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Brazil: Bottoming out – or just falling?

Almost all the economic news from Brazil over the last month has been bad, as it becomes clear that these two years – 2015 and 2016 – will represent one of the worst economic recessions the country has experienced in the last century. The question is whether the country has reached the bottom of the slump, which would imply the scene might now be set for recovery, or whether worse is still to come.

Estimates and forecasts for Brazil's economic growth have been constantly revised down in recent months. The original expectation had been that growth would continue positive, only slowing a little in 2015, and then re-accelerating in 2016. Then economists pencilled in a contraction (negative growth) in 2015 followed by recovery in 2016. Then the outlook shifted yet again, to contraction in both years, with the fall in 2016 being less sharp. Now both years are looking almost equally bad. According to the January update to its World Economic Outlook, the IMF now estimates that Brazilian GDP fell by 3.8% in 2015, and it is forecasting that it will fall a further 3.5% in 2016. The Fund also expects zero growth in 2017 meaning that Brazil will not grow again until 2018 (an election year).

Brazil has got to this unhappy place because of an inter-twining of economic and political factors. The economic crisis was triggered by the end of the global commodity boom (which has meant low oil, iron ore, soya, and coffee prices) and a domestic loss of confidence in government policies which have combined a massive fiscal deficit with high interest rates. The political crisis has made dealing with the economic problem more difficult. The corruption scandal around Petrobras, the state oil company, has implicated a large part of the political establishment and triggered impeachment proceedings against President Dilma Rousseff. A key factor is that a deeply divided Congress has consistently blocked attempts to introduce fiscal reform and control spending. Most analysts believe that impeachment proceedings will ultimately fail by around March or April this year (given that the pro-impeachment camp still lacks a two-thirds majority in Congress). But political risk continues to be high and the outcome uncertain. A poll of economists carried out by Reuters news agency in January showed they believed there was a 30% chance that Rousseff would not complete her presidential term (which runs to the end of 2018).

Brazil's 12-month inflation rate stood at 10.7% in mid-January, significantly above the core 4.5% target range (there is a +/- 2% band around the target, meaning actual inflation is also above the target ceiling of 6.5%). The Central

Bank, which had been widely expected to tighten monetary policy in an attempt to reduce inflation, decided nevertheless in its January meeting to leave the Selic rate steady at 14.25%. Some analysts said the bank had succumbed to political pressure from the government, concerned that higher interest rates would deepen the recession. Meanwhile the Brazilian currency has been depreciating rapidly against the US dollar, reflecting a global move away from emerging markets and a specific lack of confidence in Brazilian assets. The real fell 32% against the US dollar in 2015, and by a further 5% in the first two weeks of 2016. In this uncertain context, long-term domestic Brazilian interest rates have begun to move up even though the Selic has not.

Employment levels, which initially held up well, have now begun to reflect the full impact of the recession. According to the labour ministry a total of 1.5m jobs were lost in the formal economy last year, the largest number since the statistical series was launched 24 years ago. The biggest falls came in manufacturing (608,878 jobs lost), construction (416,959 job losses), and services (276,054). Only agriculture saw employment increase (up by 9,821 jobs). There were also indications that immigrant workers (who tend to be paid lower wages) increased in some sectors of the labour market such as meat processing, restaurants, retail trade, and construction. Nationwide, the formal unemployment rate increased to 9% in the third quarter of 2015. Another sign of the downturn: the index of industrial production contracted more steeply than expected in November, showing a year-on-year fall of 12.4%. Everything indicates that the Brazilian consumer is being squeezed by tighter monetary, high inflation, and rising unemployment.

“What Barbosa’s next steps will be is not yet clear. Considered more of a leftist than his orthodox predecessor Joaquim Levy, Barbosa has nevertheless acknowledged that something needs to be done about the fiscal deficit. He has said the government is now aiming to bring inflation down to around 7% in 2016.”

It is hard to visualize the road map out of Brazil’s recession at the moment. Attending the World Economic Forum (WEF) in Davos, the newly appointed finance minister Nelson Barbosa had a narrative about how bad might lead to good. “I think the beginning of this year is a turning point because we are seeing the collapse in commodity prices which is hitting us hard, but that is eliminating part of the political noise [against reform] – we expect that in the second half of this year we will have a reduction in inflation and stabilisation of the economic situation” he said.

However his optimistic “bottoming out” scenario glosses over some major necessary developments. It assumes not only that the presidential impeachment crisis is brought to a quick and more or less tidy conclusion, but also that Congress, after more than a year of rebellion, becomes more supportive of fiscal austerity and is able to approve enough belt-tightening measures to begin to rebuild some confidence in the business community. Barbosa did not mention another factor – Brazil’s municipal elections, due in October, which may make Congress and the country’s more populist politicians even less likely to associate themselves with austerity measures during the course of this year.

What Barbosa’s next steps will be is not yet clear. Considered more of a leftist than his orthodox predecessor Joaquim Levy, Barbosa has nevertheless acknowledged that something needs to be done about the fiscal deficit. He has said the government is now aiming to bring inflation down to around 7% in 2016. The minister promised to reveal details of a new “stimulus plan” for the economy on 28 January. Ahead of the announcement, officials suggested the aim would be to try and find pro-growth measures that at the same time had “zero fiscal cost”. It was suggested that there would be moves to boost infrastructure investment in ports, airports, roads, and rail as well as measures to support the financing of exports by small and medium sized companies (SMEs).

REGION

Held back by Brazil and Venezuela

The *Preliminary Overview* of the regional economies published by the Economic Commission for Latin America and the Caribbean (Eclac) points to general stagnation. The real GDP of the region as a whole is expected to shrink by 0.4% in 2015 and to expand by just 0.2% in 2016. However, this is largely due to the dismal performance of Brazil's economy. Elsewhere, prospects appear brighter.

"The *Preliminary Overview* of the regional economies published by the Economic Commission for Latin America and the Caribbean (Eclac) points to general stagnation."

Sub-par

Eclac's latest real* GDP projections for Latin America

	2015	2016
Dominican Rep.	6.6	5.2
Panama	5.9	6.2
St Kitts & N.	5.2	4.7
Bolivia	4.5	4.5
Cuba	4.0	4.2
Nicaragua	4.0	4.3
Guatemala	3.9	4.0
Honduras	3.4	3.3
Grenada	3.4	2.4
Antigua & B.	3.2	3.8
Colombia	3.1	3.0
Paraguay	2.9	3.0
Peru	2.8	3.4
Costa Rica	2.7	3.3
Mexico	2.5	2.6
El Salvador	2.4	2.4
Suriname	2.2	2.4
Argentina	2.0	0.8
Chile	2.0	2.1
Haiti	2.0	2.5
Guyana	2.0	3.4
Belize	1.7	2.7
Uruguay	1.5	1.5
Bahamas	1.5	2.4
St. Lucia	1.3	1.0
Jamaica	1.0	1.5
St Vincent & G.	1.0	2.1
Barbados	0.5	1.0
Ecuador	0.4	0.3
Trinidad & T.	0.2	0.6
REGION	-0.4	0.2
Dominica	-2.7	5.2
Brazil	-3.5	-2.0
Venezuela	-7.1	-7.0

*Constant prices in local currencies

Source: *Eclac*

Twenty-fifteen was a challenging year for the economies of Latin America and the Caribbean. One problem was declining terms of trade for many countries, with energy prices falling by about one quarter from January to October 2015 (and slipping further since then). Eclac notes that, over the same period, average prices for the metals and agricultural products exported from the region dropped by about one quarter and one tenth. Another problem was the reduction in availability of funds for emerging markets as investors correctly anticipated the moves by the US Federal Open Market Committee (FOMC) to increase the federal funds target. Meanwhile, global financial markets were volatile as it became clearer that China's economy was slowing.

