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IMF warns of emerging markets volatility

A number of Latin American currencies had a wobbly start to 2014, with the problems of Argentina and Venezuela leading to sharp drops in both their unit values. But the turbulence was expected to have a wider impact because of the 'tapering' of Quantitative Easing (QE) in the United States and lower commodity prices.

To some extent Argentina and Venezuela are special cases. London-based analysts Capital Economics noted that both have suffered from high inflation levels in recent years, have had "poor economic policy-making" and multiple exchange rates. While Argentina allowed depreciation of the peso on the official rate by around 20% in January the Venezuelans avoided an embarrassing devaluation of their official exchange rate, opting instead to introduce a range of new exchange rate tiers, all of which trade at a discount to the official exchange rate. In Capital Economics' view Argentina is being more pragmatic, seeking to accept a weaker currency in order to preserve foreign currency reserves: in contrast it expects the Venezuelan government "to continue to defend its overvalued exchange rate at the expense of FX reserve depletion, a worsening dollar drought, higher inflation, and economic stagnation".

The difficulties faced by both the countries on the foreign exchange markets coincided with a wave of emerging market nervousness, with the Turkish and Russian currencies also experiencing sell-offs, and interest rates trending upwards in a number of markets. The question being posed was whether this added up to a generalised crisis in the making. The IMF's first response was to deny any generalised issue. "The major component has to do with problems of a subset of emerging market countries", said José Vinals, a director in the IMF's monetary and capital markets department: "this is something where the US monetary policy tapering expectations have so far not played an important role" he said at the end of January.

By early February however, Alejandro Werner, director for the Western Hemisphere department at the IMF was warning of the danger of volatility over the next few months. The word 'crisis' was not used, but Werner did speak of a "very uncertain" outlook, with below-trend economic growth. He expected global economic growth to rise in 2014, led by the advanced economies with the eurozone finally on a recovery path. "We see emerging markets and developing countries as a group a bit stronger, with overall growth at around 5% this year", Werner said. "China's growth outlook is particularly key for Latin America's commodity exporters. We see it growing

at about the same as last year, 7.5%, as policies to slow credit growth and raise the cost of capital take the steam out of surging investment". Commodity prices would drop, with non-fuel commodity prices falling by around 6%. US QE tapering would tighten conditions on international financial markets "translating into higher international borrowing costs, particularly with the recent volatility in emerging markets".

The IMF at the same time trimmed this year's forecast for Latin American economic growth to 3.0% (down from 3.1% previously) and to 3.3% in 2015 (down from 3.5%). Werner said higher interest rates would make debt servicing by Latin American countries more difficult; and financial conditions generally will be "more restrictive". Conditions would vary country-to-country. Mexico would benefit from a recovery in exports of manufactures and domestic demand, as the factors behind last year's cyclical downturn begin to fade. Mexican growth would rise from 1.2% in 2013 to 3.0% in 2014.

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For big raw material exporters such as Brazil, Chile, Colombia, Peru and Uruguay the outlook was largely dependent on 'internal conditions'. Average growth would remain just under 4%, with the uplift from global growth counterbalanced by weaker commodity prices and tighter financial conditions. Brazil's internal issues – "supply bottlenecks that are constraining output and pushing up inflation" – would limit growth to no higher than last year at 2.3%. In Werner's view Argentina and Venezuela had an unfavourable outlook because of inflation, balance of payments difficulties, and currency market movements were all having a negative effect on confidence levels. Werner concluded that although growth is improving "we should expect more turbulence for our region…policy makers in Latin America and the Caribbean should not rest easy just yet."

Latin America: IMF Real % GDP Growth Forecasts

Country/Country Groups*	2013	2014
United States	1.9	2.8
Canada	1.7	2.2
Brazil	2.3	2.3
Mexico	1.2	3
South America:		
Financially Integrated (Brazil, Chile, Colombia, Peru, Uruguay)	3.9	3.9
Other Commodity Exporters (Argentina, Bolivia, Ecuador, Paraguay, and Venezuela)	5.4	3.5
Central America:		
CAPDR (Cost Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua	2.9	3.2
Caribbean:		
Tourism Dependent (The Bahamas, Barbados, Belize, Jamaica, and the ECCU member states)	0.9	1.6
Commodity Exports (Belize, Guyana, Suriname, and Trinidad and Tobago	3.5	3.7
* Latin America and the Caribbean subregional aggregates computed as simple average of growth rates		
Source: IMF World Economic Outlook		

REGION

Brake, accelerate, or crash the gears?

If the Latin American automobile industry were a race, its leading exponents can be imagined coming round the bend right now into 2014, which is shaping up as an encouraging year for global vehicle demand. But at least two regional car makers, Argentina and Venezuela, seem to have developed internal engine trouble and are loudly crashing their gears. Brazil, traditionally number one, is still motoring along, although its average speed seems to be falling back a little. And Mexico, the number two, is accelerating loudly, burning up the tarmac, and getting ready to break lap records.

Global automobile production nose-dived in 2009, the year the last global financial crisis broke and some of the US market leaders – companies like Chrysler – had to be rescued from bankruptcy. Since then there has been a rather wobbly recovery. Car production in Europe, affected by the impact of its own longer-drawn out currency and sovereign debt crisis, has looked weak for a number of years. But as recently pointed out in a research note by Scotiabank, Western Europe auto sales began to stabilise in the second half of 2013. For 2014, Scotiabank is expecting "the first synchronised expansion in global purchases since 2005", which should lift world car sales by around 5% to new record highs. The upturn will be driven by China, with double-digit sales growth (+12.6%) to nearly 17.8m units. US sales will gain 3.2% to 16m units, and Western Europe will be up by 2.9% to 11.81m units. In the US market, households and companies will take advantage of better times to start replacing ageing vehicles. Scotiabank says that "the average age of the US fleet has jumped to a record 11.4 years, at a time when US household balance sheets are the healthiest in more than a decade."

> "For 2014, Scotiabank is expecting 'the first synchronised expansion in global purchases since 2005', which should lift world car sales by around 5% to new record highs."

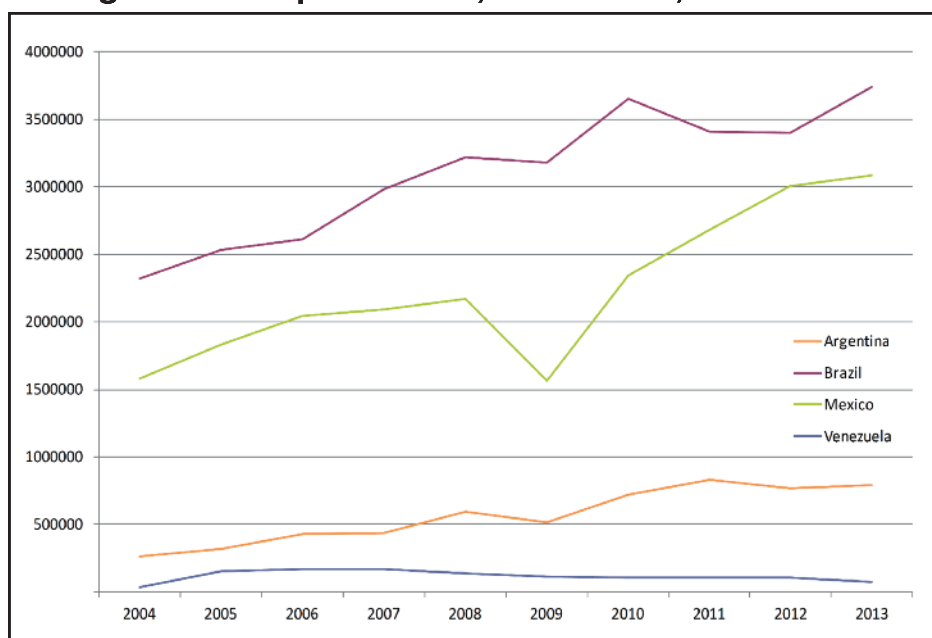
All this should in principle be good news for the Latin American car producers, but what emerges is a rather up-and-down story. Argentina and Venezuela are definitely on the down side of the equation. Both have entered 2014 with interventionist government policies, high inflation, fiscal and monetary imbalances, sharply weakening currencies and complex multi-tier exchange rates. The auto industry doesn't like that.

As both Argentina and Venezuela are relatively smaller markets, car companies operating there are focused on the assembly of component parts, many of which are imported. That means they are very exposed to exchange rate risk: depreciating currencies lead to sharp auto-part cost increases. In Venezuela, vehicle production had already dropped by 31% in 2013 to 71,763 units. Things got worse in January, with an 85% year-on-year production slump. Early in February, Toyota Motor Corp., Venezuela's largest car assembly operation, said it planned to stop production entirely at its plant in Sucre. A leaked memo to staff stated: "We are in an extremely difficult situation, for different reasons beyond our control, which affect operational continuity, due to a shortage of parts. There will be an indefinite production stoppage".

The decision led to an angry riposte from President Nicolás Maduro. "Every time there's a problem, it's the same news, Toyota's leaving. You don't have to be very intelligent to discover the political motives behind this", Maduro complained, demanding to talk to more senior executives in

Latin America or Tokyo. "The only thing these little managers want is dollars, dollars, and more dollars", he fumed, adding, "What about the productive capacity, the ability to substitute imports? Where is their capacity to manufacture in Venezuela if they've been here 10 years? Aluminium, petrochemicals, iron, steel, we have it all".

