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Economic storm clouds gather in Brazil

Things are not looking good for Latin America's largest economy. To try and rebuild confidence, the government led by President Dilma Rousseff is obliged to tighten both fiscal and monetary policy, amid an adverse political situation dominated by the major corruption scandal at the state oil major Petrobras and an increasingly rebellious congress.

Most of Brazil's economic news in February was worrying. On 23 February, local consensus forecasts for growth and inflation worsened for the eighth consecutive week. On average, the roughly 100 economists regularly surveyed by the central bank (BCB) felt that the economy would shrink by 0.5% this year (down from -0.42% the previous week), while they suggested that inflation would total 7.33% over the year (up from 7.27% previously). Speaking to investors in São Paulo, the new finance minister, Joaquim Levy, admitted that the public sector deficit, which is running at nearly 7% of GDP, is "not sustainable". He reiterated that fiscal discipline would be the key to regaining the trust of investors and paving the way for economic recovery. Yet political developments have not been supportive. The Rousseff government continues to struggle with the fallout from the Petrobras corruption scandal, and faces signs of growing congressional resistance to the initial austerity measures sought by Levy. "Investors are sensitive to this increasingly grim economic picture, as negative data keeps piling up" commented Camila Abdelmalack, an economist at the CM Capital Markets in São Paulo.

The government's fiscal deficit is a central part of the problem. Neil Shearing, of the London-based consultancy Capital Economics, argues that the deficit has been built up steadily, as part of an "incorrect" policy response to the slowdown in Brazilian economic growth from 2011. Believing that slower growth was caused by insufficient demand, the government adopted expansionary fiscal policies and boosted lending by the state development bank, BNDES. But, Shearing argues, there wasn't really a demand problem at all, but on the contrary, a supply side problem, caused by bottlenecks, low productivity and labour shortages. It follows that greater government spending and lending in 2011-2014 was counter-productive, boosting domestic inflation, widening the fiscal and current account deficits and failing to bring about faster GDP growth. Capital Economics estimates that the two key deficits, fiscal and current, rose to 6.7% and 4.2% of GDP respectively in 2014.

Levy is seen as genuinely committed to narrowing these imbalances. He has announced that BNDES lending will be reduced. In his comments in São Paulo he spoke of the need to end a whole series of counter-cyclical measures, which first were introduced after the 2008/09 global downturn and continue to give fiscal policy an inbuilt expansionist bias. As he put it, "fiscal stability is the base of currency and price stability". Levy suggested that if investor confidence could be rebuilt in 2015, a recovery would commence in 2016.

Yet for number of reasons, any correction is likely to be slow and painful. One is technical. In an ideal world, fiscal tightening might be accompanied by a more relaxed monetary policy, which would support a private sector investment and growth-led cycle. But because inflation is already trending upwards, the authorities will have to tighten on both fronts simultaneously. (The BCB in January already raised the benchmark Selic interest rate by 50bps to 12.25% to try to bring inflation back down to the target band). In addition, to begin to reduce the fiscal deficit, the government is increasing some regulated prices – a move that will lead to a short-term rise in inflation.

Key Brazil forecasts			
	2014	2015	2016
GDP % y-o-y	0	0.5	1.5
Inflation %	6.3	7	5.3
Budget balance (% GDP)	-6.7	-5.5	-4.2
Current Account balance (% GDP)	-4.2	-3.5	-3
Policy Rate (% year-end)	12.25*	12.75	11.75
Real (vs. US$, year-end)	2.74*	2.85	2.85
Source: *Capital Economics. Note: * = as at 11 February 2015*			

A major difficulty is political. Levy has already announced an initial round of reductions in labour and pension benefits, which could deliver savings of up to BRL18bn (US$6.23bn), but this is facing a degree of opposition from within the government's loose ruling coalition in congress. Eduardo Cunha of the power-wielding Partido do Movimento Democrático Brasileiro (PMDB), part of the ruling coalition but a critic of the president, has been elected leader of the federal chamber of deputies. Congress has been considering various proposals (including a readjustment of tax rate bands) that would dilute the austerity programme. This will make it more difficult for Levy to meet his target of a primary budget surplus of 1.2% of GDP this year. Indeed, according to some reports, the finance minister is considering spending cuts totalling US$28.2bn this year, which is likely to be resisted. Importantly, the Petrobras corruption scandal is a major complicating factor, also undermining investor confidence. Meanwhile the recent drought has also exposed one of Brazil's supply-side weaknesses, excessive reliance on hydroelectric power generation, which raises the likelihood of electricity outages, which would have a further negative knock-on impact on growth prospects.

Perhaps the major political problem is that a correct response to the country's low productivity and supply-side problems would be a series of structural economic reforms. But in the current political climate, the likelihood of the government being willing and able to steer such a package of reforms through congress appears vey low. This has led some economists to argue that the government will try to use the depreciation of the currency as a way of easing the adjustment and making Brazilian exports more competitive. Those who believe this policy direction holds some promise note that although Brazil's commodity export prices have peaked, they are now unlikely to fall much further. Lower oil prices are beneficial for the country, which remains a net fuel importer.

The current account deficit reached a record US$90.9bn last year, about 4.2% of GDP. With the Brazilian Real depreciating in recent months – it reached a 10-year low of BRL2.87/US$ on 23 February – some believe that Brazilian exports will slowly recover, narrowing the current account deficit and eventually helping the recovery process. Robson Andrade, president of the confederation of national industries (CNI) is one of them. "The reforms are going to take many years to be achieved. So what we have to do is try and improve competitiveness in the short term, using the exchange rate and interest rates. The dollar today should be closer to three reais", he recently commented.

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CUBA

Netflix versus 'el paquete'

"According to Netflix, Cuba is the eighth country in Latin America to receive its service, following on behind Argentina, Brazil, Chile, Colombia, Mexico, Paraguay and Uruguay. Despite massive differences in consumer purchasing power, the entry-level subscription in Cuba will be the same as in the US, the equivalent of US$7.99 a month. Average Cuban salaries are the equivalent of around US$20 a month, so a Netflix subscription would take around 40% of a regular monthly salary. If the additional US$4.50 an hour needed to pay for broadband access in some of the islands relatively few Internet cafés is taken into account, the total cost could be over half the average salary."

On 9 February Netflix, the US online film and TV series distributor, said it would begin to offer its services across Cuba "as soon as Internet access improves and credit and debit cards become more widely available". The California-based company said it was able to offer its service immediately to anyone in the country able to access and pay for it in hard currency. The move was made possible by the US-Cuba diplomatic thaw, which includes an agreement allowing US telecoms companies to develop the island's Internet infrastructure.

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Internet penetration is low on the island. According to Internet Live Stats, using information from the International Telecommunications Union (ITU) and the World Bank, Cuba's internet penetration rate is 27%. But the US-based political lobby Freedom House puts the rate at a much lower 5%. So a lot needs to be done before anything like a mass market can be said to exist.

Nevertheless, the company clearly thinks getting into Cuba now is an important strategic move. Netflix began operating in Latin America in 2011. Worldwide, it now has over 57m subscribers in over 50 countries. Its Latin America-based subscribers number around 5m, close to 10% of its global market. "We are delighted to finally be able to offer Netflix to the people of Cuba, connecting them with stories they will love from all over the world'" said Netflix CEO Reed Hastings, adding that "Cuba has great filmmakers and a robust arts culture and one day we hope to be able to bring their work to our global audience…"

While Reed spoke of taking Netflix's popular series *House of Cards* to Cuba, the reality is that it is already there – offered by 'el paquete', which could be described as an informal distribution system using technology more appropriate to Cuba's current state of development. The first series of *House of Cards*, along with *Breaking Bad* and a wide range of Mexican TV soaps, all can be rented for around 1 CUC – a convertible peso, worth US$1. Individual distributors offer these series on DVDs or hard discs. The service is illegal but widely tolerated. Many would-be local entrepreneurs use the few good Internet connections available to download the series and offer a service of home delivery. Some offer monthly subscription arrangements at 100-150 pesos (around US$3-US$5). An interesting question is whether these small local operations can be quick enough, innovative enough and flexible enough to stay in the game and even hold market share in the face of the Netflix incursion.

Cemex considering asset sales

In early February, Fernando González, chief executive of the Monterrey-based Cemex, one of Latin America's largest multinationals, told *Reuters* that the group was considering selling off some of its assets in Europe, Asia and the Mediterranean as part of a strategy to pay off debt. Some 5%-10% of Cemex Latam Holdings (CLH) might also be divested, with 50% of the earnings generated also being used to pay debts.

The problem with Cemex is that it expanded too fast in the period running up to and including the 2008/09 global downturn. Having gone on an international acquisition spree and turned itself into one of the world's largest cement manufacturers, it became saddled with heavy debts and almost defaulted three years ago. Since then it has been on a path of slow improvement.