The 0.4% contraction in the regional economy produced, according to Eclac, a 1.5% drop in per capita incomes. This was the worst outcome since 2009. In general, Central American economies performed a lot better than did their peers in South America. **[1]** Eclac calculates that Venezuela's economy contracted by 7.1% in 2015 and will shrink by a similar amount in 2016. Brazil has been, and remains, in a serious recession. As we discuss elsewhere in this edition, Trinidad & Tobago's economy is stagnating: the country has suffered as a result of the fall in energy prices, and the government has no choice but to tighten fiscal policy. At the other extreme, six economies – the Dominican Republic, Panama, St Kitts & Nevis, Bolivia, Cuba, and Nicaragua – were assessed as having expanded by 4% or more in 2015. Guatemala grew only marginally less rapidly than this.

Eclac expects the region to return to (very modest) growth in 2016. For now, it expects that many of the smaller countries (and Mexico) will achieve an acceleration in growth in the coming year. Nevertheless, Eclac warns that the various challenges which constrained growth through 2015 continue to prevail. Thanks in part to the weakening of China's economy, global trade volumes are expected to rise by only 2.5% in 2016 – or by less than global GDP. As we explain in box below though, we believe that a financial and/or economic meltdown in China is unlikely (but not impossible).

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2015 marked a reversal in the general fall in urban unemployment rates across the region. In the year to the end of March 2011, the unemployment rate was over 7%. Four years later, it stood at about 6%. Over the year to the end of September 2015, the unemployment rate was around 6.4%. The most recent increase is due to a rise in the participation rate: as economic conditions have worsened, more people have returned to the labour market. According to Eclac, many of these people have been working informally, or on their own account. The result has been a sharp deterioration in labour productivity. In a number of countries across the region, household purchasing power was reduced by the weak growth in employment, the deterioration in the quality of new jobs, and high inflation.

Given the probability that the region will only grow slowly over the next year or so, it is very unlikely that labour market conditions and household incomes will improve significantly. The result will be greater social tensions and crime in many of the region's larger cities.

In its assessment of the performance of, and prospects for, the region's economies in 2015 and 2016, Eclac noted that the slowing GDP growth of China, from 6.8% in 2015 to 6.4% in 2016, will likely contribute to continuing weakness of commodity prices.

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Scenarios for China

Observers in the rest of the world have been unsettled by the volatility of China’s A-share markets and the softness in the renminbi. LatinNews’ sources in China indicate that a financial and economic collapse in that country is a possible, but unlikely outcome. The relevant factors are as follows:

- Our sources estimate that the non-performing loans within the banking system are equivalent to around 15%-25% of GDP – a level that is manageable provided that there is not a run on the banking system or the currency.

- China has a structural excess of savings, and it has been running a current account surplus of around 2%-3% of GDP in recent years. The massive levels of debt within the financial system are held by domestic, and not foreign investors. Assistance from the IMF or other external sources will not be required.

- The general opacity of the system can be exploited by the authorities in Beijing, in that they can conceal the extent of the (bad) debts.

- The slowing of the economy has not led to a substantial rise in the overall level of unemployment: this is largely because the shedding of labour by export-oriented manufacturers and some state-connected entities has been offset by the creation of new jobs in the services sector and elsewhere.

- The sharp sell-off of the A share markets since the middle of 2015 is unlikely to have a major impact on the behaviour of consumers. Equities account for one sixth of household assets and tend to be held by wealthier households.

- Official comments indicate that the renminbi has adjusted to the desired target, in trade-weighted terms, which prevailed at the end of 2014. In the event that capital outflows result in very strong downwards pressure on the currency, the authorities could reintroduce capital controls. This would hamper the internationalisation of the renminbi, which is now a part of the basket of currencies underpinning the IMF’s Special Drawing Rights (SDR), but would otherwise not have negative effects on the economy.

- The credibility of the People’s Bank of China (PBOC, the central bank) has been harmed by miscommunication of past policies and the authorities’ pursuit of several – not necessarily consistent – policies at once.

Widespread concerns about a possible financial crisis and/or economic hard landing in China have contributed to the volatility of financial markets in the first weeks of 2016. Heightened anxiety about the ability of the authorities in Beijing to manage a shift in the Chinese economy from exports and investment towards domestic demand and consumption is one of the factors that will likely ensure that financial markets perform in a very different way in 2016 relative to 2015. Other factors that set the coming year apart from the past include increased geopolitical risk (and greater prominence of populist politicians and parties in the US and Europe), actual rather than potential increases in the federal funds target by the Federal Open Market Committee, and the slump through late 2015 of the price of oil (especially, but also of other forms of energy).

VENEZUELA

An emergency in search of a policy

The struggle over economic policy in Venezuela has intensified. The government named a new economic team and declared an economic emergency, which needs to be accepted or rejected by the opposition-dominated National Assembly. The executive and the legislative are involved in a major conflict of powers: how it will be resolved is uncertain. Both sides in Venezuela's bitter political conflict agree that the economy faces possibly its worst crisis this century, made more acute by further drops in oil prices, but there is no consensus on what should be done.

"Also in early January President Maduro presented his state of the nation address to the National Assembly. The big novelty here was that just before the speech the Banco Central de Venezuela (BCV) actually published some economic data – for the first time since 2014. While opposition economists says the numbers still underestimate the real economic predicament in which the country finds itself, they are still dramatic."

In early January the *Chavista* government of President Nicolás Maduro announced a new economic team. Most eye-catching of the new appointments was Luis Salas, who takes over the newly created ministry of the productive economy. Salas, a radical academic from the Universidad Bolivariana de Venezuela is best known for his theory that inflation is not an economic phenomenon at all, but rather an expression of the political struggle. In his academic writings he has supported price controls, and described the private sector as "parasitical". While his appointment has been taken as a sign that the government's response to the crisis will be to intensify state controls, other officials may have different ideas. Jesús Farías, appointed minister for foreign trade and international investment, has spoken of reducing Venezuela's multiple exchange rates. Rodolfo Pérez Molina, the new minister for banks and finance, is also believed to favour liberalisation of exchange rates. Dimitris Pantoulas, a political analyst, told the *Wall Street Journal*: "This cabinet is a mess. They have an economy minister who doesn't believe in the private sector, and on the other hand they say they want foreign investment. It's a contradictory policy without any direction."

Also in early January President Maduro presented his state of the nation address to the National Assembly. The big novelty here was that just before the speech the Banco Central de Venezuela (BCV) actually published some economic data – for the first time since 2014. While opposition economists says the numbers still underestimate the real economic predicament in which the country finds itself, they are still dramatic. According to the BCV data (covering the period up to September 2015) third quarter GDP last year was down 7.1% year-on-year. On the same basis investment was down 26%, consumption was down 10.4% and imports were down 26.9%. The annual rate of inflation in September was 141.5%. In the third quarter the current account deficit stood at US$5.1bn or 3.8% of GDP. Asdrúbal Oliveros of Caracas-based consultancy Ecoanalítica said however that on his estimates GDP slumped last year by 9.2% and inflation rose to 223%. According to Alejandro Werner, IMF Western Hemisphere director, inflation was 275% last year and could spiral out of control to 720% in 2016.

