House tax cut was approved by the Senate, the Peso had weakened again, touching almost MXN18.9/US$. In this context, there is some pressure mounting for an increase the policy rate at Banxico's December meeting, the first under Díaz de Leon.

Banxico voted unanimously to keep its benchmark interest rate on hold – at 7% – at its last meeting on 9 November, as was expected. Having gradually raised the rate from 3% in December 2015 to 7% in June, Banxico has left it on hold since then.

Banxico's dilemma now is that while Mexico's economic growth outlook looks somewhat more fragile, inflation remains well above the 2%-4% target range. The latest notes from the monetary policy committee were bearish, focusing largely on the downside risks related to the NAFTA renegotiations and the risk of further currency depreciation (which would further stoke inflation).

In this context, Banxico in theory might prefer to leave the policy rate on hold at 7% as it seeks to maintain a balance between the need to facilitate growth while containing inflation expectations. Its December decision is pending the day after the US Federal Reserve holds its monetary policy meeting – inevitably, a US rate increase will add to the pressure on Banxico to follow suit. Any further increase in inflation moving forward, moreover, would be additionally tricky for the monetary policy committee, as it would put pressure on Banxico to increase rates again, despite the economic uncertainty.

In the meantime, Banxico has already stepped up measures to contain exchange rate volatility. In late October, the bank said it would issue US$4bn in US dollar swaps to the end of the year. While this proactive stance has help steady the peso to date, it is unclear that this type of intervention alone would be sufficient to maintain exchange rate stability in the event of a more severe shock in 2018 – such as the failure of the NAFTA renegotiations, for example.

Ahead of his departure, Carstens stressed that Banxico should be prepared to ensure that any depreciation of the peso happens "in orderly fashion" if the NAFTA talks collapse. He also stressed that the central bank and the Mexican government should also work closely to coordinate fiscal policy to manage any exchange.

Carstens' exit, after a decade at the helm, initially prompted jitters about future monetary policy developments given the critical juncture at which the Mexican economy finds itself in. Nightmare memories of the 1985 peso crisis, sparked by a peso crash against the US dollar, are still raw in the country. Aside from the appointment of an able successor, Carstens also sought to provide other reassurances, noting in several outgoing media

interviews that Mexico's federal institutions – as well as the financial sector – are now much more robust, well-regulated and better prepared to deal with shocks. First off, he noted that Banxico itself now recognised as being more independent and with a board that remains in place over the life of successive governments. The monetary policy committee is open and transparent, and exerts firm control over monetary policy. While inflation is still above-target currently (after it reached a historic low of 2.3% in December 2015), Carstens was keen to emphasise that inflation is not unreasonable, with much of the current pressure a one-off adjustment owing to the gasolinazo. He too stressed that this should dissipate from January 2018.

Banxico also proved itself to many observers in moving decisively in late 2015 to raise interest rates amid exchange rate volatility linked to the oil price shock, a move that proved critical to stabilising market sentiment in Mexico and has helped keep the economy ticking over in the last difficult few years, marked by weak international oil prices and political upheaval in the US.).

And finally, both Carstens and his successor Díaz Leon have been clear that Banxico, backed by its healthy stock of reserves, will continue to intervene in support of the peso if needed. Banxico now has US$173bn in reserves (down from a peak of US$199bn in January 2015, but up from just US$90bn in 2007 when Carstens took office. Ultimately, in the worst-case scenario Mexico also has a (recently-renewed) US$88bn Flexible Credit Line (FCL) available from the IMF if necessary. Clearly though, Banxico never wants to get to that stage and treats the FCL as precautionary.

The Flexible Credit Line (FCL), an IMF arrangement designed for crisis prevention purposes, gives a country the flexibility to draw on the credit line at any time. Disbursements are not phased or conditioned on compliance with policy targets, as in traditional IMF-supported programs. According to the IMF, this flexible access is justified by the very strong track records of countries that qualify for the FCL, which gives confidence that their economic policies will remain strong. As such it is a more of a 'signaling tool' than an instrument that a country would ever expect to have to use.