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For 2014, Cemex reported a loss of US$424.8m, down from US$747.9m in 2013. According to the company, it is benefitting from the recovery in the US and from a better-than-expected performance in Mexico. The US is the company's biggest market by sales, with Mexico in the number two slot. However, as far as profits are concerned, Mexico remains on top, generating around one third of the Cemex global total, with the US in the number two position, due to the effect of heavy debt servicing costs in that market. The good news is that the US recovery is helping the process of working down debt: Cemex cement sales in the US grew by 11% in 2014, with new housing starts picking up pace and cement prices also on the up. Cement sales in Mexico were pretty much flat throughout the year, but they rose by 5% in the fourth quarter, suggesting better things for 2015. However sales in northern Europe, Cemex's third largest market, remained poor, falling by 9% in the last quarter of 2014. Globally, Cemex sold 17.2m metric tons of cement in the fourth quarter, up by 5% on the year-earlier period.

Presenting the company's results, González stressed that Cemex had narrowed its losses for three years in a row: 2012, 2013 and 2014. Total debt was cut to US$16.3bn at the end of 2014, 6.8% down from the US$17.5bn reported at the end of 2013. While clearly moving in the right direction, total debt still exceeded consolidated net annual sales, which totalled US$15.7bn last year. González said that Cemex was "pleased with the growth in volumes and local currency prices for our products in most of our regions, reflecting the continued positive outcome of our value-before-volume strategy".

In later comments, however, it was clear that the chief executive is seeking to accelerate the debt reduction process in 2015. He told *Reuters* that over the next 18 months Cemex would seek to regain its investment-grade rating by cutting costs and selling up to US$1.5bn worth of assets. A key target for calendar 2015 was to cut costs by US$300m and pay down debt by US$500m.

While the global outlook for cement sales in 2015 is broadly positive and should support the Cemex strategy, there are some doubts. In an investor note, Credit Suisse highlighted a potential downside of low oil prices: "We believe the market is underestimating the impact that lower oil prices will have in the Texas jobs market and construction activity" it commented. There is also a question over whether Cemex will use the proposed divestment strategy to refocus on its core cement business, or whether it will pursue some limited diversification. A sign of the latter came recently, when the company said it was launching a new energy division, Cemex Energía, to take advantage of the liberalisation of the Mexican energy sector. The new division will develop business opportunities in the power sector and in renewable energy. It will aim to supply 3%-5% of Mexico's electricity needs within the next five years. Cemex Energía also said it was launching a joint venture with Pattern Energy Group to develop a portfolio of renewable energy assets.

The automotive sector - three-way trade dispute?

Mexico and Brazil have been negotiating the future of their automobile trade agreement, which is due to expire on 19 March. Mexico, with a flourishing automotive industry, wants the two countries to move to free trade in vehicles and auto parts, while Brazil, struggling with recession, wanted to maintain a system of import quotas. The outcome of the negotiations also has implications for Argentina, which is a party to the agreement.

Until last year, Brazil, Mexico and Argentina, in that order, have been the 'big three' of the Latin American automobile industry. But in 2014 the line-up changed to Mexico, Brazil and Argentina, with Mexico overtaking Brazil in the number one position. The Mexican economy grew modestly in 2014, while Brazil struggled with a stagnant economy and Argentina slipped into outright recession. The contrast in the fortunes of their respective automotive sectors was even greater. The Mexican industry, closely integrated with automobile production in the US and Canada, and with competitive labour costs, had a boom year. Mexican car production surged by nearly 10% to 3.22m vehicles. Brazilian car production, on the other hand, fell by 15% to 3.15m vehicles. Argentine car production slumped by 22% to 617,329 units.

Mexico is in favour of returning to free trade in automobiles when its existing three-year auto industry trade agreement with Brazil and Argentina expires on 19 March. On 12 February, Brazil's trade minister, Armando Monteiro, told *Reuters* that Brazil would seek a continuation of the trade quota regime; he implied that his country would favour smaller quotas. Mexico's economy minister, Idelfonso Guajardo, countered: "I'm going… to put everything on the table so that we can return to free trade. To have credibility, first you have to respect your accords".

At issue is the future of an agreement known as ACE 55 (Acuerdo de Complementación Económica No 55), which was signed in 2012 by all three countries. Under ACE 55, Mexico accepted temporary quotas on its exports to Brazil, which were to be replaced by free trade this year. The quotas – which apply equally to both countries - were set at US$1.45bn in the first year, US$1.56bn in the second and US$1.64bn in the third. Any exports at above-quota levels are subject to tariffs of up to 35%. According to media reports, Brazil now says it cannot move to a free trade arrangement because its deficit in bilateral trade is likely to increase (in 2014 Mexico is estimated to have had a US$1.69bn surplus in its overall trade with Brazil). The Brazilians want another extension of the quota system, reportedly saying that this will allow more time to negotiate a wider free trade agreement between the two countries, which would include heavy machinery and food. According to Guajardo, Mexico has also received a proposal relating to ACE 55 from Argentina, which was "pretty poor from Mexico's point of view": the details of this proposal were not released.

After an initial round of negotiations in Brasília, a second meeting of the negotiating teams was planned for Mexico City in late February/early March. Mexico's deputy economy minister with responsibility for foreign trade, Francisco Rosenzweig, said some progress had been made. He said ACE 55 was particularly important for Mexico because of its link into the Mercosur trade block (of which the main members are Brazil and Argentina). According to the Mexican economy ministry, Mexican car exports to Brazil fell by 25.2% last year to 102,828 units. Mexican car exports to Argentina crashed by 58.3% to only 25,720 units.

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At one level, the dispute reflects the contrast between Mexico's commitment to free trade (expressed in part thought its membership of the outward-looking Pacific Alliance trade block, along with countries like Colombia, Peru and Chile), and the much more protectionist stance taken by Argentina and Brazil within Mercosur (the Southern Common Market, also comprising Paraguay, Uruguay and Venezuela).

But there are also some specific auto industry issues at stake. Eduardo Solís, president of the Asociación Mexicana de la Industria Automotriz (AMIA), says that at least ten car manufacturers in Mexico also have plants in Brazil. While Mexico exports large numbers of vehicles to the US and Canada, Brazil is seen as an important "way in" to European and Asian markets. Solís described both Brazil and Argentina as very important industry partners for Mexico. "We think there are opportunities in the supply chain to widen trilateral automobile trade", Solís said, adding that "it is very important to return to free trade because it is a mechanism which would allow our economies to develop".

MEXICO

From yellow gold to black gold?

The Mexican gold and silver mining entrepreneur, Alberto Bailleres, has launched one of the first 'post-reform' private sector energy companies in the country. The new firm, Petrobal, will form part of Bailleres conglomerate, which also includes mining companies Peñoles and Fresnillo, department stores Palacio de Hierro, and insurance company Grupo Nacional Provincial (GNP). According to the US magazine *Forbes*, Bailleres is Mexico's second-richest man, with assets totalling US$18.2bn.

"Petrobal will not be able to bid for the first group of 14 offshore licences offered by Mexico's regulator, Comisión Nacional de Hidrocarburos (CNH). This is because the rules state that bidders must have at least four years experience and three major completed exploration projects. However, it could join a consortium, as long as it can demonstrate a minimum capital of US$600m."

Petrobal's first chief executive is Carlos Morales Gil, previously an E&P director at the state-owned oil company Pemex, who resigned in February 2014 after a 30-year career at the company. Morales Gil was closely involved in developing the Ku Maloob Zaap field in the Gulf of Mexico, as well as in the first drillings in the Chicontepec basin.

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On 16 February, Jaime Lomelín Guillén announced his resignation as an independent director on the board of Pemex. A well-respected chemical engineer, Lomelín Guillén also sat on the board at Peñoles (Mexico's second largest mining company) and served as head of the chemistry faculty at the National Autonomous University of Mexico (UNAM). He said he was resigning given that the Bailleres holding group, which controls Peñoles, is now moving into the oil and gas industry through Petrobal, where it may be in direct competition with Pemex.

PERU

Troubled times for Pluspetrol

A confrontation on 10 February between local police and the community in Pichanaki, (province of Junín), could have major implications for oil and gas production in Peru. According to the government, around 500 people invaded Peruvian army barracks temporarily leased to Pluspetrol, an Argentine oil company with a licence to explore nearby Block 108. Police used tear gas to clear the area: violent clashes broke out, leaving one student dead from bullet wounds, along with 37 civilians and 30 police officers injured. The protestors say that not one, but three people were killed in the clashes.