Both the opposition and the government agree that the economic situation is terrible, but they have diametrically opposed explanations as to why this is so. And as things stand, neither have articulated a clear set of policy recommendations on how to get the economy back onto a growth track. In his speech Maduro reiterated his concept that an "economic war" is being fought against the country by the forces of domestic and international reaction. The opposition voiced its counter-view that the government's

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>
> *– Alejandro Arreaza, Barclays Bank*

entire economic model of top-down state control, nationalised industries, persecution of the private sector, and multiple exchange rates is wrong-headed and should be dismantled. In the second half of January the battle was focused on whether the National Assembly would approve or reject Maduro's request for emergency powers. It was possible the government might simply impose the emergency powers.

However, as consultancy Capital Economics noted "Mr Maduro's previous emergency decrees (he ruled by decree for most of last year) have resulted in zero economic policy changes." Capital Economics is predicting another 8% GDP contraction this year. Other analysts have spoken of both hyperinflation and a default on foreign debt as possible events this year (Venezuela must pay around US$10bn in debt service this year, with many of the payments bunched in October). In a research note Alejandro Arreaza of Barclays Bank said, "The economic emergency decree and any measures that the government could take at this point may be too late. After two years of inaction and the recent decline in oil prices, a credit event in 2016 is becoming increasingly difficult to avoid."

The government did, however, announce one small change. On 21 January it said there would be an adjustment to the exchange rate used for non-oil exports. Under existing regulations non-oil exporters have been required to sell 40% of their dollar earnings at the Sicad II exchange rate (US$1=VEN52). Now, they are being allowed to use the Simad floating rate (around US$1=VEN200). This therefore represents a devaluation, but one which applies only to around US$3bn or 2% of Venezuela's exports. The country remains 98% dependent on oil exports – and record-low oil prices are battering the economy.

MEXICO

In the eye of the oil storm

With the IMF confirming in its latest forecasts that it expects Latin America and the Caribbean as a whole to experience not one, but two back-to-back years of outright recession in 2015 and 2016, it can be argued that Mexico isn't doing too badly. For those two years the IMF now sees Mexican GDP bucking the trend and registering positive growth of 2.5% and 2.6% respectively. However, that was before January dealt a nasty surprise – an additional and even deeper slump in oil prices.

Modern Mexico is half-way dependent on oil and gas: a rather awkward position to be in. The hydrocarbons sector of the economy is relatively small (about 6% of GDP). But it still matters as a share of exports (around 10%) and much more so as a source of government revenue (about 30%, in the good times). What this means is that the economy can absorb the effects of moderate or even of low oil and gas prices – after all, cheap energy can boost other, competitive areas of the economy such as the powerhouse of manufacturing exports to the US. But it is much more difficult for Mexico to adapt to the disruptive effects of extremely low oil prices – and that is exactly where the global market appeared to be heading in January.

A combination of factors – fears of a meltdown in China, stock market nervousness, the nuclear agreement with Iran, which is paving the way for

resumed oil exports from that country – have rattled commodity and oil markets. Mexican mix crude oil, which traded at an average of US$101.96 a barrel in 2012, eased to US$98.43 in 2013, and then began a sustained downward plunge, falling 12.6% to an average of US$86,00 in 2014. Last year it plunged by a much deeper 47.8% to US$44.89. But in the transition from December to January the bottom really seems to have fallen out of the market. In mid-December the price stood at US$28.34, but by 19 January is had slumped to US$20.02. If prolonged this, potentially, is a real game changer.

In December in fact, officials had been congratulating each other on the success of the third phase of Round 1 oil licensing auctions. Unlike earlier phases, all blocks were successfully auctioned – a total of 25 onshore production contracts, representing some US$620m of new investment. Most analysts agreed that this was an encouraging result given depressed oil prices. But the subsequent oil price crash has already overshadowed that good news story.

Speaking in mid-January Lourdes Melgar, a deputy energy minister (subsecretaria) acknowledged the gravity of the situation. "We are entering the eye of the hurricane and, without doubt, the next months will be complicated" she told Radio Formula, adding: "We hope that this period passes quickly and that we are able to see better prices towards the middle of this year." Although officials have put a brave face on events, it is clear that prices have now dropped below the cost of production. State oil company Pemex has in the past spoken of an average cost of production of US$23 a barrel, but when prices dropped below that floor in January they said operating costs could in fact be as low as US$10 a barrel – excluding capital costs.

Low oil prices will have a negative impact on government revenue. According to budget guidelines, the government normally requires revenues equivalent to around 2.5% of GDP to be paid to the treasury from the oil sector. According to a local think-tank, the Centro de Investigación Económica y Presupuestaria (CIEP), at an exchange rate of 18 pesos the dollar, and a Mexican mix oil price of US$25 a barrel, the contribution to the treasury falls to only 1.8% of GDP. In late January the peso and the oil price had both overshot that mark (to 18.50 pesos and US$20/barrel respectively). So budget difficulties may be the order of the day. However, there are some offsetting factors – this year's oil exports have been hedged, and some analysts believe, as Lourdes Melgar hopes, that the price will rebound by the middle of this year.

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One big consequence is that state oil company Pemex, already in the process of restructuring as it loses its monopoly position thanks to the government's energy reforms, will now have to be shaken up further and more radically than expected. According to Jorge Piñón, an energy specialist at the University of Texas, if Pemex is to compete internationally it will need to spend the next three to seven years selling assets and cutting its workforce. "Politically, it's suicide" he has said, in a reference to the central role Pemex has traditionally occupied in the Mexican political system and the fact that there are important state-level elections this year and a presidential contest in 2018. The political dimension is important. Pemex committed a public relations blunder in December, opening its first overseas petrol station in Houston, where it began selling petrol at half the price it charges in Mexico. Pemex has already had to cut its capital spending budget for 2016 to a 9-year low, and in mid-January it said it was looking at a further MXN70bn (US$3.9bn) budget cut and laying off 13,000 of its total workforce estimated at 153,000 employees.

Unhappy New Year

The government of Trinidad & Tobago has announced its initial response to the slump in energy prices. Reconciling its desire to balance the budget with protecting low income households and boosting employment, not to mention the fairly hawkish policy of the Central Bank of Trinidad & Tobago, will not be easy.

Economic conditions in Trinidad & Tobago have been deteriorating over the last year. GDP contracted by 2.0% in real terms over the year to the end of September. The fiscal deficit in the year to the end of June was TTD5,724mn (US$894mn), or 3.2% of GDP. Excluding revenues from the energy sector (which account for about one third of the total), the deficit would have been TTD28,845mn, or 16% of GDP.

These figures do not include the surge in spending by the previous government, prior to the general election that was held on 7 September. Government spending has contributed to consumer price inflation, which was running at just under 5% over the year to the end of September **[1]**. These figures also do not include the impact of the latest slump in the price of oil to around US$30 per barrel (West Texas Intermediate) and of natural gas to US$2.22 per million British Thermal Units (mmBTU). At the end of 2014, both prices had already fallen from their peaks and stood at US$73 per barrel and US$3.8 per mmBTU. The current budget (for the fiscal year to 30 September 2016) had assumed that the price of oil would be US$45 per barrel. Meanwhile, production of crude oil has dropped from 90,000 barrels of oil per day (BOPD) in 2014 to 80,000 BOPD in 2015, while natural gas production has been broadly static at 3.8bn cubic feet per day – or less than the 4.2bn cubic feet per day that is needed by Trinidad & Tobago's LNG, petrochemicals, and power-generation industries.