Regional auto production, 2004-2013, million units



Sources: ANFAVEA, OICA, Adefa, Cavenez

The story is not very different in Argentina. Production actually increased by 3.5% last year to 791,000 units, but it began to weaken sharply in the final months of the year (it was down by 26.4% year-on-year in December). The downturn was triggered by lower demand from Brazil. Brazil is a key market for Argentine auto exports, regulated under a managed quota system within the Southern Common Market (Mercosur), and the Brazilian authorities had negotiated a lower quota for imports from Argentina. It was also affected by the introduction in December of a sliding scale of 10%-50% worth of additional domestic sales taxes for luxury vehicles – an emergency measure to try and discourage dollar spending on imports and fend off a devaluation. But the devaluation became unstoppable, and by late January the peso slumped sharply against the dollar. As in Venezuela, this quickly increased the cost of imported components. 2014 is going to be a difficult year for car makers in Argentina.

Ford has said it is monitoring developments in both Argentina and Venezuela "in real time". Although the company has been globally profitable over the last two years, it posted a pre-tax loss of US$34m in Latin America in 2013, and is expecting to remain in the red this year. Chuck Stevens, chief financial officer at General Motors (GM), said his company made a profit in the region last year, but that the volatile situation in Argentina and Venezuela was a financial risk.

Things look better in Brazil, Latin America's car-making giant, responsible for 60% of regional vehicle production. After a big increase in 2012 (+7.6%), car sales were flat last year, affected by rising interest rates. But production, which also caters for export markets, remained strong, gaining 9.9% to 3.74m units. Scotiabank sees conditions in the domestic market improving, on the assumption that as interest rates ease back and employment levels hold up – two factors that are not necessarily going to happen in 2014. But while the Brazilian industry is a world away from the troubles of Argentina and

"But while the Brazilian industry is a world away from the troubles of Argentina and Venezuela, there are still some concerns for 2014. One of the main ones is that while the domestic market will hold up, exports may not, precisely because significant volumes of Brazilian cars are exported to Argentina and Venezuela, among other destinations."

Venezuela, there are still some concerns for 2014. One of the main ones is that while the domestic market will hold up, exports may not, precisely because significant volumes of Brazilian cars are exported to Argentina and Venezuela, among other destinations. Data for January was worrying: car production fell 19.7% year-on-year to 180,143 units, with domestic sales down by 1.2% and exports plunging 22.1%.

Brazilian government policy is to actively intervene in the local automobile industry to try and boost local content and production. The five-year Inovar Auto programme launched in 2012 was a case in point. It imposed an extra 30 percentage points on the tax on industrialised products (IPI) charged on all light duty vehicles (LDVs) and light commercial vehicles, but simultaneously offered a 30 percentage point discount for automakers that could meet certain environmental, efficiency, safety and technological innovation criteria while investing in the national automotive industry. Inovar Auto and other earlier tax changes in 2011 (targeting imported vehicles) have been challenged by the European Union (EU), which has filed a formal complaint with the World Trade Organisation (WTO) stating that their combined effect is to impose a higher tax burden on imported goods while offering tax advantages to those produced locally, which Brussels maintains is discriminatory. Brazil's foreign minister Luiz Alberto Figueiredo has denied a violation of WTO rules and says that the government has "solid arguments" in its favour.

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Mexico has taken a different route to attract international car companies. A variety of factors now seem to be coming together to give its industry a major boost. With the US consumer back in the market for new cars in 2014, Mexico is ideally placed, geographically-speaking, to supply them. As a long-standing member of the North American Free Trade Agreement (Nafta) Mexico can import auto-parts from the US and re-export complete vehicles at zero-tariff rates; a series of other bilateral FTAs (about 40 in total) give an additional advantage. Importantly, Mexican labour costs have become highly competitive: they remain significantly below US hourly rates, but are also now lower than in China (because of rising wages in China, as well as currency effects).

As a result, the industry seems on the cusp of a major boom. After double-digit percentage growth in the last few years, output increased by a moderate 2.7% in 2013 to 3.08m units, but further acceleration is expected. Almost all the big carmakers are piling in with new investment, particularly in a cluster of states in the centre and north of the country. Japanese companies like Toyota, Honda and Nissan are building plants in Nafta, and specifically in Mexico, in part to protect themselves against currency swings - "building and selling in the same location" - in the words of Michael Robinet, of consultants IHS Automotive. In 2014, Mexico is expected to export more cars to the US than Japan. Ironically, a lot of those cars will be 'made in Mexico' Japanese marques. According to an estimate by the news agency *Reuters,* there is now some US$10bn worth of automotive investment in the pipeline for Mexico, including major new plants for Nissan, Honda, Mazda and Volkswagen. Germany's BMW reportedly also is considering building a plant this year.

Joseph Langley, another specialist from IHS Automotive, says that Mexico "is quickly turning into the China of the West" and by 2020 will have the capacity to build one in every four vehicles in North America. Of course there are problems – such as the ongoing issue of security in areas dominated by violent drug cartels, and an emerging shortage of trained engineers, but Mexico at present does seem to have the brightest automotive future in the region.

Itaú Unibanco launches its regional banking play

At the end of January, Itaú Unibanco, one of Brazil's largest private banks, said it was taking a stake in Chile's Corpbanca in a US$2.2bn cash and shares deal. The merger means that apart from Brazil, Itaú will be developing a presence in both Chile and Colombia. Could this be the beginning of a move towards the creation of locally owned, pan-Latin American banks?

In a statement dated 29 January, Itaú Unibanco and CorpGroup, the holding company controlled by Chilean billionaire Alvaro Saieh and his family, said they had agreed to merge their two banking subsidiaries in Chile, Banco Itaú Chile and Corpbanca respectively. The new merged Chilean bank will be the fourth largest in the country, with a 12.4% share of the loan market. It will also control a similarly merged bank in Colombia (where both Itaú and Corpbanca had pre-existing subsidiaries), which will be the fifth largest in the country, with a 6.7% market share. Bank operations in both these countries will be conducted under the Itaú brand, although the legal name of the new merged entities will be Itaú Corpbanca.

"Deutsche Bank commented: "This is an important step for the internationalisation of Itaú, and establishes the platform for further growth in Latin America. We view this transaction positively given what we see as its strategic benefits, as well as fair price paid."

In a complex deal, Itaú Unibanco will end up with a 33.58% stake in the merged Chilean Bank, with CorpGroup holding 32.92% and the remaining minority shareholders having 33.5%. Between them, Itaú Unibanco and CorpGroup therefore control two-thirds of the shares; they will also sign a separate shareholders' agreement, recognising that the Brazilian parent company will have a 50.5% stake in the controlling block. To achieve this, Itaú Unibanco paid US$652m in cash, with the remaining US$1.548bn in shares.

Analysts have on the whole been enthusiastic about this deal, which has been hailed by some as a step towards the creation of "South America's first real continental banking giant".

Some, such as the Brazilian business daily *Valor Econômico,* have suggested that Itaú has in fact stepped in to offer some relief to the cash-strapped Saieh family. Apart from banking, the family also has extensive interests in supermarkets and media. Corpbanca had made some expensive earlier acquisitions in Colombia, spending more than US$2.0bn in 2011 and 2012 to acquire the local subsidiaries of Banco Santander and Helm Bank. It has been reported that as part of the deal the Brazilians are offering the Saieh family a US$750m, seven-year credit line.

Perhaps because of this, earlier speculation that Itaú would pay higher-than market prices to acquire additional bank units proved unfounded. A research note from Deutsche Bank praised the 'price discipline' shown by Itaú, given that Corpbanca's operations were valued at US$4.4bn (1.3 x trailing book value), and the Brazilian company paid significantly less than that.

Deutsche Bank's view is that overall the deal makes "strategic sense". The merged banks should benefit from economies of scale, lower funding costs and greater cross-selling opportunities. In the joint announcement of the merger, the partners spoke of "funding cost improvements and substantial revenue synergies". They estimated that "synergies" would add up to savings of around US$100m per annum, to be achieved after completing the merger process over the next three years. Deutsche Bank commented: "This is an important step for the internationalisation of Itaú, and establishes the

platform for further growth in Latin America. We view this transaction positively given what we see as its strategic benefits, as well as fair price paid". While bank penetration is high in Chile, profitability also remains strong, with an average system-wide 17% per annum return on capital over the last five years. Banking penetration is lower in Colombia, which suggests there is significant room for market growth.

Itaú's CEO for Latin America, Ricardo Marino, indicted that the new partnership would be the vehicle for any further expansion into Peru and Central America if opportunities arose. Expansion in Mexico, where Itaú has a small presence, would be handled directly by the Brazilian head office. Itaú also has subsidiaries in Argentina, Uruguay and Paraguay. By the end of September 2013, Itaú Unibanco had US$19.9bn in Latin American bank assets outside Brazil, with a total of some 240 branches employing 6,200 staff.

The bank has been doing well in Brazil, but some observers suggest geographic diversification is a good thing to be doing right now, in view of sluggish economic growth prospects in its home market. In the last quarter of 2013, Itaú Unibanco reported a 32% increase in recurring net income to BRL4.68bn (US$1.94bn), and a reduction in its non-performing loan (NPL) ratio down to 3.7% (from 4.8% in the comparable year-earlier period). Across the Brazilian banking system, NPL ratios have come down from a peak in 2011/12, reflecting better quality borrowers, a less risky loan mix, and a changing patterns of loans (more payroll and residential mortgages, less car loans). However, investment bank Societé Genérale (SocGen) has warned that "if credit and economic growth finally slow down… NPLs will likely increase and the banks with most exposure to these sour loans could be at risk".