A number of other key facts are contested. According to Carlos Echevarría of the Frente de Defensa de Pichanaki, Pluspetrol has polluted the local environment. "For us there is nothing to negotiate: it is just a question of this company leaving the area, and nothing more", he said. In contrast, Daniel Guerra, a Pluspetrol manager in Peru said, "this is a very basic piece of exploration work, we haven't drilled, we haven't contaminated anything, and we can't spill any oil because we are not producing any".

"Pluspetrol also faces opposition in another part of the country, in oil block 1-AB in Loreto, in the northern jungle. There at the end of January, members of the local Achuar indigenous community stopped the company's exploration work by blocking roads and seizing riverboats in a dispute over compensation payments. Pluspetrol has been operating in 1-AB since 2001, and with production of 3,100 barrels per day, it is Peru's largest single oil producing block currently. The protestors are demanding compensation for the use of their lands and the installation of a local sawmill; they also want a community-owned company to be given a services contract. Pluspetrol has countered that the community should not receive compensation because it is outside the area of direct influence of oil operations."

Wider issues are involved. Some experts say Block 108 could hold gas reserves equal to, or larger than, the massive Camisea deposits (believed to total about 13.4trn cubic feet), which have given the Peruvian economy a major boost since they were discovered by Shell in 1986. Pluspetrol is one of the main partners in the Camisea operating consortium, along with Hunt Oil Co., SK Corporation, Repsol, Tecptrol and Sonatrach. And Peru's extractive sector, including oil and gas plus mining, has been facing rising opposition from local communities. It is estimated that as much as US$60bn worth of mining and energy projects are stalled because of local opposition and environmental approval issues.

At the government's request, Pluspetrol began to withdraw from the area later in the same week. Energy and Mining minister Eleodoro Mayorga initiated a dialogue with the local residents, saying that in view of local feelings the authorities would review the situation. Pluspetrol was awarded the licence to explore Block 108 in 2005, a rectangular piece of land of around 1.2m hectares. Local people generally make a living by from coffee and cocoa crops. The Argentine company says it has observed all the legal, environmental and social terms of its licence, and in doing so has consulted with 34 local communities, held 268 information workshops and reached individual agreements with over 2,000 local farmers. It says it has also funded a local health programme and school libraries.

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The 1-AB licence expires in August, and the government may ask for bids to continue operating it. Pluspetrol has said that depending on the terms, it might seek to stay on. According to Guerra, "we've definitely got a lot of experience in 1-AB, we've been working there for 15 years, it will depend on the government's tender terms, but in principle we are interested". He also noted that some of the environmental and compensation issues pre-date Pluspetrol's arrival, going back to the 1970s, when Occidental Petroleum was active in the area. The government has declared environmental emergencies in various parts of 1-AB in recent years, because of pollution linked to past spills and leaks. Pluspetrol, Guerra said, had spent roughly US$100m on environmental amelioration measures. Other oil companies have also expressed interest in 1-AB if the government invites bids for a new operating licence.

Perupetro, the hydrocarbons regulator (not to be confused with the state oil company Petroperu) has said that under existing regulations it cannot call for new bids for 1-AB until the outstanding social issues are resolved. "Since it is already producing, it is an attractive block. You come in and already have revenue", noted Perupetro president Luis Ortigas. Ortigas added that a call for bids for a further 25 blocks (19 in the Amazon and six offshore) might be postponed because of the current fall in oil prices. "With the drop in the price of crude we have to think again. Maybe we have to delay or reprogramme… we could reach the conclusion that it's not convenient now to launch bidding," Ortigas told news agency *Reuters*.

Peru's business community is troubled by the implications of Pluspetrol's difficulties. Carlos Gálvez, president of extractive industry lobby Sociedad Nacional de Minería, Petróleo y Energía (SNMPE), said that events in Pichanaki could raise questions about the rule of law and the enforceability of commercial contracts. "This could be seen as a break point, after which concession contracts signed by the state and companies are seen as not being fully respected in the future, that would be worrying" he said.

ARGENTINA

Industrialists concerned over China agreements

Having signed agreements with the Chinese government in February enabling what she described as "the most important country-to-country investments in history" President Cristina Fernández appeared both surprised and angry when a group of local industrialists said they were unhappy with the terms of the deals. The background to the controversy highlights interesting issues of trade and investment policy.

"Although President Fernández may be guilty of a degree of hype, there is no doubt that the cooperation agreements signed during her state visit to China on 3 and 4 February were very significant. After meeting China's President Xi Jinping, a total of 15 agreements were signed, covering cooperation in areas like tourism, culture, health, science, mining, nuclear energy and its peaceful use, penal affairs, communications, space exploration, information and finance. Fernández said that at their earlier meeting in July 2014, she and Xi had agreed to elevate the bilateral relationship to the rank of an "integral strategic alliance", a move that implied a qualitative step-change."

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The list of concrete Argentina-China agreements reached to date is substantial, and includes the following:

• A US$11bn currency swap agreement between the central banks of the two countries, which came into operation last year and has bolstered Argentina's dwindling foreign currency reserves (because of its dispute with US holdout creditors, Argentina is considered to be in partial default and has limited access to international capital markets). Under the terms of this agreement, Argentina last year received over US$2.3bn. According to Mauro Roca, an economist at Goldman Sachs, the currency swap "helped to reduce the perception that the country may be heading for yet another currency run".

• Chinese funding totalling an estimated US$4.5bn for two major hydroelectric dams, the Néstor Kirchner and Jorge Cepernic projects in Santa Cruz province in the south of the country. China's Gezhouba Group of Wuhan has secured the contract for the civil engineering work.

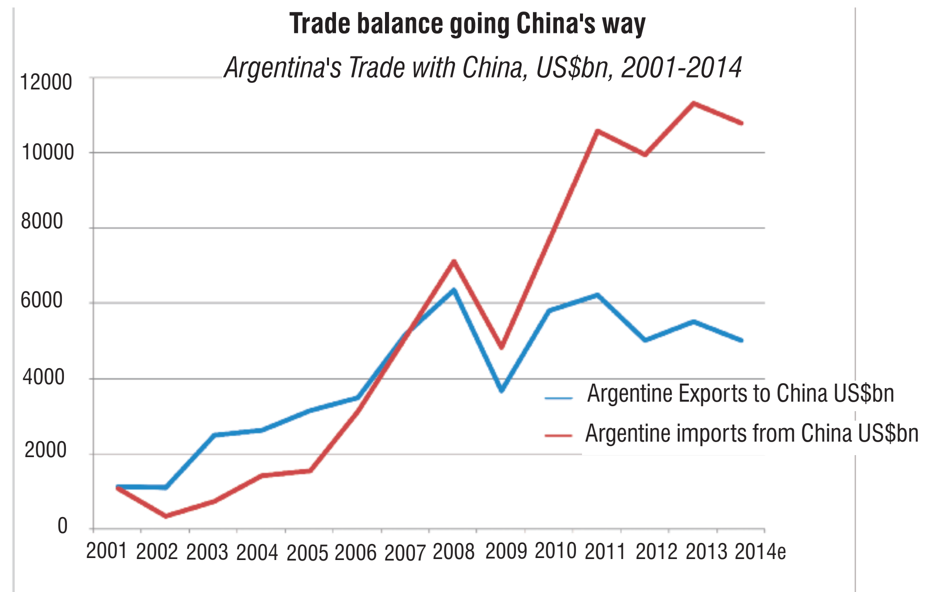
• Chinese funding and technology to build two new nuclear reactors in Argentina. (Argentina currently has three reactors: Atucha I and Atucha II in Buenos Aires, and Embalse in Córdoba. Atucha II, where China helped complete the engineering work, came on-stream this month). Under the terms of this agreement, China National Nuclear Corporation (CNNC) will provide the technology, while Argentina's Nucleoeléctrica will be in charge of the design and construction work.

• Chinese funding for the modernisation of the Belgrano Cargas freight rail service.

• China's Sinopec has signed agreements for joint oil and gas exploration with Argentina's state-owned Yacimientos Petrolíferos Fiscales (YPF), including exploration of part of the country's giant shale oil and gas deposits in Vaca Muerta, Neuquén province.

• An agreement to build a space observation and research centre in Neuquén province, which will support China's space programme, designed to land three astronauts on the moon in 2016.

According to preliminary figures, Argentina's exports to China totalled US$5.1bn in 2014 (7% of total exports), while imports from China were valued at US$10.8bn (16.5% of total imports). These figures confirm China as Argentina's second most important trading partner after Brazil. Of particular importance are Argentina's soya exports to China, which last year totalled just under 8m metric tonnes.