"A major theme of the address to the nation delivered by Prime Minister Dr Keith Rowley on 29 December was that Trinidad & Tobago has a cushion of savings that have been accumulated over the years."

A major theme of the address to the nation delivered by Prime Minister Dr Keith Rowley on 29 December was that Trinidad & Tobago has a cushion of savings that have been accumulated over the years. These include around US$10bn in official reserves (which would have been around US$2bn higher but for sales of US dollars to meet demand from importers and other parties over the course of 2015), around US$5.6bn in the Heritage & Stability Fund (HSF- the national Sovereign Wealth Fund). Resident deposits with commercial banks amount to about US$3.6bn. In addition, the National Insurance Board of Trinidad & Tobago (NIBTT – the central institution within the country's social security system) also has significant overseas assets.

Much of Dr Rowley's address was devoted to the actions that the government will take to address the problems arising from the slump in energy prices **[2]**. Every government ministry, state-owned enterprise (SOE), and statutory body, as well as the Tobago House of Assembly has been asked to present plans on a reduction in operating expenses by the end of January 2016. Land and Building Taxes will be reintroduced from January, and VAT will be introduced for a number of food items with effect from the beginning of February. Tax arrears will be collected.

The government also expects to draw US$1.0bn from the HSF in the current fiscal year and, perhaps, another US$0.5bn in the September 2017 fiscal year.

Chart 1: The worst and latest data:		
A snapshot of Trinidad & Tobago's economy		
Real GDP Growth (year-on-year)	-2.0	September
Year-on-year CPI inflation (%)	4.9	September
Unemployment Rate (%)	3.2	June
WTI Crude Oil Price (US$/bbl)	30.80	January 21
Henry Hub Natural Gas Price (US$/mmbtu)	2.22	January 19
Total Exports (US$Mn)	1,894.4	June
Total Imports (US$Mn)	1,434.0	June
BOP Current Account Balance (US$Mn)	186.2	June
BOP Overall Surplus/Deficit (US$Mn)	-259.3	June
Foreign Direct Investment (US$Mn)	-518.0	June
Net Official Reserves - US$ Millions	10,312.3	September
Import Cover (months)	11.8	September
Central Government Total Revenue (TT$Mn)	14,056.3	June
Central Government Total Expenditure (TT$Mn)	15,133.6	June
Overall Fiscal Balance (TT$Mn)	-1,077.3	June
Non-Energy Fiscal Balance (TT$Mn)	-5,457.9	June
Commercial Banks: Private Sector Credit (TT$Mn)	50,124.4	September
Money Supply M-2 (TT$Mn)	85,473.1	September
Commercial Banks Basic Prime Lending Rate (end of period %)	8.5	September
Repo Rate (end of period, %)	4.75	September
Sources: *CBTT, EIA, Bloomberg*		

Chart 2: The government's response
Every ministry, SOE and statutory body and THA to cut operating expenses by 7% - without reducing jobs
Land and Building taxes to be restored from January 2016
VAT charged on some foods from beginning of January 2016
Tax arrears to be collected
Negotiations with labour and business interests to moderate wage increases and discourage excessive profits
Incentives to encourage private capital to build houses
Merger of Trinidad & Tobago Mortgage Finance and Home Mortgage Bank
Use of US$1bn of Heritage & Stability Fund in 2016 and US$0.5bn in 2017
Separation of Heritage & Stability Fund into Heritage and Stability elements
Possible development of Loran-Manatee gas field on border with Venezuela
Increase in Personal Income Allowance**
Continuation of spending on Unemployment Relief Programme and CEPEP*
*Community-based Environmental Protection & Enhancement Program
**The Personal Income Tax Exemption Limit will be lifted from TTD5,000 per month to TTD6,000 month. The number of people who pay no income tax will rise by 59,000 to 302,000
Sources: *21 January 2016 Presentation to Cabinet of Minister of Finance Colm Imbert, 29 December 2015 Address to the Nation by Prime Minister Dr Keith Rowle.*

The government also plans to separate the HSF into two elements: Stability (ie a financial cushion for the government at times like the present, when lower energy prices have hit revenues badly) and Heritage (a source of alternative income to offset the depletion of non-renewable energy resources and a fund for future generations).

The government hopes to boost activity in the construction sector, by encouraging private sector investment. The plan includes facilitation of mortgage lending through the merger of Trinidad & Tobago Mortgage Finance (TTMF – which lends to low and middle income households on concessional terms) and the Home Mortgage Bank (HMB – the central institution in the secondary mortgage market, which also originates mortgages for middle income households). Given the fairly different focus of the two institutions, it is not entirely clear how the merger would provide an impetus to lending (and construction). Ultimately, the NIBTT, as majority shareholder in both TTMF and the HMB, will decide whether or not the merger goes ahead.

The government has also taken steps to boost the disposable income of poorer households, especially as the costs of food will rise as a result of the changes to the scope of VAT. With effect from the beginning of December, several thousand pensioners have benefited from an increase in the cap on their pension benefits from TTD4,500 to TTD5,000 (US$781) per month. The Personal Income Tax Exemption limit has been increased from TTD60,000 per year to TTD72,000 per year. This means that the number of people who will not have to file personal income tax returns or pay tax on a Pay As You Earn (PAYE) basis will rise by around 59,000 to 302,000. The government will also maintain the Unemployment Relief Program (URP) and the Community-based Environmental Protection and Enhancement Program (CEPEP – which seeks to boost employment of unskilled and semi-skilled people and help local communities to improve their local environments through landscaping etc).

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A clearer indication of the scale of the economic and fiscal challenge facing the government will come from the CBTT's next monetary policy announcement, which is due to be released on 29 January 2016. Over the last two years, the CBTT has increased its key repo rate from 2.75% to 4.75%. Commercial bank prime lending rates have also been rising, and stand currently at 8.75%. Caution on the part of the banks and their customers has been reflected in the slow increase in credit to the private sector, from TTD47,397 in September 2014 to TTD50,124mn in September 2015.

It remains to be seen whether the latest slump in energy prices – and general deterioration in the global economy – has an impact on the CBTT's policy over the coming weeks and months. On 24 December, former Governor Jwala Rambarran was removed from his post – having served about three-and-a-half years of a five year term. Officially, this was because he had breached section 56 of the Central Bank Act and section 8 of the Financial Institutions Act by disclosing the names of the largest buyers of foreign exchange in Trinidad & Tobago and the quantities that they had purchased. Mr Rambarran was replaced by Dr Alvin Hilaire, who had served as Deputy Governor of the CBTT.

In short, the government is trying to do several things simultaneously. It wants to reduce the impact on the budget of the slump in energy prices. It is trying to boost economic growth and employment (notwithstanding that, at a little over 3% in June 2015, the unemployment rate was fairly low). It wants support from organised labour and the business community. All these aims need to be reconciled with the CBTT's hawkish monetary policies. Achieving all of these objectives will not be easy.

PUERTO RICO

The stakes rise in the debt crisis

As of 22 January 2016, three bond insurers have initiated legal moves against the administration of Governor Alejandro García Padilla to prevent the diversion of funds from government-backed entities to repay interest and principal on the General Obligations (GO) and other securities issued by the government itself.

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As we noted last month, 1 January 2016 represented an important deadline for the repayment of principal and interest by the heavily indebted government of Puerto Rico and other entities that it controls. Total debt outstanding as of late 2015 was around US$73bn.