PANAMA

Size matters

Since December last year, attention has been focusing on a potentially very expensive falling out between the Panama Canal Authority (APC) and one of its main contractors in the ambitious project to widen the 100 year-old waterway: Grupo Unidos por el Canal (GUPC), the civil engineering consortium led by Sacyr Vallehermoso of Spain and including Impregilo of Italy, Jan de Nul of Belgium and Constructora Urbana (CUSA) of Panama. At first glance, the quarrel has been over who should pick up the bill for an estimated US$1.6bn worth of cost overruns on the US$3.2bn canal locks contract. But the implications go much wider than that.

In international shipping, size matters. In recent years the industry has seen a growing trend towards bigger and bigger container ships, able to capture economies of scale and reduce unit costs. The larger container ships currently able to squeeze through the Panama Canal's locks are known as Panamax vessels. At present, 5%-6% of world trade flows through the Panama Canal on board Panamax ships. Depending on exactly how they have been built, these ships have the capacity to carry somewhere between 4,500 and 5,000 TEUs (twenty-foot equivalent units) each. According to the ACP's original timetable for the US$5.25bn expansion project, when the new Canal channel was set to be opened in June 2015, the inter-oceanic waterway would be able to accommodate some of the so-called 'Post-Panamax' ships, with much larger box-carrying capacity. Vessels with the ability to carry between 5,000 and 12,600 TEUs are in the process of being re-categorised as

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'New Panamax' ships and these will be able to use the widened Canal. To give an idea of the importance of these larger vessels, Post-Pamanax ships currently make up 16% of the world's container fleet, but because of their size, they are already carrying 45% of world box cargo trade. The world's largest box-ships, known as 'Triple-E' class, can carry 18,000 TEUs and over.

Many parties have a significant financial interest in the initially-announced June 2015 inauguration date for the widened canal. For instance, a number of large international shipping companies have timed their new vessel orders so as to bring big box ships into operation when the Canal is ready. A later inauguration date means that these ships may have to be diverted to non-Canal trade routes, causing higher expense and disruption. With US West coast ports such as Los Angeles and Long Beach suffering congestion, many of their Gulf Coast and Eastern Seaboard competitors (ports like Baltimore and Norfolk) have been investing heavily in dredging and upgrading port facilities so as to receive larger ships coming through a widened Panama Canal. Also counting on the bigger Canal are commodity traders hoping to bring coal, oil and gas through in more economic loads.

The root cause of the dispute, according to GUPC, is that unforeseen geological difficulties forced them to spend much more on cement than expected. Claiming that erroneous data provided by the ACP was to blame, GUPC has demanded that the Canal authority pay the extra US$1.6bn involved. The APC refused, leading to a stand-off and, eventually, the complete paralysis of work in early February. The APC has threatened to take over the remaining 30% of the project so as to complete it itself – something that would almost certainly add years to the in-service date. There were reports in early February that both sides were working on a compromise solution. Although the parties refused to confirm details, there was speculation that a guarantee bond worth US$400m held by the insurance company Zurich American might be used as a guarantee to help fund some of the cost overrun. In the meantime, the ACP administrator, Jorge Quijano, admitted that "two or three months of reduced production and some halted activities… could lead us to finishing the work in December 2015". Such a date would be six months behind schedule; some analysts already believe that this could slip further into 2016 or beyond.

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There are also major economic and political implications for Panama itself. The Canal generates around US$960m in revenues a year, roughly 10% of the country's annual income, so the delay will have an important opportunity cost (estimated by some economists as at least US$100m a year). President Ricardo Martinelli has blamed the previous ACP administrator, Alemán Zubieta, for accepting the GUPC bid for the work in 2009, even though it was priced US$1.0bn below a competing offer from the US engineering giant Bechtel and was around US$363m below what the APC itself had budgeted for the work.

Martinelli has called the current situation "the chronicle of a death foretold". Presidential elections are due in Panama in May, although so far the issue has not become a party-political battleground. "This is a very delicate moment for Panama" said Juan Carlos Navarro, one of the 2014 presidential candidates (for the opposition Partido Revolucionario Democrático [PRD]). "Later there will be time to do a complete analysis of what went wrong and assign responsibilities. But right now everyone needs to support Quijano and demand that the expansion is completed."

Kicillof manoeuvres with key sectors

On 5 February Economy Minister Kicillof announced a deal with the country's five main oil supplying firms to limit fuel price increases to a maximum of 6% for the remainder of the month. The deal is a compromise designed to minimise inflation pressures, after some oil firms hit by the peso devaluation (and years of officially-imposed price controls) had demanded that fuel prices go up by as much as 12%. Lorry drives serving the key agri-export sector have been threatening to strike over fuel prices, a situation the government will be anxious to avoid ahead of the next soya harvest (March-May). Kicillof noted that the oil companies had also agreed to a new price evaluation body tasked with examining sector costs in coming months so as to determine "adequate" future price levels.

ECONOMY FOCUS

ARGENTINA

Still stumbling along

Over the past month, Argentina's central bank has allowed the peso currency to weaken and interest rates to increase. Meanwhile, the government has published a new and much more realistic inflation index, while the country's foreign reserves have stabilised at just under US$28bn. An exogenous shock, such as problems with the soybean harvest, might yet provoke a financial crisis. For now, though, it looks as though the government and the central bank will continue to 'muddle through' its problems, both actual and perceived, for another while.

As we went to press with our last edition of *Latin American Economy & Business* in mid-January, consensus opinion in the mainstream media suggested that Argentina, once again, was heading towards a major financial crisis. Having fallen in the preceding weeks, the Dolar Blue (i.e. black market) rate for the peso stood at ARS11.95/US$ on 20 January. This compared with the official rate of ARS6.81/US$. Another widely followed exchange rate, the Dolar Bolsa, stood at ARS10.35/US$. The Dolar Bolsa is the rate at which institutional investors may gain access to foreign currency buy buying debt securities in pesos and then selling the securities for US dollars.

Nearly a month later, the message from official and unofficial currency markets is that the risks of a crisis have been reduced. As of 14 February, the Dolar Blue rate stood at ARS11.85/US$, implying a marginal appreciation of the currency. Following an announcement by the Banco Central de la República Argentina (BCRA - the central bank) that it would no longer defend the currency (previously managed under a sliding peg regime), the official rate stood at ARS7.79/US$; this implies a depreciation of around 15%. Meanwhile, the Dolar Bolsa rate was ARS10.56/US$, more or less the level of mid-January.

In short, the premiums of the Dolar Blue and Dolar Bolsa rates to the official exchange rate have narrowed. The Dolar Blue rate premium has slipped to just over 50%. This is the lower end of the 50%-65% range in which the premium moved for much of the second half of 2013. In May 2012, when the Dolar Blue rate for the first time spiked above ARS10/US$ (the so-called 'Messi rate', after the Argentine football star's jersey number), the premium was around 100%.

In mid-January, we argued that a true financial crisis was not imminent. We agree with currency market participants that developments since then are consistent with a reduction in risks. Thanks in part to the BCRA's decision not to defend the currency, foreign exchange reserves have stabilised at around US$27.8bn. The central bank has also increased interest rates. The Badlar rate, which is paid by banks on wholesale deposits, has been raised by around 400 basis points: as of 7 February, the rate paid by private banks stood at 25.5%. The BCRA has also accepted a rise of around 600 basis points on interest rates that it pays on short-dated notes. In late January, for instance, the central bank offered 98 day notes at a yield of 25.9%.

In short, the central bank has, realistically, allowed peso interest rates to move upwards towards levels where they are positive in real terms. On 13 February, Argentina's national statistics institute (Indec) published inflation figures according to a new methodology, as had been demanded by the International Monetary Fund (IMF). The new national consumer price index (IPCNU) suggested that consumer prices had risen 3.7% in the month of January alone. That is the highest officially reported monthly inflation since 2002, and is close to estimates of private analysts. Given that the government has been accused of massaging the official inflation statistics since 2006, the new figures represent a significant step towards orthodox policies (and an

improvement in relations with the IMF). Economy Minister Axel Kicillof argued that the IPCNU January rate was higher because of “particularities” such as a “furious campaign” to economically destabilise the government following its partial relaxation of foreign currency controls, which sparked a minor run on the peso. Additional new price controls are also designed to keep a lid on inflation in coming months.

However, official recognition of higher domestic inflation could have implications for the government led by President Cristina Fernández. For one, labour unions may redouble their salary demands in collective wage agreement talks due in March. Already, they have set down a minimum increase of 30% (based on consensus private inflation estimates).

Union demands

On 12 February, President Fernández met the leaders of the government-aligned faction of the Confederación General del Trabajo (CGT) to discuss the upcoming March collective salary negotiations. A recent meeting of provincial governments concluded that union demands for salary increases should be capped at 25%. While Fernández did not demand that union leaders limit themselves to a particular percentage increase, she did suggest that wage negotiations be held on an annual rather than a six-monthly basis.

In our analysis a month ago, we suggested that the Fernández government would have to achieve three objectives simultaneously in the event of a true financial crisis. It would need to boost the foreign currency reserves at its disposal. It would need to stabilise the Dolar Blue rate. It also would need to engineer a profound change in sentiment of investors and other protagonists. Latest developments and figures suggest that the government has made progress on at least two fronts (in particular, the stabilisation of the Dolar Blue rate); and has managed this in the absence of an open crisis.