Source: *International Trade Centre; 2014 estimate from Cámara Argentina de Comercio (CAC)*

So bearing the importance of the relationship in mind, President Fernández seems to have been caught off-guard on her return to Argentina by criticism from the main manufacturers' association, Unión Industrial Argentina (UIA), and from the exporters' lobby, the Cámara de Exportadores de la República Argentina (CERA). The UIA focused on a framework agreement signed on 18 July last year, which in early February was still awaiting congressional approval. It said that this 'Economic Investment and Cooperation Agreement' gave China too many advantages. Article 5 of the agreement allows contracts to be assigned directly to Chinese companies without competitive bidding, when China is offering funding at subsidised interest rates. Article 6 also allows favourable conditions for the use of Chinese labour on projects in Argentina. A further article allows additional agreements to be reached without the need for congressional approval on the Argentine side.

In a comment attributed by the daily *La Nación* to Techint, a leading Argentine civil engineering group, there is "a very high risk when our industry competes with centrally planned economies, with distortionary price and subsidy policies, which do not follow the principles of fair trade". Techint managers are also said to have warned against "de-industrialisation' – a situation whereby Argentina becomes relegated to the role of raw materials exporter, importing manufactured goods from China.

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The president condemned these comments, which she said were like "spitting at the sky". She said she had difficulty understanding Techint's position, since the company was benefiting from a US$400m credit from China. "It's almost as if we should tell the Chinese not to lend them the US$400m and for them to find it elsewhere" she said. Sources in the company said the project in question is the El Tamboral hydroelectric complex, an extension of two earlier projects (Punta Negra and Caracoles). Techint's contract is not directly with the Chinese, but with EPSE, a provincially owned entity in San Juan. As for the comments about jobs and Chinese workers, the President insisted that "I went [to China] with 112 Argentine companies, and those companies employ workers. If anything characterises this government it has been the defence of labour and business people, and I think we deserve a vote of confidence".

Yet the controversy looks set to continue. Luis Palma Cané, an economist at Fimades, a local consultancy, says that on the surface Article 5, allowing direct contracting of work to Chinese companies when the project is being funded with soft loans from China, may appear reasonable. "But this is misleading" he notes. "When a country offers Argentina long term financing at a 3% annual interest rate, in a situation where the rest of the world won't lend to us at less than 20%, then it is clear that something else must be involved. That something else means we are tied in to using their technology, and we can't control the price of the work." Dante Sica, of consultancy Abeceb.com, agrees. "We can only use Chinese technology, where there may be German or French suppliers who might offer better quality", he points out. Palma Cané adds that because of Article 6, it is possible that the Neuquén space observation and research centre will be entirely staffed with Chinese scientists.

It is not just parts of the business community that see a downside to the China agreements. A number of labour unions, including Uocra, the construction workers' union, and UOM (engineering workers) wrote to Planning Minister Julio De Vido to express their concern over jobs. De Vido appears to have reassured them, saying that the major Chinese-funded infrastructure works would create between 20,000 and 25,000 new jobs for Argentine workers over the next three years, and that large quantities of Chinese workers would not be flown in to do the work instead. But some say negotiations can be tough. *La Nación* quoted a source close to the interior and transport minister, Florencio Randazzo, who said that the contract to modernise the Belgrano Cargas freight railway was valued at US$2.47bn. The Argentine government has been required to pay a deposit equivalent to 15% of this amount, with the People's Bank of China (PBC, the central bank) providing the rest via a 15-year loan, with an initial 5-year grace period, at annual interest rates of less than 4.5%. "What to the Chinese do?" the source asked: "Well they lend you the money, but then they demand 80% Chinese content for the work. We managed to get them down to 50%".

GUATEMALA

The problems of a small budget

Strengthening government revenues will be essential if Guatemala is to achieve sustainable and inclusive growth.

Many aspects of Guatemala's economy are favourable. The UN's Economic Commission for Latin America and the Caribbean (ECLAC) in its *Preliminary Overview of the Economies of Latin America and the Caribbean*, released in late 2014, put real GDP growth at 4.0% for the year, accelerating from 2013, when the economy expanded by 3.7%. In output terms, ECLAC estimated that activity in the mining and quarrying sector rose by 27.1% year on year. It put growth in the financial and business services sector at 4.8%. Growth in private services, retailing and manufacturing was below the headline figure but nevertheless ECLAC suggested that each sector rose by at least 3.0% in 2014.

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According to the Banco de Guatemala (BanGuat), annual consumer price inflation fell from 4.0% to 3.0% over the course of 2014, and was just 2.3% in January 2015. Looking forward, ECLAC expects the economy to expand by around 4.0% in 2015, "given expectations of continued growth in exports and domestic demand, the latter primarily attributable to private consumption."

Consumption is being driven by credit growth - from a level that is low in the context of the economy as a whole. According to latest estimates from the International Monetary Fund (IMF), nominal GDP was about US$58.3bn in 2014. BanGuat noted that total credit from commercial banks to the private

sector amounted to GTQ153.9bn (US$20.1bn) as of 12 February 2015. Of this amount, about one third, or GTQ54.7bn (US$7.1bn), was foreign currency-denominated (i.e. US dollars). BanGuat data indicated that year-on-year growth in local currency lending was 6.9%, with foreign currency lending up 18.4%. Total deposits with commercial banks amounted to QTQ160.8bn (US$21.0bn): this indicates that deposits, very largely, are being recycled as loans. Over the past year, Guatemala's financial system has benefited from the general abundance of liquidity globally. Average one-week lending rates in local currency have trended down from about 20% to just over 17%. In foreign currency, equivalent rates have moved down from about 6.5% to 6.0%.

"Developments outside Guatemala have also been positive. ECLAC noted that remittances from expatriate workers in the US and elsewhere amounted to US$4.65bn in the first 10 months of 2014, up 8.6% over the corresponding period of 2013. ECLAC also estimates that foreign direct investment (FDI) in to Guatemala was up 8.0% year on year over 2013 (when FDI flows expanded by 5.2%). FDI in the first half of 2014 amounted to US$713.4m. It came mainly from Canada (destined for the agriculture and mining & quarrying sectors), the US and the UK (mainly retailing) and Colombia (financial services)."

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The latest IMF data highlights additional strengths, notwithstanding that the Fund's projections for economic growth in 2014 and 2015 are slightly less optimistic than those of ECLAC.

Chart 1

Guatemala's economy: as the IMF sees it

	2013	2014e	2015e	2016e
Gross domestic product, constant prices (% change)	3.7	3.4	3.7	3.6
Gross domestic product, current prices (US$bn)	53.8	58.3	62.6	66.8
Gross domestic product per capita, current prices (US$)	3,475	3,674	3,850	4,007
Inflation, average consumer prices (%)	4.3	3.5	4.3	4.2
Total investment (% GDP)	14.2	14.3	14.4	14.5
Gross national savings(% GDP)	11.5	12.2	12.2	12.2
Volume of imports of goods and services (% change)	4.8	4.5	6.6	6.3
Volume of Imports of goods (% change)	4.2	6.4	6.9	6.8
Volume of exports of goods and services(% change)	4.6	2.4	4.1	4.8
Volume of exports of goods (% change)	5.8	4.3	4.4	5.2
Population mn	15.48	15.87	16.27	16.67
General government revenue (% GDP)	11.7	11.2	11.2	11.2
General government total expenditure (% GDP)	13.8	13.3	13.4	13.3
General government net lending/borrowing (% GDP)	-2.1	-2.1	-2.2	-2.1
General government primary net lending/borrowing (% GDP)	-0.6	-0.6	-0.7	-0.6
General government gross debt (% GDP)	24.6	24.8	25.3	25.7
Current account balance (US$bn)	-1.5	-1.2	-1.4	-1.6
Current account balance (% GDP)	-2.7	-2.0	-2.2	-2.3

Source: *International Monetary Fund, World Economic Outlook Database, October 2014*

In both years, total investment and gross national savings are forecast at 14.3% and 12.2% of GDP respectively. The resulting annual current account deficits, of about US$1.2-US$1.4bn (or 2.0%-2.2% of GDP) are easily financed. Given the likely robustness of domestic demand, imports are set to grow faster than exports. However, net foreign reserves held by BanGuat amounted to US$7.7bn as of 12 February 2015, equivalent to just over four months of imports of goods and services, as per the ECLAC 2014 preliminary figures. Over the last year or so, the GTQ has been allowed by BanGuat to appreciate slightly, rising from US$1:GTQ7.851 in January 2014 to US$1:GTQ7.6505 on 12 February 2015.

Meanwhile, the government's overall budget deficit is running at around 2% of GDP. The primary deficit (i.e. before interest payments) is about 0.6% of GDP. Gross government debt is around 25% of GDP: given the nearly balanced budget and an environment of low interest rates, the ratio is rising slowly. However, the debt is high relative to government spending, which is 13.3% of GDP. This is a major source of weakness for the economy as a whole. The other problem is widespread poverty, in a country where the per capita income is a little under US$3,900.