On 30 December, the Government Development Bank (GDB) of Puerto Rico confirmed that it would, on 1 January, pay around US$444m in interest and principal on bonds issued or guaranteed by the government itself. Some US$164m of this money came from 'available revenues' that had previously been earmarked for service of debt issued by the Highways and Transportation Authority (HTA), the Puerto Rico Infrastructure Financing Authority (PRIFA), the Convention Center District Authority (CCDA), and other government-backed entities. HTA and CCDA were able to make full payment of the amounts that were due on their bonds on 1 January. So too was the Sales Tax Financing Corporation (COFINA). PRIFA was also able to make payment on its 2015 Series Dedicated Tax Fund Revenue Bond Anticipation Notes. However, PRIFA did not have sufficient funds to make full payment on its Series 2005A-C and Series 2006 Special Tax Revenue Bonds. The shortfall was US$36m.

The less-than-full payment by PRIFA resulted in claims against three bond insurers, Ambac Financial Group Inc, Assured Guaranty Limited, and Financial Guaranty Insurance Co (FGIC). By the end of the third week of January, all three had launched lawsuits against the government to prevent the diversion of funds from PRIFA and the other government-backed entities to pay GOs and other obligations of the government itself.

As of the end of September last year, FGIC had provided insurance cover in relation to US$769m of PRIFA's bonds. Its exposure to principal and interest of bonds issued by Puerto Rico-based entities amounts to around US$2bn, with the final repayment taking place in 2045. Assured Guaranty and Ambac Financial have respective exposures of around US$8bn that extend to 2047 and US$10bn that extend to 2054. Another bond insurer, National Public Finance, has exposures of about US$9bn that extend to 2046[1].

The lawsuits complicate negotiations between the government and its creditors at a time that the Working Group for the Fiscal and Economic Recovery

[1] *Bloomberg Business*, 22 January 2016, 'Puerto Rico Sued by Third Bond Insurer to Halt Revenue Raid'.

of Puerto Rico has announced that it envisages a larger funding gap for the government and its entities than it had forecast in September 2015. On 18 January, the Working Group noted that "even with economic growth and all of the measures outlined in the Fiscal and Economic Growth Plan (FEGP), the cumulative [budget] deficit [of the government and all the other entities], *assuming contractual debt service is paid* [stress added], will grow by approximately US$23.9bn over the ten year period". Without all the measures to boost revenues and to reduce spending, the debt is forecast to balloon by US$63.4bn. Over the next five years, the corresponding figures are US$16.1bn and US$28.0bn. Previously, the Working Group had envisaged that the funding gap would grow by US$14.0bn over five years if the recommended measures were adopted. Lower-than-anticipated revenues are the main reason for the US$2.1bn rise in the funding gap.

The clear implication from the Working Group's latest report is that the government of Puerto Rico and its entities remain in a debt trap from which they will only emerge if there is a very substantial renegotiation of their obligations with their creditors. In the meantime, the burden of debt service (ie including both interest and capital payments) is relentless. Total debt service in 2016 is expected to be US$4,121m. The largest elements of this are the government's GOs (US$1,126m), obligations of the GDB (US$1,064m), COFINA (US$682m), PRIFA (US$158m in short-dated paper and an additional US$128m in other obligations), HTA (US$323m), the Public Building Authority (PBA – US$277m), and the Employees' Retirement System (ERS – US$167m). Debt service should fall to US$3,396m in 2017 and to US$3,272m in 2018, thanks to the maturity of PRIFA's short-dated paper. However, annual debt service should exceed US$3,000m each year until 2025.

"The governor himself is under no illusion as to the scale of the challenge. On 14 December 2015, García Padilla had announced that he would not seek re-election in the polls that are due to take place in early November 2016. Instead, the governor will focus his efforts on resolving Puerto Rico's problems and, in particular, the debt crisis."

The governor himself is under no illusion as to the scale of the challenge. On 14 December 2015, García Padilla had announced that he would not seek re-election in the polls that are due to take place in early November 2016. Instead, the governor will focus his efforts on resolving Puerto Rico's problems and, in particular, the debt crisis.

In short, the government will face a chain of deadlines for debt service payments and will continue to face legal challenges from bond insurers as long as it is making payments on GOs and other securities that it guarantees with funds from other entities. During the coming weeks and months, the pressure will mount for the government to persuade lawmakers in the US Congress to enact legislation that will allow for an orderly default (eg via Chapter 9 of the US Bankruptcy Code) and to renegotiate its debts with its creditors.

REGIONAL BUSINESS REVIEW

BRAZIL

Warning lights flashing on Rio Olympics

The decision to choose Rio de Janeiro as the venue for the 2016 Olympic Games was taken in 2009, when Brazil expected that its commodities-led boom would continue for years. It didn't. With the games now only seven months away (5-21 August) commodity prices are at record lows. Brazil is struggling with a double-headed political and economic crisis with

President Dilma Rousseff facing impeachment proceedings. In the most dramatic scenario she might even be replaced before the games start. The economy is expected to contract by over 3% this year – the second year of shrinkage. Will all this cause serious problems for the games? It depends who you talk to.

Most Brazilian officials acknowledge that this is a time for belt-tightening, and the games cannot escape what is happening to the rest of the country. But some seek to place this in a reassuring context. One of them is Mario Andrada, communications director for the Rio 2016 organising committee. He has acknowledged that the operating budget (estimated at close to US$2bn) will have to be cut by between 5% and 20%. This, he says, will be achieved by widespread trimming: television sets won't be installed in athletes' rooms (although they will get air conditioning), there will be fewer computer printers, the opening ceremony will be modest, and visiting VIPs are likely to be served feijão – Brazil's staple meat and beans dish – rather than more luxurious fare.

Yet Andrada insists that "the Olympics are going to be spectacular" and that all the key elements will be in place. In his words the organising committee will cut back "nothing from the tracks, nothing from the sports, nothing from the ceremony, nothing from the legacy". Given the recent terror attacks in Paris, Wilson Trezza, head of Brazilian intelligence, told AFP news agency that security measures are well in hand, and that "Rio will be the safest city in the world during the Games". Rio de Janeiro state governor Luis Fernando Pezão, a member of the Partido do Movimento Democrático Brasileiro (PMDB) and himself a potential presidential candidate in 2018, needs the games to be successful. He too has adopted a matter-of-fact tone. "Come on, we are not China, we are not England" he said in early January, referring to the two previous hosts of the games. He added: "We are not a rich country. So, every time I can cut some of the budget for the Olympics – we will do it. This is not going to be the Olympics of wasting money."

"Matt Smith, a World Rowing executive, is worrying whether 4,000 temporary grandstand seats for the rowing events will be built. "I've been around since Los Angeles in 1984 and we haven't seen a country that is staging the games in such a vulnerable situation", he said recently."

Others, however, say there is genuine cause for concern. Matt Smith, a World Rowing executive, is worrying whether 4,000 temporary grandstand seats for the rowing events will be built. "I've been around since Los Angeles in 1984 and we haven't seen a country that is staging the games in such a vulnerable situation", he said recently. There has been widespread media coverage of high levels of contamination in both Guanabara Bay and the Rodrigo de Freitas lagoon, the venues for sailing, rowing, and canoeing events. Plans for a major environmental clean-up have effectively been shelved, with the authorities now relying on smaller stop-gap measures such as the use of 'eco-boats' to gather surface garbage and debris. Electricity and water supplies have been cut off to the Nilton Santos stadium, where track and field events will be held, in a dispute over who is responsible for some US$250,000 in overdue bills. Public services in Rio are under heavy pressure because of budget cutbacks, with a state of emergency declared in Rio hospitals last month after they said they were running out of funds to pay for drugs, equipment, and salaries.