Looking Ahead

On 8 November, the IMF's Executive Board concluded the latest Article IV consultation with Mexico and on 30 November approved a successor Flexible Credit Line for the same US$88bn amount as previously. Following the Executive Board's discussion, Christine Lagarde, the IMF Managing Director and Chair, noted in a statement that Mexico's macroeconomic policies and policy frameworks "remain very strong".

Monetary policy is guided by an inflation-targeting framework in the context of a flexible exchange rate, the statement noted. Fiscal policy is anchored by the fiscal responsibility law, and the authorities are committed to a consolidation path that would lead to a reduction of the public debt-to-GDP ratio over the medium term. The financial regulatory and supervisory framework is strong, it likewise noted, adding that "the authorities have implemented an ambitious structural reform agenda that is beginning to show results and should help boost medium-term growth".

"The Mexican economy has successfully navigated a complex external environment", the statement went on. "Economic activity has shown resilience, although near-term growth is projected to slow down amid prolonged uncertainty related to Mexico's future trade relations, as well as tighter macroeconomic policies. Inflation has started to decelerate following a pick-up owing to temporary shocks, and the financial system is sound. Nevertheless, given Mexico's close ties with the global economy, particularly the United States, its economy remains exposed to external risks through both trade and financial channels", the Fund observed.

In terms of other external risks, the Fund noted that "the global risk environment has improved, but the risk of an abrupt change in Mexico's trade relations, or of a surge in financial market volatility and a sharp pull-back of capital from emerging markets, continues to be high.

As such, it said that the new arrangement [under the FCL], with an unchanged level of access, would continue to play an important role in supporting the authorities' macroeconomic strategy "by providing insurance against external risks and bolstering market confidence".

Finally, the statement emphasised that the Mexican authorities "remain committed to enhancing the country's resilience to external shocks further through steadfast implementation of the ongoing fiscal consolidation plans, continued anchoring of inflation expectations, gradual rebuilding of reserve buffers, strong oversight of the domestic financial system, and steadfast implementation of structural reforms". In conclusion, it also made the point that the Mexican authorities do not intend to make permanent use of the FCL, and would plan to continue to treat the arrangement as precautionary before "gradually phasing out Mexico's use of the facility, conditional on a reduction in external risks".

Near term outlook

Banxico has cut its 2017 GDP growth forecast to 1.8%-2.3%, from 2%-2.5% previously, after Q3 was hit by natural disasters. Agustín Carstens delivered the blow in his final quarterly report, but sought to cushion it by leaving the 2018 forecast unchanged at 2%-3%. The IMF now forecasts growth of 1.9% in 2018 (down from 2% previously).

Banxico's 2019 forecast range remains 2.2%-3.2%, but with the US heading for a cyclical slowdown in 2019-2020, the outlook for Mexico will be moderate at best, prompting questions for policy makers, including the IMF.

Alejandro Werner, director of the Fund's Western Hemisphere department, told the Mexican business daily *El Financiero* in early December that the country's low growth rate, and its failure to spread growth across all regions if the country (plaged by a structural North-South divide), was one its main challenges, as well as the weak state of law and corruption. He also identified infrastructure and education as critical challenges for the country.

Werner noted that the Fund had penciled in growth of about 3% from 2020 as recent structural reforms feed through into the domestic economy. This forecast is also contingent, however, on a successful NAFTA renegotiation and a continued rise in FDI into Mexico on the back of that.

REGION

Honduran coffee – brewing nicely

While the region's main coffee producer, Brazil, is cutting projections for coffee output amidst continuing troubles with pests and drought, the Honduran coffee sector is enjoying a firm recovery. In its latest report, released on 7 November, the International Coffee Organization (ICO) revised up its global coffee production forecast for crop year 2016/2017 to 157.4m bags, a 3.4 % increase on 2015/2016, due largely to the increase in production in Honduras, the ICO noted.

Production

With crop year 2017/2018 now in progress in all exporting countries, the ICO said that on the basis of new information from member countries it had revised up its estimate of total production for crop year 2016/2017 upward to 157.4m bags, which would be a 3.4 % increase on 2015.2016.

Within this, according to the ICO, Arabica production is up by 14.7 % to 101.6m bags in crop year 2016/2017, with increases observed for all three Arabica groups. Production of Colombian Milds rose by 2.7 % to 15.82m bags, with other Milds up by 15.6 % to 30.29m bags, and Brazilian Naturals up by 18.1% to 55.44m bags.