In its 2014-2015 Global Competitiveness Report, the World Economic Forum (WEF) rated Guatemala the 78th most competitive country of 144 assessed. In 2013-2014, Guatemala was rated at 86/148. In the two preceding years, its rating had been 83/144 and 84/142 respectively. In the context of Latin America and the Caribbean, Guatemala is a mid-ranking country. For instance, it is less competitive than Mexico (61), Peru (65) or Colombia (66). However, it is more competitive than Uruguay (80), El Salvador (84) or Jamaica (86). Its overall macro-economic environment, the level of development of its financial market and the efficiency of its goods market, boosts Guatemala's overall competitiveness.

Chart 2: Guatemala's ranking for global competiveness

Out of 144 countries assessed

Overall Global Competitiveness Index	**78**
Basic requirements (40% weighting)	84
Institutions*	109
Infrastructure	67
Macroeconomic environment	64
Health and primary education**	100
Efficiency enhancers (50% weighting)	76
Higher education and training***	103
Goods market efficiency	45
Labour market efficiency	85
Financial market development	45
Technological readiness	88
Market size	78
Innovation and sophistication factors (10% weighting)	62
Business sophistication	52
Innovation	95

*Includes wastefulness of government spending (128), diversion of public funds (127), crime costs (142), organised crime (144), investor protection (123) and reliability of police (124)

**Includes quality of primary education (130),

***Includes quality of the education system (127)

Source: *World Economic Forum, Global Competitiveness Report, 2014-2015*

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In recent years, successive governments have taken steps to improve the ease of doing business in Guatemala. According to the World Bank's *Doing Business 2015 report*, Guatemala's global business environment ranking fell slightly to 73rd, of 189 countries assessed, having placed 71st in 2014.

Chart 3: Guatemala's ranking for ease of doing business			
Out of 189 countries assessed			
	2014	**2015**	Movement*
Overall ranking	71	73	-2
Starting a business	107	98	9
Dealing with construction permits	116	122	-6
Getting electricity	20	18	2
Registering property	64	65	-1
Getting credit	10	12	-2
Protecting minority investors	174	174	0
Paying taxes	66	54	12
Trading across borders	104	102	2
Enforcing contracts	141	143	-2
Resolving insolvency	154	155	-1
* A negative sign indicates a deterioration in ranking out of 189 countries assessed			
Source: *World Bank Group, Doing Business 2015*			

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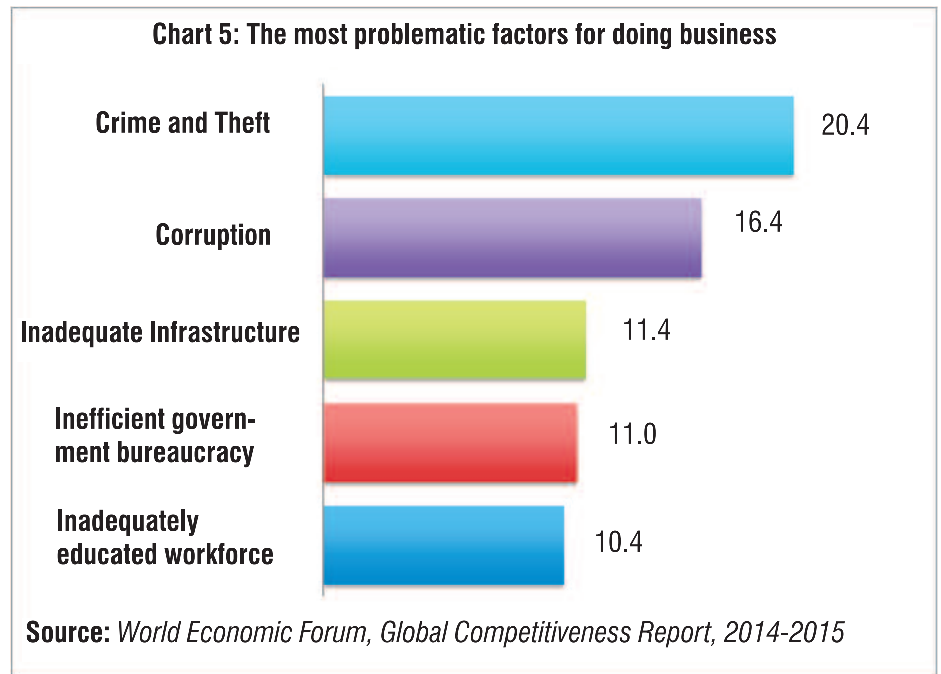
However, this is in the context of other countries' also having taken steps to improve their business environments. In Guatemala, significant progress has been made in two areas: the processes involved in starting a new business; and facilitating the payment of taxes. Details are shown in chart 4.

Chart 4: Improvements to the business environment in Guatemala 2013-15
2015
Elimination of certain company registration fees
Reducing time to publish notice of incorporation
Improvement to ease of paying tax through enhancement of electronic systems for filing.
Reduction of capital gains and corporate income tax rates
2014
Introduction of online platform that permits simultaneous registration of a company with several agencies
Streamlining of processes for dealing with construction permits
Introduction of new electronic filing and payment systems to facilitate payment of taxes
2013
Introduction of a risk based aproval system to facilitate issuance of construction permits
Source: *World Bank Group, Doing Business Reports*

Many of WEF’s basic requirements for a competitive economy are (very) deficient in Guatemala. In the WEF's latest assessment, Guatemala was rated at 109/144 for the quality of its institutions. The rating was dragged down (weak) investor protection standards (where it was placed at 123/144), the reliability of the police force (124), the diversion of public funds (127), the costs of crime and

violence (142) and organised crime. In terms of health and primary education - another basic requirement, the country's overall rating was 100. However, within this the rating for the quality of primary education was a low 130. Across all those factors that the WEF considers to be efficiency enhancers, Guatemala's rating was 76, or broadly in line with its overall competitiveness rating. However, the country was rated at 103 for higher education and training: this included a rating of 127 for the quality of the education system.

These areas were among the factors identified by the WEF survey respondents as being the biggest problems for doing business in Guatemala.



> “Organisational changes at the customs and tax agencies are necessary but not sufficient moves for Guatemala's government to reach a point where it has substantial room to ease fiscal policy in the event of a cyclical downturn and an ability to greatly increase investment in education and law and order. In the meantime, the key metric to monitor remains the ratio of government revenue¬ to debt.”

By quite a margin, the two largest challenges were identified as crime and theft (by a weighted 20.4% of responses) and corruption (16.4%). Lesser but still significant challenges include inadequate infrastructure (11.4%), inefficient government bureaucracy (11.0%) and an inadequately trained workforce (10.4%).

In theory, some progress could be made in addressing the most serious problems if the government had a greater ability to spend more on law & order, primary education and tertiary/technical education. In 2012, the government sought a major tax reform, which broadened corporate and personal income taxes and increased vehicle taxes, while removing a number of VAT exemptions and streamlining customs duties. The reform sought to boost fiscal revenues by 1%-1.5% of GDP over the course of 2013 and 2014. However, as the IMF noted in its September 2014 Article IV consultation, the reform efforts have been disappointing. Legal challenges in the Constitutional Court from vested interests have slowed collections. Meanwhile, administrative problems at the customs and tax agencies have also resulted in revenue shortfalls.

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VENEZUELA

The government seeks to nationalise the parallel currency market

In mid-February 2015, the left-wing government led by President Nicolás Maduro introduced a new, and third, official currency trading system, the Sistema Marginal de Divisas (Simadi). The main ambition behind the Simadi is that it provides an incentive for parties who would otherwise trade US dollars through the so-called 'parallel' (i.e. black) market to deal through institutions regulated by the government. The move by itself is unlikely to resolve the fundamental problems facing the Venezuelan economy, however.

Individuals and companies in Venezuela wanting foreign currency have been able to go through two official channels. Importers of food, medicine, certain agricultural products (and the manufacturers of these) are eligible to buy US dollars through the Banco Central de Venezuela (BCV) at the main (Cencoex) rate of BF6.3/US$. Other productive sectors could buy currency at two secondary Sicad rates, sold via central bank auction, in which the BCV has set the quantity and the price. The Sicad rates have been BF12/US$ and BF50/US.

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The new Simadi system has three elements. The cash retail element will operate through banks and exchange houses. Individuals will be able to buy or sell dollars at the rate determined the previous day. At exchange houses, purchases of US dollars by individuals will be limited to US$200 per day, up to a monthly limit of US$2,000 and/or an annual limit of US$10,000. The daily limit for individuals is US$3,000 at a bank, with a minimum transaction size of US$300. The cash retail rate will also be used for credit card transactions and customs duties.

For companies using banks the minimum transaction size is US$3,000. Currency will be purchased or sold at the rate determined on the previous day. However, banks can only deal with their own clients and they cannot trade currency with each other. Furthermore, they cannot hold US dollars (or other foreign currencies) on their own account. If they are net buyers of US dollars from clients on a particular day, they must sell the excess US dollars back to the BCV.