Christopher Gaffney, an urban planning expert from the University of Zurich, has said that "Rio tied its welfare to the price of commodities, and now it is suffering at the same time as it is on the hook for billions to the International Olympic Committee". There are also worries over the recent

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spread of mosquito borne diseases such as dengue, chikungunya and zika. Zika is the newest, with officials saying up to 1.5m people may have been infected. Although it is concentrated in the impoverished north east of the country, there has been a growing number of cases in Rio de Janeiro state.

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There is some nervousness over the Metro project referred to by Coates – this is a 16km subway extension designed to link central Rio to the Olympic park in the western suburb of Barra da Tijuca. At present it is expected to be completed only weeks before the games are due to start, leaving little time for testing. Even that will depend on Rio securing hundreds of millions of dollars in extra support from the federal government in Brasilia, and whether that is forthcoming or not may depend on the latest turns in the impeachment crisis. For the organising committee Andrada was asked if extra buses would be hired if the Metro extension was not completed on time: “there is no Plan B” he replied.

COLOMBIA

All eyes on agriculture

Colombian agriculture is going to be under scrutiny in 2016, for a variety of reasons. The proposed peace settlement between the government and the Fuerzas Armadas Revolucionarias de Colombia (FARC) insurgents contains a series of commitments on land reform and rural development. At the same time the government has passed legislation creating rural development zones (known as Zonas de Interés de Desarrollo Rural Económico y Social, or Zidres) that have met with opposition. And hanging over both these developments is the whole question of modernising the agricultural and agro-industrial sector of the economy.

Traditionally a key sector of the Colombian economy, agriculture has suffered from a fair degree of neglect. According to an April 2015 report by the OECD, the share of primary agriculture in GDP dwindled from 16.5% in 1990 to 5.2% in 2013. Agriculture’s share of employment also fell, from 26% to 17.5% in the same period. The sector now represents only around 11% of the country’s exports and continues to be dominated by traditional commodities such as coffee, bananas, and sugar. In the last two decades output growth has averaged a disappointing 1.6% per annum. The OECD was critical of producer price support mechanisms used by the government, which it said

were "most production and trade-distorting, and least efficient in increasing producer incomes". It also highlighted deficiencies in land tenure, transport systems, water management, education, and market information systems, all of which undermined competitiveness. It also noted that "an inclusive land access policy in Colombia, while politically complex, is necessary to stabilise the country and to promote rural development".

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The issue of land ownership and land reform has in fact been central to the country's more than half a century of rural violence. The FARC itself came into being in the 1960s in part to resist the expulsion of peasant farmers from farming areas by powerful local families and business groups. According to human rights group Amnesty International the ensuing struggles between left-wing guerrillas and right-wing paramilitaries led to the displacement of almost 6m people – nearly 13% of the population – and the illegal acquisition of around 8m hectares of land, some 14% of the country's territory (an area equal to the size of Costa Rica). As a result Colombia has had one of the world's most unequal distributions of land ownership (around 1% of the population is estimated to hold 50% of the land). Amnesty has been highly critical of an initial attempt to restore land to the displaced, through the Victims and Land Restitution Law (Law 1448) of 2012. The human rights lobby said that only a tiny fraction of the 8m hectares have been returned, and that the returnees have faced threats of violence from paramilitary groups (at least 35 have been killed). Nor do returnees receive basic infrastructure or financial support.

In 2014, as part of its negotiations with the FARC, the government reached a draft agreement on the broad outlines of rural reform. One of the key sentences was: "For the de-concentration and promotion of more equitable land distribution, the national government will create a Land Fund for free distribution. The land fund will distribute (xxx) million hectares of land in a period of (xxx) years". The key numbers to replace the "x's' in the final document have yet to be agreed. Distribution is to be carried out on the basis of smallholdings, known as family agricultural units (the Unidad Agrícola Familiar – UAF) that are defined as being sufficient to earn at least two minimum wages and to allow the accumulation of savings. There are also commitments to build road, irrigation, electricity, and internet infrastructure, and to offer rural education and health services.

However, one of the key issues currently under debate is whether a recovery in the agricultural sector will be based around smallholdings or around larger, more commercial faming units. Even if the answer is 'both', a variety of stakeholders have strong views on how resources and priorities should be distributed amongst the two alternatives. The debate has been catalysed by the passage of the Zidres law through Congress in December. The new law seeks to promote large-scale farming, picking up a theme the government had previously sought to address through attempts to promote the use of fallow land. A Zidres is now defined as an area of land that is isolated, has low population density, and requires large-scale investment and infrastructure for its development as a productive agricultural, livestock, or forestry unit. The law says that a Zidres can be constituted irrespective of the nature of land tenure – the land may be bought, rented, or created by an association of smallholders; it may be fallow or cultivated, with no size restrictions. A Zidres may be set up for a 30, 40, or 60 year term. Opponents of the Zidres

say it provides a way to bypass other legislation that protects smallholders and prevents accumulation of more than one UAF at a time.

The government is clearly trying to balance a social and political objective, offering land and livelihoods to the small-scale farmers displaced by internal conflict, with a much more commercial one: encouraging a new wave of large-scale investment and growth in agriculture and agro industry. The danger is that the two will be seen as contradictory or mutually exclusive. Supported by the government and the private sector Sociedad de Agricultores de Colombia (SAC), the law has been opposed by lobby groups such as Oxfam and the Commission of Colombian Jurists (CCJ). Senator Jorge Enrique Robledo (from the opposition Polo Democrático) says that fallow land, which should be broken up and distributed to landless peasants, will instead be rented or sold off in large blocks to Colombian or foreign agro-industrial conglomerates. Some critics have gone as far as describing the Zidres law as part of "an agricultural counter-reform". The FARC says it contradicts the spirit of the draft land reform agreement reached with the government.

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On the other side of the coin, the government clearly believes there is an important economic potential in large-scale farming which could help Colombia reduce its current dependence on hydrocarbons and extractive mining. The *llanos orientales* (eastern highlands) are likely to be opened up as part of any peace agreement and here there are high hopes for new development. Some have argued that the area has an agro-industrial potential comparable to that of the Brazilian cerrado for soya and other crops including palm oil, and that it could generate up to US$5bn a year in export earnings. The area is estimated to have at least 10m hectares that could be used for commercial farming, doubling Colombia's current cultivated area.

ARGENTINA

Good times for grain exporters?

The peso has been devalued, export taxes have been slashed, and export permits are no longer required. Cristina Fernández de Kirchner – who had an epic quarrel with Argentina's farmers when she was president from 2007-2015 – has been voted out of office. Does this mean that the good times are set to roll again?

There is no doubt that Argentina's farmers have received a big boost. Since taking office on 10 December the new centre-right President Mauricio Macri has delivered on his initial promises. The controlled official exchange which overvalued the national currency has been eliminated, with the peso plunging from 9.80 to the US dollar to a new freely floating rate of around 14.0 pesos. In addition, the much-hated *retenciones* (export taxes) were slashed. Export taxes on wheat (23% ad valorem), maize (20%), sunflower (32%), beef (15%), and other products produced by regional economies (5%) were all reduced to zero. The export tax on soya was cut from 35% down to 30%. In addition the old system of export permits – known as 'registro de operaciones a la exportación', or ROEs – was also scrapped.