Further (and aside from its pre-existing price and export/import controls), the government has not resorted to wholesale unorthodox solutions. It has not, for instance, sought large scale funding from Chinese sources. Nor has it issued US dollar certificates of deposit (Cedins) and economic development bonds (Bodes) on attractive terms, with the aim of attracting ‘blue’ dollars circulating within Argentina.

The bottom line is this: yet again, Argentina's central bank and government appear to be 'muddling through' a temporarily challenging situation (which, this time, involves lack of access to foreign currency) - in spite of dire predictions by many external observers. We accept that a full-blown crisis is still a possibility - but we stress that this outcome would require an exogenous shock beforehand: problems with Argentina's soybean harvest is the most obvious, but not the only, source of such a shock.

Even if an exogenous shock produces a full-blown crisis, the government still has a number of (mainly unorthodox) tools at its disposal with which it can bring the situation under control. The laudable decision to publish inflation statistics more widely accepted as being accurate can be seen as a positive wildcard. If inflationary pressures are seen to be falling and peso interest rates rise to levels that provide investors with real returns, sentiment towards peso-denominated assets could improve significantly.

To accomplish this outcome, the government would need to do a few things simultaneously. It would need to stop monetising its spending through the compliant central bank, which is the principal cause of the high inflation. It would also need to achieve a moderation in labour unions’ wage demands. These are not easy tasks, but they are not impossible either. With progress on this front, Argentina just might move towards a virtuous circle of lower interest rates and true currency stability.

IPCNU

Instead of only measuring data from the Greater Buenos Aires metropolitan area, the new IPCNU inflation index will take into account price variations in all the provinces, with the exception of the city of Buenos Aires, which chose not to be part of it. The index will be published monthly and will use a fixed basket of goods and services based on the latest household consumption data, as compiled by the 2012-2013 households’ survey. No details have been released yet as to the methodology but in previous statements government representatives have said 200,000 prices would be measured by 500 pollsters in 100 locations nationwide.

Subsidies and the energy deficit – also muddling through

As detailed in the previous article, in January Argentina hit the headlines again for all the wrong reasons, with the peso losing around 20% of its value as the government allowed it to float downwards on the official exchange market. While a degree of stability had returned to the currency markets by mid-February, the domestic economic situation remains unstable. The government's immediate problem is to try to contain surging domestic prices and escalating wage and salary demands. However, it also needs to tackle serious structural economic imbalances. Here we look at subsidies and the energy deficit.

The trigger for Argentina's forced devaluation was the relentless fall in the country's foreign currency reserves, and that fall, in turn, has been caused by serious imbalances in the economy. Total international reserves held at the Banco Central de la República Argentina (BCRA) stood at US$52.1bn at the end of 2010. The reserve position eroded slowly at first, falling 10.9% to reach US$46.4bn at end-2011 and then another 6.7% to US$43.3bn at the end of 2012. Thereafter , the decline accelerated, with reserves dropping by 29.3% - almost a third - to US$30.6bn at the end of 2013. In January 2014 alone, they fell over US$1.0bn more.

“Since 2010, the bank calculates that subsidies, measured in local currency, have grown at a cumulative annual rate of 41%. It estimates that subsidies totalled ARS134bn in 2013, with 61% of that total (ARS82bn) going on energy subsidies.”

In round numbers, international reserves declined US$13bn in 2013. Ramiro Castiñeira of the Buenos Aires-based consultancy Econométrica estimates that US$6bn of that went on foreign debt payments, with the remaining US$7bn flowing out as the net effect of all other transactions, among which he highlights the energy deficit and the tourism deficit.

Last year the central government had a primary deficit (before interest payments on foreign debt) equivalent to 2.8% of GDP, or US$14bn at the official exchange rate. A big contributor to this deficit was the fact that total subsidies paid out by the government during the same year grew to 5% of GDP or US$25bn. In Castiñeira's opinion, the BCRA has been forced to give up its traditional role of defending the value of the national currency, to instead become primarily a financier to the government, either by printing money or drawing down its own foreign currency reserves. He estimates that the BCRA funded the government last year to the tune of 4.5% of GDP, 75% of which was paid out in pesos, and 25% in foreign currency.

Subsidies to be pared back selectively

A study by Banco Ciudad says that total government subsidies have been growing at an "explosive" rate. Since 2010, the bank calculates that subsidies, measured in local currency, have grown at a cumulative annual rate of 41%. It estimates that subsidies totalled ARS134bn in 2013, with 61% of that total (ARS82bn) going on energy subsidies. Energy subsidies are paid out mainly because Argentina's domestic oil and gas production has been falling, while consumption has been rising. With gas, petrol and electricity tariffs largely frozen during the last few years, the only way to meet demand has been to increase imports. Argentina spent US$6.2bn more on energy imports than it earned from energy exports last year. (Imports of fuel and energy rose by 23% in 2013 to US$11.4bn, while exports dropped 24% to US$5.2bn)

The government also subsidises public sector transport fares, as well as both public and private sector companies that provide public transport services. An example of one of the beneficiaries is the loss-making state-airline, Aerolíneas Argentinas. According to the Instituto para el Desarrollo Social Argentino (IDESA), a think-tank, central government subsidies to Aerolíneas

in the first 11 months of last year totalled ARS3.12bn (US$0.40bn), more than the entire education budget for the province of Formosa.

All of this puts the government led by President Cristina Fernández in a politically difficult position. For more than a decade, her administration and that of her late husband and predecessor Nestór Kirchner (2003-2007) have repeatedly described themselves as 'national' and 'popular', condemning orthodox IMF-inspired economic policies, which are said to always place the burden of economic adjustment on the poor, and not on the rich. Governments representing the rich minority were said to do this through a combination of devaluation, price increases, and public utility tariff increases – in fact, exactly what the current Argentine government has either just done, or is now having to contemplate doing.

At first glance, there seems no way to avoid a politically damaging U-turn, because the existing level of subsidies is unsustainable. To keep them rigidly in place in 2014 could be catastrophic for a government that is now struggling to get to the end of its term in office in 2015 without an economic collapse.

The initial signs are that the Fernández administration will seek to reduce subsidy levels in a way that minimises the political damage. In a speech on 11 February, the president defended the introduction of subsidised utility tariffs after the 2001/2002 default and devaluation crisis, saying they had been essential to preserve purchasing power and inaugurate a decade of 'prosperity'.

"The initial signs are that the Fernández administration will seek to reduce subsidy levels in a way that minimises the political damage.... Fernández sought to boil this down to a catch phrase: 'not economic adjustment policies; economic equity policies'."

Now however, she suggested, some people are benefiting from subsidies although they no longer needed them. It did not make sense that the same people who could qualify to buy dollars for the purpose of adding to their savings were also receiving subsidised electricity. Fernández sought to boil this down to a catch phrase: "not economic adjustment policies; economic equity policies".

The phrase is unlikely to cut much ice with the electorate, as the adjustment has already begun. In January, the government announced a 60% increase in urban bus fares, followed in February by a 50% hike in highway toll charges. While insisting on bringing in an additional price control scheme in supermarkets (known as *Precios Cuidados*), officials have reluctantly agreed to increases in fuel prices. Economy Minister Axel Kicillof has admitted that an increase in utility rates is "being considered".

Limping to the finish line

At Econométrica, Castiñeira calculates that beginning to reduce subsidies in a phased manner, starting with a cut equivalent to around 1% of GDP, would require nominal increases of around 50%-plus in public utility tariffs. He suggests increases of that order can be expected in gas and electricity rates, perhaps beginning in March. Some analysts note the difference between 'social' subsidies, designed to help particularly vulnerable groups; and 'economic' subsidies, such as those designed to keep electricity tariffs low (which benefit the entire population).

Castiñeira says that with 35% of the population below the poverty line (on private sector estimates), it is not equitable to provide the same level of subsidies for 100% of the country's citizens. The government may seek to account for that by creating 'social tariffs' for particular groups, or by boosting targeted social spending such as state pensions in an attempt to protect the more vulnerable (already in this vein, pensions will be increased by 11.3% effective from March). Castiñeira's conclusion is that the adjustment has already begun and is designed "not to resolve the problems that will be inherited by the next government, but only in the measure necessary to avoid a crisis between now and 2015".

CHILE

How to manage expectations in Bachelet's second term

The latest (11 February 2014) economic expectations survey published by the Banco Central de Chile (BCC – the central bank) was downbeat. Respondents are looking for an easing of policy this month: economic growth is slowing at a time that inflation is moderate. The overall environment is not germane for the education and tax reforms proposed by President-elect Michelle Bachelet, who will take office on 11 March.

One of the key features of global financial markets in January was an (aggressive) tightening of monetary policy by a number of emerging market central banks in response to current account deficits, slumping currencies and deteriorating perceptions. This did not include the BCC. At its meeting on 16 January, the BCC kept its key policy rate unchanged at 4.50%.

Moreover, the accompanying comments had a decidedly dovish tone. The BCC noted that "the Chilean economy has continued to lose strength. Domestic output and demand have grown somewhat less than assumed in the latest [December 2013] Monetary Policy Report, particularly in investment-related sectors. … Meanwhile inflation expectations remain around the target [of 3.00%] over the projection horizon and the pace of nominal wages' growth shows a moderation in recent months."

Copper, peso

Copper was trading at US$3.25/lb. on 13 February, compared to just over US$3.7/lb. a year ago. The Chilean peso was trading at about CHP546.75/US$ on 17 February, from CHP525.43/US$ on 31 December 2013.