The third element involves the trading of US dollar-denominated securities through approved brokers. All deals need to be approved by the BCV. The securities are bought or sold at an agreed exchange rate. Again, brokers can only deal with their own clients and cannot trade currency with other brokers or banks. Banks and brokers are, however, allowed to take positions (i.e. they do not have to sell excess US dollars back to the BCV). Parties who receive US dollars from the sale of securities are required to keep the proceeds in a US dollar account with their own bank.

Since the Simadi system began operating, the exchange rate set has been trading at around BF170|US$, which has been fairly close to the parallel rate (which in February was trading at about BF180|US$). However, the (illegal) parallel market remains in existence. Given that the parallel market provides a forum in which Bolivars can be bought or sold without any records being kept, it is unlikely to disappear entirely. However, the Simadi system should facilitate the supply of otherwise scarce US dollars, and through channels that are controlled and monitored by the government. To the extent that US dollars are sourced through Cencoex or Sicad and then sold through the Simadi system, there will be massive opportunities for arbitrage profits. Without the Simadi system, these profits would have been harder to achieve.

The Simadi system represents formal recognition by the Caracas government that the currency is grossly overvalued at the Cencoex or Sicad rates. The intro-

duction of the Simadi system can therefore be considered a massive devaluation. In most countries, a devaluation of this extent would be regarded, with good reason, as a sharp reduction in the purchasing power of all citizens with savings in Bolivars. It would also, in most cases, be highly inflationary.

However, given the already acute shortages of consumer goods in Venezuela, and an already hyper-inflationary situation, the introduction of the Simadi system is unlikely to have much of an impact on ordinary households. On 13 February, for instance, the BCV reported that consumer prices had risen by 5.3% in December 2014. For the year as a whole, the official inflation rate was 68.7%. Ominously, even the BCV recognises that prices have been rising most rapidly for basic food and beverage items.

A major beneficiary of the devaluation may be the state oil company, Petróleos de Venezuela SA (Pdvsa). Within Venezuela, Pdvsa typically has substantial net liabilities (i.e. amounts owing to the government, workers, suppliers etc) denominated in Bolivars. When the government devalued the official (Cencoex) rate from BF4.3/U$1 to BF6.3/U$1 in February 2013, Pdvsa had net liabilities equivalent to US$25bn or so. The US dollar value of those liabilities was reduced by US$7.8bn as a result of the devaluation: in Pdvsa's accounts, which are kept in US dollars, this amount was booked as a gain in 2013. Assuming that the effective devaluation from the introduction of Simadi is treated in the same way, there should be a much more substantial gain recorded in Pdvsa's books for 2015.

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Pdvsa is by far the most important source of export revenues in Venezuela. Its gross revenues fell from about US$125bn in 2012 to US$114bn in 2013. Given the slippage in the global prices of oil and gas through second half of 2014, revenues almost certainly will have fallen for 2014 and will do so again in 2015. Nevertheless, even if revenues in 2015 drop to say, US$60bn (given the approximate halving of the oil price), the amount of foreign exchange flowing through the company will still be substantial in absolute terms and relative to other metrics of Venezuela's financial system. For instance, latest data from the BCV indicates that at end-November 2014, broad money (M3) amounted to just under BF1.9trn. Sight deposits accounted for some BF1.36trn of this, with only BF156bn made up of cash and banknotes in circulation. Given the rampant inflation, Venezuelans have been reluctant to keep their Bolivars in savings accounts, which amounted to just BF328bn. The official inflation figures suggest that M3 has been growing by 5%-6% per month, which means that, as of late February 2015, M3 should be in the order of VEF2.25trn. At the Simadi exchange rate of BF170/US$, that is equivalent to a little over US$13bn.

In other words, the Simadi system makes it much easier for the government (or parties that it can direct) to control or reduce the Bolivar money supply by undertaking sales of US dollars. Currently, foreign exchange reserves held by the BCV amount to around US$22bn (but much of this is illiquid). In an extreme situation, the government could dollarise the economy by buying up all the Bolivars on issue. The main benefit of this would be that it would end hyperinflation and change expectations. However, it would be an extremely unpalatable move politically. It would also greatly increase the risk of a default by the government, in that its expenses would be denominated in hard currency.

In short, the introduction of the Simadi system by itself does nothing to address the three core problems of the economy and the financial system. These include: the perpetual monetisation of fiscal deficits, which has caused hyperinflation; the shortage of US dollars that the government needs to meet its obligations over the next two years, which has been exacerbated by the slump in energy prices; and the distortions to markets from official controls on prices and quantities. These problems, and the resulting instability in financial markets, look set to continue.

Energy subsidies: time for a change?

A new paper from the International Monetary Fund (IMF) argues that the fall in energy prices provides an opportunity for governments in the region to reduce fuel and electricity subsidies.

A February 2015 paper* published by researchers at the International Monetary Fund (IMF) found that across Latin America and the Caribbean, government fuel and electricity subsidies (to reduce costs for consumers) amounted to 1.8% of GDP, on average, over the three years to the end of 2013. Fuel subsidies were equivalent to 1.0% of GDP, while electricity subsidies were slightly lower, at 0.8% (*see chart*).

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Pre-tax energy subsidies

(% of GDP, average for 2011-13)

	Total	Fuel	Electricity
Low-ranked*, and oil producers	**5.1**	**3.7**	**1.4**
Venezuela	8.9	7.1	1.8
Ecuador	7.5	7.0	0.4
Bolivia	6.2	6.1	0.0
Argentina	3.9	2.1	1.8
Belize	2.7	0.0	2.7
Suriname	1.7	0.0	1.7
Low-ranked*, and oil importers	**1.5**	**0.3**	**1.1**
Guyana	3.0	1.7	1.3
Haiti	2.9	0.2	2.7
El Salvador	2.2	0.7	1.5
Nicaragua	2.1	0.0	2.1
Dominican Republic	2.0	0.1	1.9
Honduras	0.9	0.0	0.9
Grenada	0.9	0.4	0.5
Guatemala	0.4	0.0	0.4
Jamaica	0.1	0.0	0.1
Paraguay	0.1	0.0	0.1
High-ranked*, and oil producers	**1.2**	**0.9**	**0.3**
Trinidad & Tobago	2.7	2.0	0.6
Mexico	1.8	1.1	0.7
Brazil	1.2	1.2	0.1
Colombia	0.4	0.2	0.2
Peru	0.2	0.2	0.0
High-ranked*, and oil importers	0.4	0.2	0.2
Antigua & Barbuda	1.2	0.5	0.8
Bahamas	1.0	0.4	0.5
Panama	0.8	0.3	0.5
Barbados	0.8	0.6	0.2
St Kitts & Nevis	0.6	0.1	0.5
St Lucia	0.3	0.3	0.0
Dominica	0.1	0.0	0.1
Uruguay	0.0	0.0	0.0
Chile	0.0	0.0	0.0
Costa Rica	0.0	0.0	0.0
St Vincent & the Grenadines	0.0	0.0	0.0
REGION	**1.8**	**1.0**	**0.8**
Ex. Low-ranked* and oil producers	1.0	0.4	0.6
Low income** countries	2.2	0.5	1.7

*In terms of institutional aspects, such as budget transparency, rule of law, competitiveness and ease of doing business.
**Bolivia, Guyana, Haiti, Honduras and Nicaragua.
Source: *IMF Working Paper 15/30 of February 2015*

A separate study by the IMF in 2013 entitled *'Energy Subsidy Reform: Lessons and Implications'*, found that, globally, energy subsidies typically ranged between 0.7% and 2.5% of GDP.

The latest paper found that, by this metric, subsidies varied very widely across the region. At one extreme, the governments of Uruguay, Costa Rica, Chile and St Vincent & the Grenadines provided essentially no subsidies. At the other, subsidies amounted to 8.9% of GDP in Venezuela. The country's massive subsidy for fuel, which is effectively free at the petrol pump, accounted for the vast majority of this, representing 7.1% of GDP.

The IMF researchers classified the countries in four groups. The first group comprises oil producers with weak business operating and legal environments, as ranked by independent research institutes and non-government organisations (which consider institutional aspects like budget transparency, the rule of law, general competitiveness and the ease of doing business).

The second group included oil-importing countries with weak business operating and legal environments. The third group comprised oil exporters with strong operating environments, while the final group comprised oil importers also ranked highly for their institutional aspects.