As a result of these measures local currency revenue from exports has begun to jump sharply. The international price of wheat is currently around US$5.60 a bushel. Under the previous government, that was worth 26.72

pesos (official exchange rate of 9.8 pesos less the *retención* of 23%). Under the new government the value in the exporters' pocket has multiplied by 2.4 times to reach 64.40 pesos (floating exchange rate of 14.0 pesos, no *retención*). Even in the case of soya, which remains subject to the export tax, farmers are seeing their income rise by over 50% per tonne sold.

With some delays, the change is beginning to make itself felt. From long before the December elections many farmers had begun to hold back exports, stockpiling them in the hope of getting a better price in early 2016. According to CIARA-CEC, the chamber of grains exporting and soya crushing companies, some US$2bn of grains-export dollars were sold to the central bank in the first three weeks after controls were lifted, about 10% of the annual amount. The new government had commitments from farming lobbies that in return for the removal of controls they would boost shipments, thereby generating dollars to stabilise the country's perilously low foreign currency reserves. In early January agriculture livestock and fisheries secretary Ricardo Negri expressed a degree of disappointment saying "we were expecting that more stock reserves would have been sold by this point, and we hope this happens in the coming days".

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A number of analysts say that the benefits of devaluation and lower taxes came a little late in the 2015/16 crop year, after decisions on how much to sow of particular crops had already been taken. As a result the full positive impact will not be felt until 2016/17. A source in Sociedad Rural (SR), a farming association, told *Clarín* newspaper that the changes had generated "enthusiasm, but it is a shame they came a little late, after planting had been completed". But Federico Bert of CREA, another farming lobby, said it was clear the area left fallow, estimated at about 2m hectares last October, has already been reduced by around half. Gustavo López of consultancy Agritrend said that by April/May this year sowing plans for wheat are likely to rise to 4m ha from the present 3.6m, with expansion also likely in maize. He estimated the overall harvest could rise to 120m tonnes in 2016/17, from around 105m t in 2015/16.

In a related move on 18 January the government lifted a prior 7-year old ban on the import of raw soya. Argentina has in the past imported soya from Paraguay and Uruguay. The decision was designed to support the soya crushing and processing industry in agro-industrial centres such as Rosario, allowing it to use spare capacity and encouraging higher value-added exports. Soya milling in the first 11 months of last year was up by only 0.8% to 38.2m tonnes, in part because of the holding back of raw soya stocks. Mariano Balestra of KPMG Agronegocios welcomed the decision, which he said would be very positive for production of soya oil, soya meal, and soya pellets.

While the outlook for Argentine agriculture has improved, there are still a number of concerns. Farmers are enjoying the price benefits of the devaluation, but it will also, after a time lag, have an upward impact on their costs. Much will depend on whether the new government can contain the feared surge in domestic inflation. Another worry is that after years of underinvestment, and with an ageing transport infrastructure, it will be difficult to raise agricultural yields in the short term. And although there was an initial success – in December Argentine exports won a tender to deliver 120,000 tonnes of wheat to Egypt, against competition from Russian suppliers – the reality is that there is significant oversupply in the international market for grains and oilseeds, which is likely to keep prices subdued.

Corporate Radar

Eurnekian bets on IPOs

Argentine businessman Eduardo Eurnekian is reported to be planning up to four IPOs on the New York Stock Exchange (NYSE) this year, arguing that conditions could be "ideal" for such a move if Argentina successfully resolves its long legal dispute with the hold-out creditors. Reuters said that Eurnekian, one of the country's most successful businessmen, was thinking of floating shares in his airports operating company, in his energy unit Compañía General de Combustibles (CGC), in his nanotechnology group (which trades as Unitec Blue in Argentina and as Unitec in Brazil), and in his agricultural company as well. He said launching the IPOs would be a complex process, but he hoped it could develop in tandem with Argentina's gradual re-insertion into global capital markets. He would use proceeds from the IPOs to fund expansion of his holding group, Corporación América, into other South American markets such as Brazil, Ecuador, and Peru. Corporación América, which has overseas interests as far away as Italy, Morocco, and Armenia, has an estimated annual revenue of US$2bn. Eurnekian said he was optimistic about the long term outlook for gas – through GGC he has an interest in gas fields in Patagonia.

Foreign companies betting on Brazil

When things get really bad, then it's time to buy. That may – or may not – be a thought going through the minds of Brazil-focused corporate investors. What is clear, according to two separate studies, is that last year foreign companies were more active in Brazilian mergers and acquisitions (M&A) than the Brazilians themselves. According to KPMG, in 2015 there were 773 M&A transactions. Of the total, more than half – 396 – involved purchases by foreign companies. According to KPMG partner Luis Motta: "The current state of the economy and the depreciation of the real may have been accelerating the arrival and expansion of foreign companies in Brazil, despite worsening growth expectations and rising country risk". According to a separate report by PwC, foreign investors accounted for 51% of a total of 672 acquisitions and capital increases that it analysed last year, up from 38% in 2014. PwC expects the proportion to rise a little further to 55% this year. PwC Brasil partner Rogerio Gollo said "Foreigners are going to remain interested in Brazil while domestic companies will continue to have financing difficulties". One of the biggest transactions last year was the US$3.37bn purchase of the Jupiá and Ilha Solteira hydroelectric generators by Three Gorges Corp of China. New York-based Coty Inc also agreed to pay US$1bn for the beauty-care unit of Hypermarcas of São Paulo. Gollo said the sectors likely to attract most interest in 2016 are information technology, trade, agribusiness, and renewable energies.

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>
> *– Luis Motta, partner at KPMG*

Ford plans new plant in San Luis Potosí

According to press reports – yet to be formally confirmed – Ford Motor Co will in the first quarter of this year announce a major new investment in an assembly plant in the state of San Luis Potosí in Mexico. It is believed the plant will be used to launch a new model in the car company's range. It is thought to involve investment of US$1.5bn and would produce some 350,000 units per annum. Earlier, in April 2015, the company said it was investing US$2.5bn to expand its engine and transmission manufacturing in central and north Mexico. The Mexican automobile industry continues on a

strong growth trajectory. Last year Mexico produced an all-time record of 3.4m vehicles, up 5.6% on 2014. Exports rose by 4.4% to 2.76m vehicles. This consolidated its position as Latin America's leading carmaker, ahead of Brazil (where production slumped by 21.6% to 2.33m vehicles). Globally Mexico is the seventh largest car producer; some estimate that this year it could overtake India and move up to sixth position. North of the border, a new agreement with one of the main US auto industry trade unions, the United Auto Workers (UAW), may also be positive for Mexico. Under its terms companies such as General Motors, Ford, and Fiat Chrysler have offered improved pay and health care to their US workforce in return for the right to boost output of some cheaper, lower-margin passenger cars in Mexico. Average wage costs in the Mexican industry are around $5 an hour compared to $29 in the US. The agreement may therefore lead to further relocation of plants from the US to Mexico.

Trouble with the Isagen sale

"Former President Álvaro Uribe, using a calculation based on the cost of acquiring new generating capacity, claims Colombian tax payers have been short-changed by as much as US$1.5bn. But local brokers say the sale price actually exceeded fair value."