The BCC's latest survey of economic expectations, published on 11 February, found respondents in a similarly downbeat mood. They are now looking for real annual GDP growth of 3.8% and 4.3% in 2014 and 2015 respectively, having revised down their expectations over several months. The consensus expectation is that the central bank will cut the benchmark rate by 25 basis points to 4.25% at its February meeting. This is at a time that the central bank's IMACEC index of economic activity slipped to 2.60 in February, down from 3.00 in January. The index has fallen consistently on a month-to-month basis since October 2013, when it stood at 4.40, and more generally since March 2013, when it stood at 5.40 (see table 1)

Table 1: Chile: Expectations - Selected Items - %

Survey Month	Policy rate, current month	Policy rate, next month	IMACEC, One Month Ago	GDP Growth, 2014	GDP Growth, 2015	Dec 2014 Inflation
Mar' 13	5.00	5.00	5.40	5.00	4.80	3.0
Apr' 13	5.00	5.00	4.80	5.00	5.00	3.0
May 13	5.00	5.00	4.80	4.80	5.00	3.0
Jun' 13	5.00	4.75	4.50	4.70	4.75	3.0
Jul' 13	5.00	5.00	4.00	4.50	4.70	3.0
Aug' 13	5.00	4.75	4.30	4.50	4.50	3.0
Sep' 13	5.00	5.00	4.10	4.50	4.50	3.0
Oct' 13	5.00	5.00	4.40	4.40	4.50	3.0
Nov' 13	4.75	4.50	4.00	4.10	4.50	2.7
Dec' 13	4.50	4.25	3.50	4.00	4.40	2.8
Jan' 14	4.50	4.25	3.00	4.00	4.30	3.0
Feb' 14	4.25	4.25	2.60	3.80	4.30	3.0

Source: Banco Central de Chile, Expectations Survey

As the BCC itself recognised, both the reality and expectations about the strength of the economy have fallen short of the official forecasts in the last

Monetary Policy Report. For some time, most of the main macro-economic indicators have been moving in the wrong direction. Thanks in part to a steady fall in the global price of copper, Chile's main export, the balance of trade has been deteriorating, and at a time that domestic demand has also been softening (see table 2).

Table 2: Chile: Official Forecasts, December 2013			
	2012	2013f	2014f
(Annual change, %)			
GDP	5.6	4.2	3.75-4.75
National Income	6.3	5.2	4.4
Domestic Demand	7.1	3.9	4.8
Investment (GFCF)	12.3	3.9	4.1
Consumption	5.8	5.4	4.7
Goods & Services Exports	1.0	5.3	3.1
Goods & Services Imports	4.9	4.4	4.6
(% of GDP)			
Current Account	-3.5	-3.2	-3.7
National Savings	21.4	21.1	20.6
GFCF	24.1	24.4	24.3
(Other)			
LME Copper Price (US cents/lb)	361	332	310
December CPI Inflation (%)	1.5	2.6	2.5
Source: Banco Central de Chile, Monetary Policy Report - December 2013			

"One possibility is that Bachelet attempts to buy time with a fiscal boost to the economy. The budget is broadly in balance. Total government debt, at about US$34bn, is low and is held overwhelmingly by domestic investors. As noted above, inflationary pressures (and expectations) are low."

As we discussed in the December 2013 edition of *Latin American Economy & Business*, President-elect Michelle Bachelet has identified three main priorities for her incoming administration. One is a hike in the corporate tax rate from 20% to 25%. A second is wholesale education reform: this includes the introduction of free university education, even though this is rare (or non-existent) in most other countries. Bachelet believes that the increase in the corporate tax rate could boost government revenues by about US$8.2bn annually (in the context of a country whose 2012 GDP amounted to US$268.2bn) and fund her planned education reforms. The third priority is constitutional reform.

A slowing economy and higher taxes are not the only challenges facing Chile's corporate sector. A wave of industrial unrest in the public sector (especially) in the final quarter of 2013 means that employers are having to sustain real increases in pay costs that are not necessarily being matched by higher productivity. In any event, labour productivity in Chile is lower than in any other country in the Organisation for Economic Cooperation and Development (OECD), apart from Mexico. Low labour productivity is one consequence of the deficiencies of Chile's educational system. According to the World Economic Forum's 2013-14 Global Competitiveness Report, Chile is the 34th most competitive country (out of 148 rated): however, it is in 74th place for the overall quality of its education system.

The demands of Chile's students, which Bachelet hopes to meet with her education reforms, and the demands of workers, which have been partially met with pay rises, are symptomatic of a key structural problem: the inequality of income in the country. With a Gini Index* of 0.52, the distribution of income in Chile is less equal than in any other OECD country. (*The

Banco do Brasil

In spite of a poor final quarter, the state-owned Banco do Brasil, the country's largest lender, reported a record net profit of R$15.75bn (US$6.5bn) in 2013, up 29.5% higher on 2012 (and just above Itaú's R$15.69bn profit for the year). The bank's results mean that its profits for last year are the highest ever recorded by a Brazilian bank. In December 2013 Banco do Brasil's volume of assets reached R$1.30bn (US$536m); an annual growth rate of 13.5% and up 3.5% on the previous quarter, thanks mainly to the expansion of its loan book. The bank's loan portfolio reached R$692m in late December, an annual increase of 19.3%. The strongest growth area was in property. The bank's default rate, which measures the percentage of debts payable over three months in arrears, fell from 2.06% at the end of 2012 to 1.98% in December. Banco do Brasil is controlled by the government, but some of its shares are traded on the São Paulo stock exchange.

Gini Index measures the extent to which the distribution of income or consumption expenditure among individuals or households within an economy deviates from a perfectly equal distribution, with 0 representing perfect equality and 1 representing perfect inequality). Meanwhile, expectations have been boosted by the steady economic growth – the result of years of good governance and, prior to 2013, high or rising copper prices.

For now, there is a policy-making hiatus until the new administration is inaugurated on 11 March. Thereafter, Bachelet will have to try to fulfil the expectations of workers and (especially) students at a time that the economy is clearly weaker than it was on 15 December, when she won the second round presidential run-off vote in a landslide. One challenge for the new government arises from the fact that it will likely take years for new education reforms to be seen to be beneficial. Another arises from the possibility that higher corporate tax rates may have an adverse impact on jobs. As of December 2013, the official unemployment rate was 5.70%, on BCC data.

One possibility is that Bachelet attempts to buy time with a fiscal boost to the economy. The budget is broadly in balance. Total government debt, at about US$34bn, is low and is held overwhelmingly by domestic investors. As noted above, inflationary pressures (and expectations) are low. An increase in public sector consumption or investment would underpin overall economic growth until Chile begins to derive benefit from the clear recovery in the US and other developed economies. It could well be that economic conditions in Chile are much more conducive to the reforms that Bachelet envisages towards the end of her four year term. In the meantime, she will have to work assiduously to manage the (high) expectations of various sectors.

BRAZIL

World Cup 2014: are the worries justified?

With the Fifa 2014 World Cup now just four months away (kick-off is on 12 June), in business and political terms it is still not clear if the event will be a 'net positive' or a 'net negative' for the administration led by President Dilma Rousseff. Here we look at some of the arguments raging around the rights and wrongs of hosting one of the world's top sporting events for a month.

The World Cup is about lots of things including money, television rights and football: but for the government led by Dilma Rousseff perhaps one single issue stands out above all others: it is about Brazil's image on the global stage. Ever since the country won the right to host the 2014 World Cup back in 2007 – seven years ago – it has been clear that the whole event has been envisaged as an opportunity to put the country on the map, both as an emerging economic power and as a key business, investment and tourism destination. The decision to distribute the competition between 12 stadiums in 12 separate cities was part of this approach, to give visitors and the TV cameras a taste of the diversity of Brazil's vast geography and different cultures.

Measured purely in terms of global marketing impact, to date the World Cup has had mixed results, at best, for the government in Brasília. The key negative was the outbreak of major anti-government protests in June 2013, with complaints about the World Cup spend featuring large. These protests have continued at reduced intensity since then, but with general elections due on the heels of the World Cup (in early October), things are starting to rumble again.

The diverse protest movement has made a point of contrasting the government's big spend on building World Cup stadiums and other facilities (which are meant also for the 2016 Summer Olympics in Rio de Janeiro) with its poor performance in delivering health, education and public transport services.

This is a message that has been widely broadcast and it has dominated international press coverage of the run-up to the competition.

It is not unusual for major sporting events to be preceded by bad publicity (there were riots in London a year before the 2012 Olympics; the 2014 Sochi Winter Olympics were also preceded by criticism of Vladimir Putin's Russia over corruption and human rights issues). It is still possible that a dazzling and successful football championship will figuratively wipe the slate clean, more than offsetting the earlier bad press and making the whole enterprise worthwhile for Dilma Rousseff's administration. But it remains to be seen whether that will actually happen.

For one, the organisation and planning of the event has prompted serious questions. Andrew Zimbalist, an economics professor at Smith College in the US, has noted that "the obstacles are severe: they include labour shortages, bureaucratic encumbrances, political corruption, legal entrapments, insufficient funds, incompetence and inadequate infrastructure."

Forecasts deteriorate

The consensus forecast on real annual GDP growth in 2014 fell to 1.67% in the 21 February Focus Report compiled by the central bank, down from 1.91% four weeks previously. The end-year benchmark Selic rate was forecast at 11.25%, with year-end inflation of 6.0%. The current account deficit was forecast US$75bn.