As a general rule, fuel subsidies tend to be higher in countries that are oil producers. In this respect, the region is no different from other parts of the world. Globally, fuel subsidies are larger as a percentage of GDP in Saudi Arabia and Iraq than they are in Venezuela, with Algeria not far behind. The IMF paper also found that fuel subsidies tend to be higher in countries that are rated poorly for their institutional aspects. In the region's oil producing countries, subsidies normally take the form of administered pump prices. In theory, this is a mechanism to spread the benefits of mineral wealth across society: in practice, it is usually the richer households (who consume the most fuel) that benefit disproportionately.

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In oil importing countries, subsidies often arise from price stabilisation mechanisms: at times of high and volatile prices, these mechanisms involve substantial costs to governments.

Electricity subsidies, on the other hand, tend to be largest in low-income countries - and especially those in the Caribbean and Central America. In these countries, it is not uncommon for tariffs to be lower than generation and distribution costs. Moreover, fraud and non-payment for power by consumers is often also a problem.

The IMF identified a number of challenges arising from energy subsidies. Across the region as a whole, governments generally ran fiscal deficits of about 3% of GDP in the three years to end-2013. In a number of countries, there were higher energy subsidies and a worse-than-average budget deficit. Venezuela, where the government was running an estimated fiscal deficit of nearly 15% of GDP, is an extreme example. However, other countries in which energy subsidies were exacerbating relatively large fiscal deficits included Haiti, Mexico, Dominica, Honduras, Guatemala, Argentina and El Salvador. Subsidies represented a sizeable portion of tax revenues in many

countries that were rated poorly for institutional aspects and/or were low-income countries. Over the three-year period, examples included Argentina (14%), Bolivia (20%), Haiti (23%), Ecuador (55%) and Venezuela (85%).

Sometimes, fuel subsidies are not accounted for in a transparent way: however, the IMF noted that stabilisation funds, whose balances adjust in response to changes in energy prices, normally provide a clear picture of what is happening. Sometimes governments are exposed to substantial contingent liabilities arising from the need to provide support power companies or state oil companies that are making low (or no) profits as a result of subsidies.

Energy subsidies are normally damaging for state-owned oil companies. In Venezuela, the woes of Petróleos de Venezuela (Pdvsa) have been exacerbated by the requirement that it sell refined products on the domestic market at extremely low prices and supply fuel on concessional terms to regional members of the left-wing Venezuelan government's discount oil scheme, Petrocaribe.

In Brazil, Petrobras has suffered losses from its domestic refining and marketing operations in recent years, as it has been required by the government to sell refined products at below international prices. However, Petrobras has also enjoyed access to low cost funding through the state owned development bank, Banco Nacional de Desenvolvimento Econômico e Social (BNDES). In Trinidad & Tobago, the government's arrears, in respect of subsidies, to the state-owned oil company Petrotrin amounted to 5% of GDP in 2013. However, most of the arrears were paid in 2014.

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Electricity companies have also suffered as a result of subsidies. Typically, the requirement that utilities provide power at below-cost results in underinvestment over the long-term. In Argentina's case, electricity companies have been unable to meet peak demand for power, with the result that blackouts have been common. The IMF also noted: "Haiti appears to be in a circle of high generation costs, low investment, poor service, and high levels of theft and de facto subsidy".

Resources allocated to subsidies are resources that are unavailable for other social purposes. The IMF paper observed that, across the region as a whole, energy subsidies were equivalent to around 45% of expenditures on health and education. For low-income countries, the equivalent figure was about 80%. It was 110% or so for oil exporting countries with weak institutions. Electricity shortages tend to have the greatest impact on low-income households, because they have no means to hedge against energy rationing (for instance through the purchase of their own generators).

Finally, another IMF report, *'Getting Energy Prices Right: From Principle to Practice'*, published in 2014, notes that energy prices in much of the region are too low, even when there are low or no subsidies. In essence, the rates paid by consumers for power or fuel are too low given the externalities associated with energy use - such as environmental damage, traffic congestion and health problems. That study found that gasoline prices were too low in those countries with subsidies, as well as in the Dominican Republic, El Salvador and Panama. Countries in which the price of diesel did not include the costs of externalities included Chile, Colombia and, to a lesser extent, Brazil and Peru.

The IMF argues that the current environment is generally 'benign' for the reduction of subsidies. This is partly because of the progress in poverty reduction in Latin America and Caribbean in recent years. It is also because some

countries have already embarked on reforms. Furthermore, the fall in energy prices since mid 2014 has served to reduce the cost of many of the subsidies.

The paper acknowledges that a reduction in or removal of subsidies often results in lower growth and higher unemployment in the short term, with the benefits often only achieved in the long-term. Also, reform is often opposed by vested interests. For this reason, a reduction in subsidies needs to be backed by an effective communications program to emphasise to the public that citizens will benefit over the long-term. Finally, reforms need to take into account political cycles. The paper suggests that reforms be undertaken gradually (and with measures to mitigate their impact on low income groups) and be accompanied by a strengthening of governance structures in state-owned enterprises.

[*IMF Working Paper WP/15/30 - *'Energy Subsidies in Latin America and the Caribbean: Stocktaking and Policy Challenges', February 2015*]

COMMODITIES

Soya outlook: strong supply, weaker prices

The immediate outlook for soybeans is of great importance to Argentina and Brazil, two of the world's leading exporters. Both have strong reasons to need good export revenues this year. Argentina faces an economic crisis in an election year, while Brazil, where elections were held last year, is struggling to reduce its fiscal and current account deficits as a precondition for economic recovery.

The global commodities outlook offers a mixed picture for exporters like Argentina and Brazil. The commodities boom is a thing of the past: 2014 was the fourth consecutive year of poor performance by commodities in general. As far as agricultural commodities are concerned, bumper harvests and high stock levels are continuing to hold prices down. On the upside however, it is clear that an adjustment has taken place, and further steep falls in price levels are unlikely. Slower growth in China is now priced in to forecasts; European demand remains poor, but the US recovery is cause for some cautious optimism.

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There may also be some upside from the strengthening US dollar, which has risen by around 17% on a trade-weighted basis since mid-2014. Since prices are set in US currency terms, a rising dollar increases profit margins for non-US commodity exporters (whose main costs are incurred in local currencies), and gives them the option to become more competitive, reducing prices while remaining profitable and therefore gaining market share. In Brazil, where depreciation of the Real against the dollar has also been significant, this has helped boost coffee exports. Brazilian soya exports should also benefit, and are expected to gain market share from US soya exports.

In the 2014/15-crop year, the overall picture, however, is one of plentiful global grain and oilseed supplies. Soybeans are set for a second consecutive record world harvest. Soybean prices fell 22% in calendar 2014 to an average of 1,019 US cents a bushel. Most forecasters are talking of a similar fall to around 800 US cents per bushel in calendar 2015, but they expect a price recovery to begin to make itself felt in 2016.

Brazil, now the world's largest soya exporter, has been on track for a record harvest, but it is experiencing severe drought conditions. In the short term, a truckers' strike in February has also disrupted export shipments. In the same month, the US Department of Agriculture (USDA) cut

back its estimate for the Brazilian harvest by 1m metric tonnes to 94.5m mt – lower, but still a record.

Citing ample moisture and mild temperatures, the USDA at the same time raised its estimate for the Argentine crop by 1m mt to 56m mt. The Rosario Grains Exchange is more bullish, forecasting a record harvest of 58m mt in 2014/15, up from its previous estimate of 54.5m mt. The USDA's figures, which put the global harvest at 315.2m mt, imply that Argentina and Brazil will together account for almost half of that (47.7%). A research note from US investment bank Piper Jaffray, based on a recent visit to soya-growing areas in both countries, says its analysts left with "increased confidence in producing a record crop in the region and a higher level of appreciation for the region's ongoing drive to adopt technology".

The problem, however, is that if international soybean prices fall by around one-fifth this year, export volumes will need to grow by at least the same proportion to maintain the value of export earnings. That seems difficult to achieve, implying that soya export earnings in calendar 2015 will be lower than in 2014.

According to Finsoport, an Argentine consultancy, the soya harvest there this year is likely to grow by 3% to 55m mt, while soya oil exports will decline by 7.2% in value terms to US$3.24bn, while soya flour exports will drop by 6.8% in value terms to US$11.71bn. Overall, Finsoport believes that Argentina's maize, soya and wheat exports will drop by 9% in value terms in 2015 to US$22bn. According to Brazil's ministry of agriculture, despite last year's fall in soya prices, the 'soya complex' was able to achieve a 1.4% increase in the overall value of its exports to US$31.4bn. It will be hard-pressed to remain in positive territory this year. The conclusion for both countries seems to be that soya will remain a vital export commodity, but one that will not deliver increased dollar earnings until 2016.

REGIONAL MARKETS REVIEW

Capital markets: more of the same in 2015?

Last year's main trends in regional capital markets should persist into 2015, but there is some concern about the position of Brazil.