However, Robusta production is estimated to have fallen by12.2% to 55.9m bags. Coffee production increased in Africa, Mexico & Central America and South America by 5.3%, 16.3% and 8.6%, respectively, while production decreased by 9% in Asia for crop year 2016/2017. The significant increase in production in Mexico & Central America is largely attributed to increased production in Honduras, the ICO continued, amid recovery from the coffee leaf rust outbreak in the region, as well as beneficial weather.

Exports

Total exports in September 2017 reached 8.3m bags, compared to 9.8m in September 2016. While coffee year 2016/2017 registered a decrease in its final month, total exports reached a record 122.5m bags, 4.8 % greater than the 116.9m bags shipped in coffee year 2015/2016.

Export trends in coffee year 2016/2017 broadly matched trends for coffee production, with shipments of all three Arabica groups increasing. As such, exports of Colombian Milds grew by 8% to 14.66m bags, Other Milds by 15.6 to 27m bags, and Brazilian Naturals by 2.6 to 35.8m bags.

While production of Robusta coffee declined greatly in crop year 2016/2017, shipments were relatively stable, according to the ICO report., amounting to 44.9m bags.

Brazil

Of the ten largest exporters in coffee year 2016/2017, only Brazil and Vietnam recorded decreases compared to shipments in coffee year 2015/2016. While Brazil's exports declined by 8.8% to 31.6m bags, its production increased by 9.2% to 55m bags in crop year 2016/2017. Compared to coffee year 2015/2016, preliminary figures for exports of green and soluble coffee from Brazil suggest that exports of both forms of coffee fell by 8.8%% in coffee year 2016/2017 to 28.1m bags and 3.43m bags, respectively. Shipments of roasted coffee are also estimated to have declined, but accounted for less than 1% of total exports.

Colombia

In crop year 2016/2017, Colombia is currently estimated to have produced 14.5m bags, up 3.5% on 2015/2016, recording its fifth consecutive season of growth. Increases in exports have followed the same pattern as production, aside from 2015/2016, when a strike at the country's ports hindered shipments. Colombia's total shipments increased by 9.6% to 13.49m bags in crop year 2016/2017, as gains in production have provided ample supplies. Green coffee exports, which account for 93% of total exports, have increased to 12.6m bags. Shipments of soluble coffee have increased to 0.77m bags, representing 6% of total shipments in coffee year 2016/2017.

Honduras

Exports of green coffee from Honduras rose by 41.8% to a record 7.3m bags in coffee year 2016/2017. This represents the third consecutive season of growth and makes Honduras the fifth largest exporter in coffee year 2016/2017. Beneficial weather and improved yields, resulting in part from tree renewal projects, have contributed to the boost in production and exports.