Fifa, the world football federation, required all stadium construction work to be completed by the end of 2013: only six of the 12 stadiums were in fact ready by that date, and the organisers are still scrambling to finish the work. Curitiba's Arena da Baixada stadium was a source of particular concern, and risks being dropped from the competition entirely. There was also a dispute over the funding of temporary facilities at the Beira-Rio stadium in Porto Alegre. Following a number of fatal accidents on stadium construction sites (particularly in Manaus), there has also been criticism of health and safety standards. Fifa's president, Sepp Blatter, went on record earlier this year as saying: "No country has been so far behind in preparation since I have been at Fifa".

There are also severe delays in construction projects for roads, airports and hotels. According to government report in November 2013, 22% of 148 World Cup-related energy projects were running behind schedule; there are still worries about the national grid's capacity to handle a surge in electricity demand during the competition. Given the protests and concerns over security, the government has created a new 10,000-strong special riot police squad.

It has become evident that an intended by-product of World Cup preparations – an improvement in public transport and airport infrastructure – has suffered serious delays. Some projects planned for 2014 will now only be ready for the Rio Olympics in 2016. New metro lines in Salvador and São Paulo, airport upgrades in Salvador and Natal, and tramways in Brasília and Cuiabá, all face potential delays. The proposed bullet train service linking Rio and São Paulo has effectively been shelved and will not be ready for 2016. Inevitably, costs have escalated. A total of BRL25.6bn (US$10.6bn) has been earmarked for the World Cup – intended as a combination of public and private investment. Anecdotal evidence suggests that the government's share of that total is rising (to around 80%, according to some estimates), and there are serious cost overruns in the works.

Some members of the business community already consider the World Cup an expensive distraction in a difficult year. A joke 2014 calendar circulating on social media sites suggests that because of summer holidays in January-February, a late Carnival (due in March this year), public holidays in April, the World Cup in June and July, the general elections in October and summer holidays starting again in December, there will only be around three months' worth of work done in Brazil this year (August, September, and November).

However, to put things in context, it is worth remembering the importance of football as a national sport in Brazil, along with the view taken by many that the successful 2010 World Cup in South Africa did indeed attract more tourism and investment to that country. In a Datafolha survey published in

October 2013 63% of Brazilians supported the World Cup, significantly ahead of President Rousseff's approval rating of 41% at that time.

And while Rousseff's image has suffered as a result of controversies over the handling of the World Cup, she remains the front-runner in the presidential race. David Sonter, head of the Brazil group at international lawyers Freshfields, Bruckhaus and Deringer, is optimistic: "If Brazil does win the World Cup, the resulting energy and enthusiasm will mean 2015 will be a cracking year for business."

BRAZIL

The spectre of recession?

Retail sales fell in December for the first time in nine months, resulting in a full year result of 4.3%, the weakest in a decade (in 2003 the sector rose 3.67%) according to latest data from the national statistics institute (Ibge). Sales unexpectedly fell 0.2% month-on-month (in volume terms) ahead of the Christmas season, though they were still up 4.0% in volume terms over the previous December. The IBC-Br economic activity index compiled by the central bank also fell sharply in December, raising the possibility that Brazil was in recession in late 2013.

Brazilians have lost their lust for shopping amid slowing job growth, rising interest rates and the impact of higher inflation on their take-home pay. Consumer confidence in January fell to its weakest level since mid-2009, according to the main ICC index compiled by the Fundação Getulio Vargas (FGV). The FGV polls 2,000 families in the seven main cities for the ICC, which measures the willingness of families to make purchases of a basket of consumer goods and gauges expectations about employment, income and economic opportunities. The index ranges from 1-200, with 100 considered an indicator of neutral sentiment. It ended January 2014 at 108.9 points, down from 112.5 in December. That was the lowest since June 2009, when it dipped to 108.7 points in the midst of the global economic crisis. A wider Ibge retail sales index including the automotive and construction sectors fell 1.5% month-on-month in December after car sales dropped sharply (3.4%). That index rose 3.6% overall in 2013.

Critics of the government of President Dilma Rousseff say that its policy focus on tax breaks aimed at stimulating consumption have run out of mileage. The government argues that these polices were only ever intended as temporary measures to prop up growth during the crisis and that its new focus is on investment-promotion polices so as to facilitate private sector-led domestic economic output over the medium term.

"Critics of the government of President Dilma Rousseff say that its policy focus on tax breaks aimed at stimulating consumption have run out of mileage. The government argues that these polices were only ever intended as temporary measures to prop up growth during the crisis and that its new focus is on investment-promotion polices so as to facilitate private sector-led domestic economic output over the medium term."

The IBC-Br economic activity index fell 1.35% in December over November, in seasonally adjusted terms. The IBC-Br, a GDP proxy, rose 2.57% in calendar 2013 as a whole, however, it fell for two straight quarters in the third and fourth quarters (-0.21% and -0.17% respectively), which amounts to a technical recession. The broader official GDP data compiled by the national statistics institute (Ibge) is due out on 27 February. Real GDP contracted 0.5% in the third quarter of 2013, on the Ibge measure.

Primary surplus target cut to measure

On 20 February Brazil's treasury, led by the externally-discredited finance minister Guido Mantega, announced a cut in the official primary surplus target to 1.9% of GDP for 2014, from 2.3% previously. The government said it would freeze R$44bn (US$18.44bn) in public spending to meet the primary surplus target, up from R$38bn last year. "Our projections are attainable and realistic and conservative, so we should

deliver this result in December," Mantega stated at a press conference. The latest projection is based on real GDP growth of 2.5% year-on-year in 2014 (down from a previous forecast of 3.8%), with inflation of 5.3% (down from 5.8% previously).

Markets welcomed the 'reality check' and the Real rose 1% in response to close the day at R$2.37/US$, its strongest level since 21 January. Yet fiscal analysts remain slightly sceptical as to whether the government will be able to deliver on its promise ahead of President Dilma Rousseff's bid for re-election in October. Steadily shrinking primary surpluses mean that the overall budget deficit hit a three-year high of 3.2% of GDP in 2013, up from 2.48% in 2012.

MEXICO

Pepsi not put off by soft drinks tax

Since 1 January 2014, soft drinks have become more expensive in Mexico. As part of fiscal reforms introduced by the government led by President Enrique Peña Nieto, and reflecting health concerns over the spread of diabetes in the country, a one-peso tax has been added to the retail price of soft drinks (equivalent to a duty of around 12%), while an 8% tax is being applied to high-calorie processed foods such as potato chips, chocolate and ice cream. Major bottling companies opposed the soft drinks tax, but this did not stop PepsiCo from announcing, at the end of January, a major new US$5.0bn investment programme in Mexico, which is expected to create 4,000 new jobs.

PepsiCo likes Mexico, and it is not too hard to see why. The country has the highest per capita consumption of carbonated drinks in the world (last calculated at 163 litres per head per annum). Although PepsiCo's traditional rival, Coca-Cola, has a giant 71% market share of the Mexican soft drink sector, PepsiCo's smaller 14% is still an important source of sales. PepsiCo's Frito Lay division also has a big share of the local snack market through brands such as Doritos, Cheetos and Sabritas.

"Announcing the latest investment, Pedro Padierna, president of PepsiCo Mexico, stated: "Mexico is an important market for PepsiCo and we believe there is a tremendous opportunity for growth and expansion throughout the country. This investment reflects our confidence in Mexico's future"."

Sabritas has an 80% share of Mexico's salty snack market. In fact, Mexico was the company's number three source of global revenue in 2012, after the US and Russia. It generated US$4.0bn, or 6% of global PepsiCo sales. The company's Latin American Foods (LAF) division has outstripped all others in terms of annual growth rates. Announcing the latest investment, Pedro Padierna, president of PepsiCo Mexico, stated: "Mexico is an important market for PepsiCo and we believe there is a tremendous opportunity for growth and expansion throughout the country. This investment reflects our confidence in Mexico's future".

Company executives also said that they expect Mexico's middle classes to expand, pushing up consumptions of soft drink and snacks. Significantly, the new investment will not just go into increased food and beverage production, but also into locally-based research and development, through, among other things, the creation of a 'Global Baking Category Innovation Centre' to be based in Monterrey. In the end, the higher taxes do not seem to have been a big deterrent. According to Marisol Huerta, an analyst at Grupo Financiero Banorte SAB, PepsiCo still sees strong sales: "the consumer will feel it, but will most probably absorb it," she concluded.

Others have also seen the opportunity. Coca-Cola itself earlier announced a US$5.0bn investment programme, while the Switzerland-based Nestlé is investing US$1.0bn over the next five years to build new factories including an infant nutrition production plant at Ocotlán and a pet food plant in Silao.

ECONOMIC FOCUS

PUERTO RICO

Old problems, new investors...

The downgrading of Puerto Rico's sovereign rating to below investment grade by the three major agencies merely confirms the perceptions of market investors. A financial crisis is not imminent, just as it wasn't in October last year, when there was widespread comment in the mainstream media about the government's financial problems. In essence, the government's funding costs have risen – and it is increasingly being supported by High Yield, rather than US Municipal Bond investors. The main problem remains stagnation in an economy that has enjoyed only one year of growth since 2006.

In the first half of February 2014 the three major ratings agencies – Standard & Poor's (S&P), Moody's Investor Service and Fitch Ratings – all downgraded the general obligations (GOs) of the government of Puerto Rico, and related securities, to below investment grade. In some cases, securities were downgraded by two notches.