Data from Dealogic shows that issuance of international bonds by borrowers in Latin America and the Caribbean in 2014 amounted to US$139bn, or about 10% more than in 2013. Issuers were able to take advantage of abundant liquidity in the global financial system, thanks to quantitative easing (QE) by central banks in the US, Japan and the UK and investors' appetite for higher yielding assets.

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The tempo of issuance slowed from the third quarter of the year onwards. This was due to investor concerns over the eventual rise in interest rates in the US, the adverse impact on many regional economies of the rise in the US dollar; and country specific issues. These issues included the corruption scandal affecting Brazil's state oil company Petrobras, the ongoing dispute between Argentina's government and holdout creditors and the ongoing deterioration in economic conditions in Venezuela.

2015 activity

The United Nations' Economic Commission for Latin America and the Caribbean (ECLAC) identified several highlights in regional debt markets from July 2014 onwards. These included Jamaica's return to market, with the government issuing a US$800m 2025 bond, the first in three years. Chile's state copper company, Corporación Nacional de Cobre (Codelco) raised EUR600m in 2024 bonds in a debut in European markets. The Mexian government raised ¥60bn in a triple-tranche

Samurai bond. Brazil's state-owned savings bank, Caixa Econômica Federal (CEF), raised US$500m, in the first Basel III Tier Two bond to be sold in Brazil (and the third to be offered within the region). The governments of both El Salvador and Peru returned to international markets after absences of two and three years respectively.

Landmark deals by non-government issuers included offerings by Empresas Públicas de Medellín (Colombia), El Puerto de Liverpool (Mexico), Peru's Unión Andina de Cementos (Unacem) and the Central American Bank for Economic Integration (CABEI).

Dealogic noted that the volume of merger & acquisition (M&A) deals with targets in Latin America rose by 3% to US$122bn in 2014. The rise was in spite of a 20% fall in M&A deals involving Brazilian targets to US$56bn. The sectors with the greatest activity included telecommunications (US$28bn), utilities/energy (US$18bn) and finance (US$13bn).

Dealogic separately observed that volumes of project finance and public-private partnership (PPP) deals in the region rose to a record US$56bn - in spite of a 7% fall in the value of such transactions globally.

Of course, the region is not homogeneous. ECLAC noted that in the first three quarters of the year, the three main international ratings agencies (Moody's, Standard & Poor's and Fitch) issued 12 positive and 15 negative ratings changes with respect to sovereign issuers. At the end of October, sovereign spreads over US for more creditworthy issuers (Chile, Peru, Colombia, Mexico, Uruguay and Brazil) were clustered between 146 and 236 basis points. For Argentina, Venezuela and Ecuador, the corresponding figures were 495, 703 and 1,507 basis points respectively.

"Although the fall in energy and minerals prices over recent months does have a very substantial implication (whether positive or negative) for many of the countries in Latin America and the Caribbean), much of the adjustment already has been borne by currency movements. Further, many countries in the region have the foreign reserves, arrangements with the International Monetary Fund (IMF) or sovereign wealth funds (SWFs) that enable their governments to cope with the change. In the meantime, global interest rates remain at very low levels: while the US Federal Reserve has ended its quantitative easing program, the European Central Bank has announced that it will undertake massive purchases of sovereign bonds. Investors will maintain their appetite for bonds."

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Accordingly, we anticipate that volumes of bonds issued in the region in 2015 should not be markedly below those of 2014. The slippage in currencies in many countries means that assets can be purchased (much) more cheaply than in 2014. As regional economies and financial markets become more integrated with global markets, there should be more landmark deals, involving both sovereign and non-government issuers. Conditions and perceptions will change for the worse in particular countries, but contagion across the region will be limited. The regional shortage of infrastructure means that Latin America will remain prospective territory for private equity and PPP deals.

Brazil under strong pressure from ratings agencies

Despite a charm offensive by Joaquim Levy, the new finance minister, Moody's stripped Brazil's oil giant Petrobras of its investment grade status on 24 February. Levy had contacted the agency on 23 February to insist on the credit-worthiness of the state-backed company, but despite his credibility with the markets, the appeal did no good. Shares in the company slid and bond yields spiked as a result, with Moody's warning that further downgrades may follow. So far the other two credit rating

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In its explanatory note, Moody’s cited the ongoing corruption scandal rocking the company, in which contractors are alleged to have colluded to overpay on Petrobras deals. With no clear figure as to the scale of the losses caused by the scheme, creditors are anxious to see last year’s fully audited results. Though the company has a 30 April deadline, it has already indicated it may be unable to produce the results until June. “Extended delay carried the risk that creditors could take actions that lead to a declaration of technical default, followed by payment acceleration,” Moody’s warned.

While the downgrade was expected, the government attempted to minimise its significance. “Petrobras has not arrived at the point that it should lose its investment status,” Edison Lobão, the mines and energy minister, said. “This is a storm that the company is passing through and which it will overcome.” Former president Lula da Silva (2003-2011) held a rally in support of Petrobras on the day of the downgrade, in which he recalled the company’s achievements and urged President Dilma Rousseff to be bolder in her defence of the oil major.

For the opposition, however, the news was catnip. Aloysio Nunes Ferreira, of the Partido da Social Democracia Brasileira (PSDB), said Moody’s decision showed the size of the hole Petrobras was in. “It is yet another consequence of the tragedy in which the PT (the ruling left-wing Partido dos Trabalhadores) staffed Petrobras with a gang of thieves.” Ferreira added that the consequences of Moody’s decision went beyond the company itself, to affect the Brazilian economy as a whole. “The oil and gas sector in Brazil provides 13% of GDP. It’s a sector already in recession, and now it has been hit again.”

Following Moody’s decision, the government led by President Dilma Rousseff is attempting to reinforce its message that its fiscal adjustment plan is credible.

At present, Moody’s rates Brazil as Baa2 with a negative outlook, two notches above junk status. Analysts fear that a major cash injection by the government into the crisis-hit oil company could have an impact on the country’s credit rating. Mauro Leos, an analyst with Moody’s, said that this possibility has already been factored into the current assessment. But the high level of public indebtedness will only remain palatable to the agency if “the government responds with a credible plan for fiscal consolidation, improving debt levels and increasing investment and growth”.

MINING

Aratirí mine deal in Uruguay

The Indian multinational Zamin Ferrous has presented Uruguay’s government with a proposal significantly reducing in scale the Aratirí open-pit iron ore mine.

Back in 2011, Zamin proposed a record investment in Uruguay of US$3bn, promising the annual extraction of 18m tonnes (t) of iron ore from Aratirí, a 6,210-hectare plot of land criss-crossing the borders of Durazno, Florida and Treinta y Tres departments in the centre of the country. It would also require a 212km-mining duct and a new Atlantic port.

The less ambitious proposal Zamin has now tabled would result in the extraction of around 1.5m to 2m t of iron ore a year, which could be processed by the port of Montevideo.

This proposal has its advantages for the government. The open-pit mine has been a major cause of controversy with Uruguay’s powerful agriculture and livestock sector, with the agricultural lobby insisting that the scale of the project was far too big for a country of Uruguay’s size and would seriously alter the environmental balance of the area. Zamin’s much more modest proposal would undercut their protests to some extent.

The government is also keen to provide more business for the port of Montevideo, which it fears is being strangled by Argentina as a result of cargo transhipment restrictions imposed by Buenos Aires; this has resulted in a big fall in maritime cargo traffic passing through the port of Montevideo.

Zamin's latest proposal for Aratirí came the day before the senate narrowly voted in favour of extending by one year the deadline to seal a deal with the company to excavate the mine. The right-wing opposition Partido Colorado (PC) and the centre-right Partido Nacional (PN; Blancos) accused the government of "weakness", caving in to a company which has done nothing but drag its feet, potentially in order to sell the project on to another company and get out of Uruguay.

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PN Senator Luis Alberto Heber accused the ruling left-wing Frente Amplio (FA) of pushing through a "shameful law". He alluded to a comment by the (now former) President José Mujica in an interview with a local radio station that Uruguay could potentially face an international lawsuit if it threw the company out, as Zamin has already invested US$300m in preliminary investigations in Aratirí. Heber said the government was giving in to "coercion".

FA Senator Ernesto Agazzi maintained that President Mujica had been misinterpreted and that the point he had been trying to make was that any possible lawsuit would delay everything by another four to five years.

This explanation, however, failed to cut any ice with the opposition. PC Senator Alfredo Solari said it was like living in "a banana republic", with the government amending the law for the benefit of companies that were not even bringing in investment.

PC Senator Pedro Bordaberry argued that Zamin had left the government with egg on its face, having pushed through congress legislation regulating large-scale mining operations in the country in September 2013, in response to the fierce opposition of the agricultural lobby, specifically with Aratirí in mind. "Don't keep insisting that the law was not made for Aratirí, because nobody believes that", he stated.

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