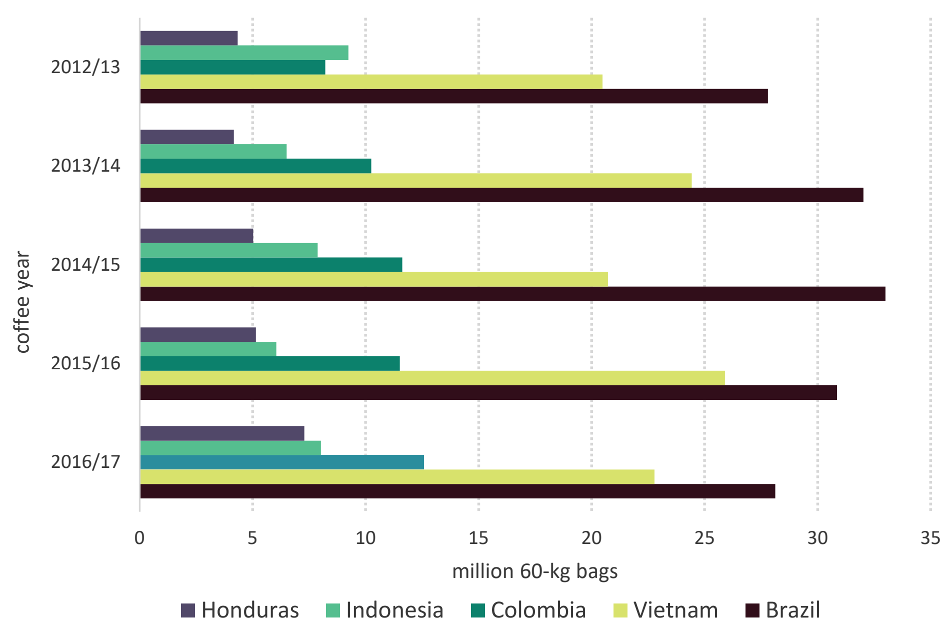
Prices

Coffee prices have drifted downwards since the end of August, the ICO reported, though prices in October were fairly stable, with a drop at the end of the month. In October, the ICO composite indicator price averaged 120.01 US cents/lb, down 4.45 US cents/lb from the average price in September.

The Arabica group all showed declining trends in October. The average price for Colombian Milds, Other Milds and Brazilian Naturals fell by 4.8%, 4% and 3.9%, respectively. Compared to the Arabica groups, Robusta was relatively stable, ranging between 98.16 US cents/lb and 99.46 US cents/lb for most of the month, before falling to 94.6 2US cents/lb on the last day of the month. As a result, the monthly average for the Robusta group was marginally lower (0.8%) than in September.

Global Consumption

Finally, the ICO noted that after increasing for two consecutive years, world coffee consumption is estimated to have remained stable at 155.06m bags, based on provisional figures for coffee year 2016/2017. Given the rise in global coffee output against stable consumption, the ICO now sees coffee year 2016/2017 in surplus, after two consecutive years of deficit, with production exceeding consumption by 2.38m bags. The market is well supplied at the start of coffee year 2017/2018 by the replenishment of stocks over this past year, the ICO concluded.



Source: *International Coffee Organisation*

Outlook

A report in the *Financial Times* (*FT*) in early November noted rising nervousness amongst commodity traders and farmers as meteorologists say there is an increased probability of a La Niña weather phenomenon in the first quarter of 2018.

Caused by the cooling of the tropical Pacific Ocean, brings increased drought in the north and more rainfall in the South, including Southeast Asia, Australia and South America. The US National Oceanic and Atmospheric Administration is predicting a 55-65% chance of the weather phenomenon occurring in the northern hemisphere autumn and winter 2017-18.

In the last La Niña, in 2012, heavy rains led in Colombia caused a deadly coffee fungus to spread rapidly, damaging production and leading to an increase in coffee.

Meanwhile, the *FT* notes that traders are also anxious about the Brazilian coffee crop. Although the main coffee regions in the country, including Minas Gerais, have had some rain recently, there is a need for more consistent rainfall in order to boost the chances of a decent crop next year.

Corporate Radar

Colombia's ISA invests in Peru

Colombia's ISA is investing US$450m to build Latin America's most elevated high-power transmission line, a 500kw capacity line running for 918kms across 16 Peruvian provinces and 52 municipalities. Parts of the line will be around 4,000 metres above sea level. The line will connect the Mantaro, Marcona, Socabaya and Montalvo power stations, along with associated sub-stations. Through its subsidiary Consorcio Tranmantaro, ISA won the 30-year concession to build and operate the transmission line. Building the line will involve the erection of 1,934 pylons, before connecting them with 12,000 kms of cable.

Avianca strike ends

On 10 November, pilots from Colombia's national airline Avianca, affiliated to the Asociación Colombiana de Aviadores Civiles (Acdac) civil aviation pilots' union, announced the end of the indefinite strike they launched on 20 September. Over 700 pilots (half of all Avianca's pilots) took part in the strike in demand of improved salaries and working conditions. This forced Avianca to cancel over 13,000 domestic flights, affecting 400,000 passengers, and resulting in US$2.5m of losses for the firm. The strike was ended after being declared illegal by the courts, which found that only a minority of Acdac members had voted in favour of it; and after government-mediated negotiations between Avianca and the union broke down, and Avianca threatened to layoff all striking pilots.