The box below summarises how the agencies explained their decisions. The financial position of the government of Puerto Rico has been deteriorating for some time, principally because of the general stagnation of the economy since 2006. The latest data in this respect is uninspiring: the Economic Activity Index (EAI) published by the Government Development Bank for Puerto Rico (GDB) fell by 1% month-on-month and 5.2% year-on year in December 2013. Further, the government has less access than previously to funding from the GDB. This is at a time that its ability to raise money by issuing bonds has been reduced – thanks in part to the assessments of the agencies themselves.

"The financial position of the government of Puerto Rico has been deteriorating for some time, principally because of the general stagnation of the economy since 2006. The latest data in this respect is uninspiring: the Economic Activity Index (EAI) published by the Government Development Bank for Puerto Rico (GDB) fell by 1% month-on-month and 5.2% year-on year in December 2013."

Puerto Rico is an unincorporated US territory. Accordingly, the government and its agencies could readily sell bonds into the US$3.7trn US municipal bond market, not least because their interest payments were exempt from federal, state and local taxes. In mid-October 2013, there was widespread commentary about the government's financial problems. This was partly because the GOs had fallen in price by around a fifth since the beginning of 2013, and were trading on yields normally associated with High Yield (i.e. sub-investment grade, or junk) bonds. This meant that they had grossly underperformed other municipal bonds. It was also also because of the publicity surrounding the mid-July filing for Chapter 9 bankruptcy by the City of Detroit. For its part, the government published a comprehensive 'Update on Fiscal and Economic Progress' on 15 October.

In the October 2013 edition of *Latin American Economy & Business,* we argued that a financial crisis was not, in fact, imminent. This was partly because the outstanding debt of the government and its agencies, which amounted to around US$70bn, was manageable in relation to public sector budgets of around US$29bn annually, if high relative to GDP of around US$100bn. It was partly because the government and its agencies did not have to access to capital markets for the remainder of the fiscal year to the end of June. In any event, the government could borrow from the GDB. At the time, the GDB had about US$2.8bn in liquid and high quality securities (e.g. US treasury bonds, agencies, and mortgage-backed securities). In theory, the GDB's balance sheet could also have been boosted by the transfer of public sector deposits with private sector banks, and by other measures.

As the agencies have indicated, there have been a number of positive developments in the recent past. The administration of Governor Alejandro García Padilla has undertaken necessary reforms of the pension systems for

public servants and teachers (and in face of industrial action by the latter). The administration has increased the Sales and Use Tax (SUT) from 2.75% to 3.50%. As highlighted by S&P, the "administration [has] just announced an intention … to reduce the current year deficit and to introduce a balanced budget in April for fiscal 2015, which would be the first balanced budget in many years". Crucially, the US economy has continued to strengthen.

In the meantime, the fall in the price of the GOs (and other related bonds) through the first three quarters of 2013 indicates that investors, collectively, have made allowances for the risks and problems. On 12 February 2014, Fitch noted that, over the last seven months of 2013, single-state municipal bond mutual funds had reduced their average exposure to Puerto Rico securities from 4.7% to 1.5%. Municipal Bond funds investing across the US had cut their exposures from 2.0% to 0.8%. Fitch thinks that the municipal bond funds that had retained exposure to Puerto Rico securities had tended to reduce their exposure by selling bonds of COFINA – an agency of the GDB through which SUT revenues are channelled: this was because the COFINA bonds were more highly rated than the GOs and losses realised on sales would have been less.

Fitch suggests that the enactment of the 2013 Puerto Rico Investment Company Act (PRICA) could result in further sales of GOs and other government-related securities by Puerto Rico-based mutual funds, which had assets under management (AUM) of over US$11bn at the end of last year. "Mutual funds operating out of Puerto Rico currently invest almost exclusively in Puerto Rico municipal debt. If they adopt the new PRICA, they would be allowed to diversify their portfolios outside of the Commonwealth or into local corporate exposures. Selling municipal bonds could further stress prices of the island's debt."

"In the end, the higher taxes do not seem to have been a big deterrent. According to Marisol Huerta, an analyst at Grupo Financiero Banorte SAB, PepsiCo still sees strong sales: "the consumer will feel it, but will most probably absorb it," she concluded."

In practice, though, the prices of GOs and other government-related bonds have not been adversely affected by the downgrades. On February 12, Fitch noted that the price of GO pension funding bonds maturing in 2016 had bounced by around 14% from lows in the first week of the month. The price of COFINA SUT bonds had recovered by about 9% from lows in December 2013.

In essence, the latest announcements from the ratings agencies confirm changes that have already taken place. The government's funding costs have increased. Whereas previously, it was being financed by municipal bond investors, it is now reliant significantly on High Yield bond investors. Although some of the metrics are alarming (such as the US$37bn unfunded actuarial liability in the public servants', teachers' and judicial pension schemes identified by S&P), a financial crisis does not appear to be imminent. In the short-term, the government's planned issue of bonds to refinance GDB borrowings will provide a useful indicator of the views of investors. Over the medium-to-long term (i.e. six to twelve months), the key factor will be the growth trajectory of the US economy. If the recovery is faster than generally expected, perceptions of the GOs of the government of Puerto Rico (and related securities) could improve significantly.

Ratings agencies' comments

'The downgrades follow our evaluation of liquidity for the Commonwealth, including what we believe is a reduced capacity to access liquidity from the Government Development Bank (GDB) of Puerto Rico. In a related action, we downgraded the GDB to BB, and the rating remains on CreditWatch with negative implications. We also believe that the Commonwealth's access to liquidity either through GDB or other means will remain constrained in the medium term, even in the event of a potential issuance of debt planned next month. We believe that these liquidity constraints do not warrant an investment grade rating. … That the rating is not lower is due to the

progress the current administration has made in reducing operating deficits, and what we view as recent success with reform of the public employee and teacher pension systems, which had been elusive in recent years. We view the reform as significant and could contribute to a sustainable path to fiscal stability.' *Standard & Poor's, 4 February 2014*.

'The problems that confront the Commonwealth are many years in the making, and include years of deficit financing, pension underfunding and budgetary imbalance, along with seven years of economic recession. These factors have now put the Commonwealth in a position where its debt load and fixed costs are high, its liquidity is narrow and its market access has become constrained. In the face of these problems, the administration has taken strong and aggressive actions to control spending, reform the retirement systems, reduce debt issuance and promote economic development. Despite these accomplishments, however, in our view the Commonwealth's credit profile is no longer consistent with investment grade characteristics. While some economic indicators point to a preliminary stabilisation, we do not see evidence of economic growth sufficient to reverse the Commonwealth's negative financial trends.' *Moody's Investors Service, 7 February 2014*.

'Fitch placed the general obligation (GO) and related ratings on Negative Watch in November 2013, citing the challenge facing the Commonwealth in maintaining financial flexibility in light of the deterioration in capital markets access. Recent downgrades have triggered new liquidity requirements and lowered expectations for the market available for the Commonwealth's finances or economy since November. In the context of other credit challenges related to a weak economy and elevated liability levels, Fitch believes that these additional hurdles preclude … an investment grade credit profile. … Fitch believes that the ultimate success of efforts to put the Commonwealth's finances on a sustainable path will be dictated by the performance of the economy.' *Fitch Ratings, 11 February 2014*.

BARBADOS

A tough position, but not an impossible one

The International Monetary Fund (IMF)'s latest Article IV Consultation with the government of Barbados has highlighted the challenges that the island government faces. After years of economic stagnation and soaring public debt, the Bridgetown government needs to promote growth and put its finances on a stable footing, within the constraints of a fixed exchange rate regime. Fortunately, Barbados' reasonably competitive US$4.0bn economy is one in which relatively few new investments could have a positive impact – especially as the UK and US economies are recovering.

Data published on 12 February by the IMF do not show Barbados in a good light. Thanks mainly to the weakness of the economies of its main trading partners (the UK, the US and other Caribbean countries); the local economy has stagnated for the last five years. Low inflation in the past two years has gone hand-in-hand with a contraction in bank lending to the private sector, with both financial institutions and their customers remaining cautious. The government's fiscal deficit has been rising, and stood at a little over 7% of GDP in 2013. Since 2010, the ratio of outstanding government debt to GDP has risen from about 70% to over 90%: the figures are even more alarming if one includes government debt held in the investment portfolio of the National Insurance Scheme (NIS – the island's social security system). The current account deficit has been running at around 10% of GDP – although inwards Foreign Direct Investment (FDI) has been sufficient to cover this. International reserves have been falling, in part because the central bank has been monetising some of the government's spending, and now cover about three months of imports. The major ratings agencies downgraded the Barbados government to below investment grade in 2012 (*see table 1*).

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> "The IMF identified a number of risks that "would aggravate vulnerabilities and could trigger a disorderly adjustment process." These risks include delays to implementation of the government's proposed fiscal adjustments. However, most of the risks emanate from outside Barbados. Volatility in global financial markets could hamper the government's access to funds. The maturity profile of the government's outstanding debt means that its total financing requirement is expected to rise from 39% of GDP in 2013/14 to 50% of GDP in 2018/19."