VW modernising Argentina plants

Volkswagen said that it would invest US$650m to modernise its assembly plants in Argentina. The German company's plant in Pacheco, Buenos Aires province, will be upgraded, creating 2,500 additional jobs. The plant is being prepped to build VW's new SUV (sports utility vehicle) for sale across Latin America. Globally, VW is planning to launch 20 new vehicles by 2020. VW Argentina president, Hernán Vázquez, said the country was playing a prominent part in the company's map of global investments.

Concern over murder of Televisa executive

In a statement issued on 20 November, Coparmex, Mexico's largest business association, called on the government to review its security strategy after the murder of Adolfo Lagos, the corporate vice-president of telecommunications at the Televisa media group. Lagos was killed the previous day, as he was cycling on the outskirts of Mexico City. Thieves stole his bicycle and shot him dead.

Coparmex said, "It is urgent to halt the incidence of crime, as this can affect growth and investments". It added that the country was experiencing a "security crisis" that required new approaches and "immediate actions" from the authorities. Government data shows that 31.1m crimes were committed last year, with an estimated cost of 1.1% of GDP. The homicide rate has been increasing this year. Citing data from 2015, Coparmex said over one-third (35.5%) of companies report suffering some type of crime. "We need to tackle and stop this growing problem" Coparmex stressed.

Petrobras profits

Brazil's state-owned oil firm Petrobras has released its financial results for the third quarter of the year, which show that the firm posted a profit during the period.

A Petrobras statement said that the firm's net income in the third quarter reached R$266m (US$80.6m), below the R$316m it reported in the previous quarter but a significant improvement on the R$16.4bn in losses it reported in

the third quarter of 2016. With the new financial results, the heavily indebted firm has now registered profits in four consecutive quarters, with Petrobras noting that its accumulated net income for the year now stands at R$5bn.

The Petrobras statement described its third quarter financial results as "very positive" and driven by an increase in oil exports, improvements in the international price of oil, revenue raised via the sale of some of its assets, and a reduction in personnel costs, among other factors.

However, the level of third quarter profits reported by Petrobras was substantially lower than the R$3.21bn consensus forecast made by sector analysts, leading to some concern that the financial and administrative restructuring plan that the firm embarked upon in 2015, in the wake of the major internal corruption scandal uncovered in 2014, is not progressing as well as hoped.

The third quarter financial report shows that the firm's liquid debt fell by 11% year-on-year in the third quarter from the US$100.3bn reported in 2016 to US$88.1bn as of September this year.

Brazil registers record trade surplus

Brazil posted a trade surplus of US$2.93bn in November, according to preliminary data released by the industry and trade ministry (MDIC). This brings Brazil's accumulated trade surplus for the first 11 months of the year to a record US$61.4bn. That is already bigger than the entire trade surplus for last year (US$47.7bn), itself the largest in the current series dating to 1989.

For calendar year 2017 overall, the MDIC now expects Brazil to post a trade surplus of between US$65bn and US$70bn. The Focus Report, a consensus survey of local economists by the central bank (BCB), in late November projected a full-year surplus of US$65.5bn.

Groupon announces merger with Peixe Urbano

On 27 November, the discount vouchers site Groupon LATAM, owned by investment fund Mountain Nazca, announced acquisition of its competitor Peixe Urbano, which operates in Brazil and is owned by Chinese online search giant Baidu. The value of the acquisition is not yet known and the deal is still pending approval from Brazil's competition authority, Cade.

In a statement, representatives from Groupon and Peixe Urbano said that their operations would not be affected by the merger and that consumers would eventually benefit from greater consumer choice. "It's the sum of two giants. We have joined the leadership from Groupon Brazil in the beauty and local travel market with the expertise of Peixe Urbano in gastronomy and entertainment. At the end of the day, it is the consumer who benefits from getting the best of both worlds," the president of Groupon Brazil, Félix Lulion, said.

For its part, Peixe Urbano can offer the addition of a 'buy now' button, which works better for spontaneous Brazilian consumers than the traditional discount voucher model, where users may have to wait six months before the offer is valid. "The use of immediate vouchers corresponds to 90% of restaurant booking requests using the Peixe Urbano platform," Alex Tabor, co-founder and chief executive of Peixe Urbano, said.

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