Table 1: Barbados: Selected Economic Indicators

Fiscal year to 31 March	2011	2012	2013	2014	2015
Annual Change %					
Real GDP	0.2	0.8	0.0	-1.7	-1.2
CPI Inflation (Ave.)	5.8	9.4	4.5	2.3	2.0
Exports (Goods & Services)	7.9	6.7	-6.6	-3.1	2.5
Imports (Goods & Services)	9.5	2.6	-7.8	-0.8	-4.0
Broad money	3.9	-2.9	6.3	1.2	1.7
Private sector credit	1.5	2.7	10.5	-2.5	-2.8
Percentage of GDP %					
Central government revenues etc	25.8	29.4	27.6	23.9	24.9
Central government spending	34.6	33.9	35.6	33.5	29.5
Interest on debt	5.7	6.1	6.6	7.3	7.5
Balance	-8.8	-4.4	-8.0	9.6	-4.9
Gross government debt [1]	70.3	78.0	85.8	92.0	94.7
Gross government debt [2]	96.7	106.1	118.2	126.4	129.8
Current Account	-5.8	-11.4	-10.1	-11.4	-7.8
Overall External Balance	-0.6	-0.1	0.3	-3.9	-1.3
Memo: L/T Private Flows	4.9		7.7	1.8	8.0
US$mn					
Net International Reserves	718	712	729	563	509
Nominal GDP	4,434	4,369	4,225	4,284	4,316

[1] Excludes bonds held by National Insurance Scheme (NIS)

[2] Includes bonds held by NIS

Source: IMF, Press Release 14/51, 12 February 2014.

As the IMF highlighted, the government has not been sitting by idly. In the second half of 2013, the government announced a 13% reduction in the number of civil servants, "further downsizing by attrition, wage cuts for elected and appointed officials, and a two year nominal wage freeze". The IMF thinks that these measures could reduce the fiscal deficit to 4.9% of GDP. This should enable the debt-to-GDP ratio to stabilise from 2015/2016 and to decline slowly thereafter. For its part, the IMF believes that the government can also take steps to boost revenues, "by broadening the tax base, reducing tax exemptions and improving tax and customs administration". The IMF also sees potential for improvement in the performance and oversight of the main public enterprises (PEs), many of which have not reported on their results to the finance ministry for several years.

All parties are committed to maintenance of the currency peg, which fixes the Barbados dollar to the US dollar at a rate of 2:1. One implication of this is that the IMF has argued that the central bank should stop financing the government and allow interest rates to rise in order "to reflect a credible risk premium". In essence, maintenance of the peg should be, and be seen to be, the paramount aim of monetary policy conducted by an independent institution. The other implication is that Barbados' economy could adjust to the current imbalances through falls in prices and wages – an internal devaluation. In the early 1990s, the government undertook a fiscal adjustment equivalent to 7% of GDP in one year, along with real wage cuts and other adjustments over a period of years. This had the desired effect – and the government sustained primary surpluses of 2%-4% of GDP for about a decade. However, the IMF notes that this approach would be much riskier now, given that growth is slower and the mountain of public debt much larger.

In its Article IV consultation, the IMF identified a number of risks that "would aggravate vulnerabilities and could trigger a disorderly adjustment process." These risks include delays to implementation of the government's proposed fiscal adjustments. However, most of the risks emanate from outside Barbados. Volatility in global financial markets could hamper the government's access to funds. The maturity profile of the government's outstanding debt means that its total financing requirement is expected to rise from 39% of GDP in 2013/14 to 50% of GDP in 2018/19. Tourism receipts are vulnerable to future weakness in key markets. A fiscal shock in the US or a shock in the UK or Trinidad & Tobago – the country's three biggest trade partners – would also hurt.

However, we would highlight a number of positives. Although Barbados has been losing market share to other tourist destinations, its upmarket 'brand' is reasonably well established. According to the World Economic Forum's latest (2013-2014) *Global Competitiveness Report,* Barbados is the 47th most competitive economy of the 148 surveyed, and compares favourably with similar economies except in terms of its macroeconomic environment and the absolute size of the market. Although the country's international business/ offshore finance sector is smaller than others in the region (e.g. Bermuda and the Cayman Islands) it is substantial: the IMF notes that, in 2012, there were 4,000 licenced entities, including 45 offshore banks. The six domestic banks are well capitalised and are owned by foreign institutions. Subsidiaries of Canadian banks account for about three-quarters of total assets of the banking system.

"Most importantly, an economy that is only about US$4bn in size, but in which per capita incomes are a little over US$16,000, is one in which positive changes are relatively easy to engineer."

Most importantly, an economy that is only about US$4bn in size, but in which per capita incomes are a little over US$16,000, is one in which positive changes are relatively easy to engineer. In its analysis, the IMF identified 11 large capital investment projects that will be underway in 2014/15 and which have a combined face value that exceeds 10% of GDP (*see table 2*). The announcement over the next year or so of additional investment projects – probably related to tourism or offshore business, the two sectors in which Barbados clearly has a competitive advantage –would have a positive impact, both on the economy and on perceptions.

Table 2: Investment Projects 2014-15

Green Energy	**Tourism**
Sustainable Energy Investment Program	Sandals Resort
Public Sector Smart Energy Program	Cruise Ship Pier and Ancillary Facilities
Solar Electricity Roof Project	Pierhead Marina Development
Waste to Energy Facility	**Others**
Agriculture	Bushy Park
Sugar Cane Restructuring Project	Low Housing Project
	Road Rehabilitation Project

Source: IMF Country Report 1452, February 2012, p8.

In short, we believe that the position of the government of Barbados is tough, but not impossible. Over the next six months or so, we believe there are three factors to monitor that will provide clues as to whether the position is improving. One is the health of the US and UK economies, the island's key trading partners. The second is the extent to which the Bridgetown government is actually implementing measures to cut expenses and/or to boost revenue. The third is the extent to which the central bank is ceasing to act as short-term financier of the government. Progress in any of these three areas would be good news.

EU-Brazil
The EU-Brazil strategic partnership was established in 2007. The EU is Brazil's main trading partner and the top destination of Brazil's exports. EU exports to Brazil were valued at US$55bn in 2013, up slightly from US$54.5bn in 2012, on EU data, of which about 90% consisted of manufactured goods (automotive, aircraft, chemicals, and other machinery). Brazilian exports to the EU were worth US$45.3bn in 2013, down from US$51.3bn in 2012. Primary products (food and drink, raw soy beans, oilcake, iron ore, coffee and crude oil) made up about 70% of Brazil's total sales to the EU.

Pacific Alliance vs. Mercosur debate continues

In a research note on Latin America's economic outlook published on 20 February, the Spanish bank BBVA predicts that the Pacific Alliance countries will grow at more than double the rate of the Southern Common Market (Mercosur) countries this year. There has been considerable debate in recent months over the relative merits of the putatively rival trade blocs, the newly-created Pacific Alliance (comprising Mexico, Colombia, Peru and Chile) and the 23-year old Mercosur (comprising Argentina, Brazil, Paraguay, Uruguay and Venezuela). The former is seen as more outward looking and market friendly than the latter. BBVA does not make a comparative analysis of their trade policies, but it does underline that, based on an aggregation of individual performances, the Pacific Alliance will grow by an average of 3.8% this year, against Mercosur GDP expansion of only 1.5%.

Based on BBVA's data, the Mercosur countries have been leading the GDP growth race for the last three years (2011-2013), but are now being overtaken by the newer and 'in' Pacific Alliance group, which looks set to be in pole position both in 2014 and 2015. BBVA has raised its forecast for the Pacific Alliance to an overall growth rate of 3.8% in 2014 and 3.7% in 2015. It has also revised its growth forecast for Mercosur downwards to 1.5% in 2014 and 1.8% in 2015. This means that over the next two years the Pacific Alliance will be growing at double the rate of Mercosur.

At one level, this is completely unsurprising. Brazil, the largest economy in Latin America and dominant in Mercosur, is slowing down. Mexico, the number two in Latin America and the largest in the Pacific Alliance, is speeding up. And Mercosur is also likely to be dragged down by two crisis-hit economies, Argentina and Venezuela. But BBVA makes some interesting additional points. Pacific Alliance growth will be led by solid domestic consumption levels and recovering export demand in Chile, Peru and Colombia. Mexico will benefit from the US recovery and enthusiasm about its recent structural reforms.

In contrast, BBVA believes that after a number of good years, domestic consumption-led growth in Brazil has lost impetus as the country struggles with the need to begin new structural reforms. Contagion from Argentina's financial difficulties is also a problem, although a weaker currency will help exports. BBVA expects Brazil's public sector spending to be cut back in 2015, after this year's elections. Uruguay and Paraguay will perform well, but risk being dragged down by their neighbour.

Rousseff in Brussels to give EU-Mercosur deal a push

On 24 February in Brussels, Brazil's President Dilma Rousseff was expected to use the seventh bilateral Brazil-European Union (EU) summit to give another push to the stop-start talks on a free trade deal between the EU and the Mercosur four (Argentina, Brazil, Paraguay and Uruguay).

Rousseff had private meetings scheduled with the respective presidents of the European Council and the European Commission, Herman Van Rompuy and José Manuel Barroso, to discuss the current state of play in the EU-Mercosur talks. With one eye on the pending new EU-US free trade deal, and another on the rapid evolution of the Pacific Alliance, Brazil is anxious not to become isolated. March will be a key month, during which Rousseff hopes to get a consensus within Mercosur itself on its proposed tariff schedule (i.e. drag Argentina kicking and screaming into line with the other Mercosur three), while an EU protectionism case against Brazil at the World Trade Organization (WTO) is also scheduled to be heard. Separately, the EU and Brazil were expected to announce a bilateral deal on mutual recognition of standards and commercial norms, investment and competitiveness.

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