The Colombian government's long-running plans to divest a majority stake in power generator Isagen have finally concluded with a sale – but a legal challenge is on the way. In January the government sold 57.6% of the company's shares to Canadian investment fund Brookfield Asset Management for COP6.49trn – around US$2bn. Formally this was a sale by auction, but Brookfield was the only bidder after Chile's Colbún, the only other company left in the race, decided to drop out after the government raised the minimum share price. Brookfield's bid came in at the minimum and was accepted. The government says it has met all legal requirements for a successful privatisation. Medellín-based Isagen operates six hydroelectric and one thermal power station, with an installed capacity of 3,032MW. It generates about 16% of total electricity supply in Colombia. It is regarded as well-run and profitable. But an unusual alliance of left and right wing opposition members of Congress is mounting a legal challenge on the grounds that the sale was not competitive. On the right, former President Álvaro Uribe, using a calculation based on the cost of acquiring new generating capacity, claims Colombian tax payers have been short-changed by as much as US$1.5bn. But local brokers say the sale price actually exceeded fair value. On the left Clara López Obregón of Polo Democrático has claimed electricity tariffs are likely to go up as a result of the privatisation. The government intends to use the proceeds from the sale to fund its 'Fourth Generation' (4G) road-building programme.

REGIONAL FINANCIAL MARKETS REVIEW

REGION

Lower flows, higher assessed risk

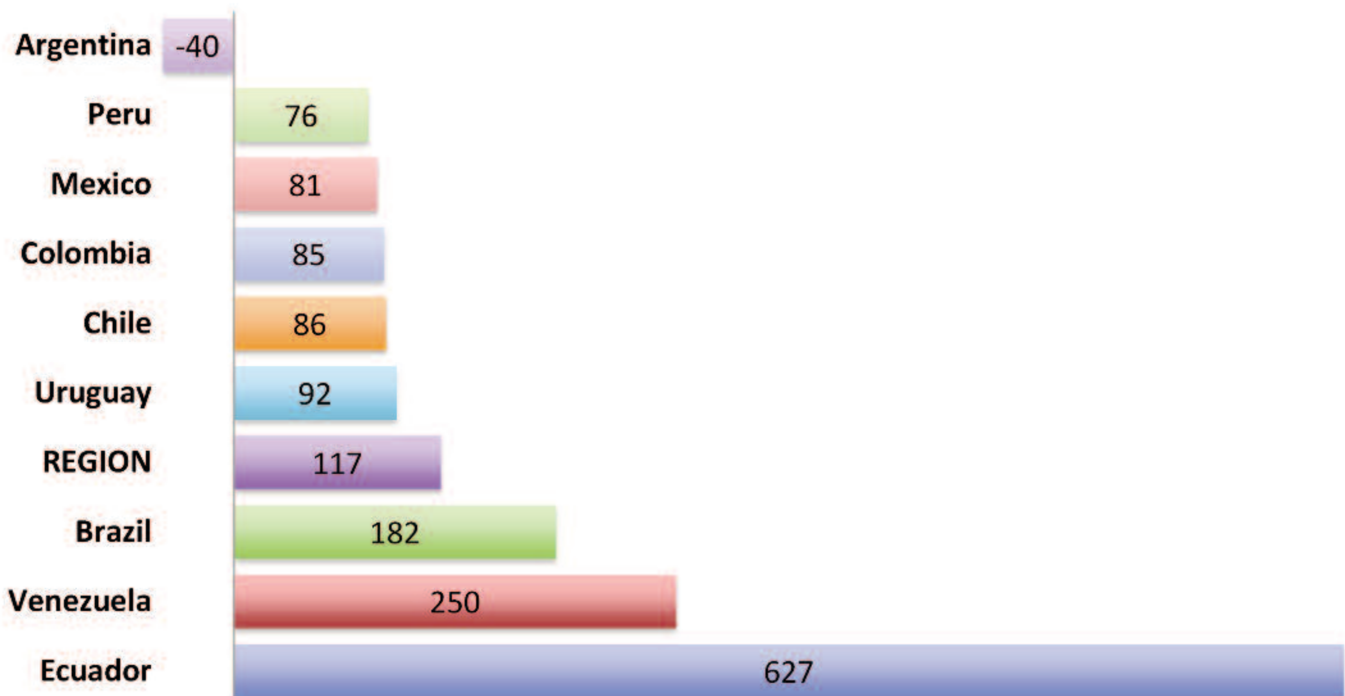
Portfolio investment flows to Latin America and the Caribbean fell sharply during 2015 and, in particular, through the latter months of the year.

In its Preliminary Overview of the region's economies in 2015 and 2016, the Economic Commission for Latin America and the Caribbean (Eclac) noted that inwards foreign direct investment last year was around US$107bn, or 22% below the level of 2014. Eclac anticipates that portfolio flows (ie investment in shares and bonds) will be US$70bn, or about 40% lower than in 2014.

In a report issued in early December by its Washington DC office[2], Eclac noted that there was a precipitous drop in issuance of bonds by the region's governments and larger companies in late 2015. Issuance rose from US$21bn in 4Q14 to US$31bn in each of 1Q15 and 2Q15. Issuance then slumped to just over US$10bn in 3Q15. More than half of the decline was explained by the absence of Brazilian borrowers from global markets.

The well publicised (and, as we discuss elsewhere in this issue, possibly overstated) problems of China hurt investors' appetite for risk. So too did the acceleration of the fall in prices of energy and other commodities, of which Latin American countries are major exporters. For the region as a whole, government bond spreads (ie the difference between yields and those of corresponding US Treasuries) widened by 117 basis points (bp) through 3Q15. Spreads widened most for bonds issued by the governments of Ecuador (627 bp) and Venezuela (250 bp) as investors fretted about the implications of the fall in the oil price. Spreads on Brazilian government bonds widened by 182 bp. However, yield spreads in Argentina compressed by 40bp as investors recognised the possibility of more market-friendly policies under an administration of President Mauricio Macri **[1]**. Eclac noted that spreads on corporate bonds issued by Latin American names widened by 226 bp in 3Q15, having been broadly unchanged for much of the preceding two years. Investors assessed that the depreciation of regional currencies made it harder for the issuers to service their debts.

Chart 1: Movement in government bond yield spreads, 3Q15 (basis points)*



*per JP Morgan's EMBI Global index
Source: *Eclac*

Just as the economic performance of the various countries in the region varied quite markedly through 2015 – with the GDP of Venezuela contracting by around 7% and that of the Dominican Republic growing by well over 6%, for instance – so the assessments of the sovereign issuers by the major ratings agencies have also been quite diverse. Eclac noted that, from the beginning of 2015 to 19 November, there were 27 different actions announced by Moody's, S&P, and Fitch. Thirteen of these actions (in relation

[2]Eclac, *Capital Flows to Latin America and the Caribbean: Recent Developments*, 7 December 2015.

to Paraguay, Jamaica, Honduras, Dominican Republic, Uruguay, Nicaragua, Bolivia, and Argentina) were positive. The remainder (in relation to Venezuela, Costa Rica, Brazil, Guatemala, El Salvador, Ecuador, Trinidad & Tobago, and the Bahamas) were negative. S&P downgraded Brazil one notch from BBB to BB+ (ie below investment grade) with a negative outlook on 9 September 2015. In early November, Moody's changed the outlook on Argentina's Caa1 rating to stable from negative. Three weeks later, Moody's changed the outlook to positive.

Given the general deterioration in economic conditions, for the major commodity exporting countries especially, and the reduction in investors' appetite for risk, regional equity markets performed badly through 2015 – especially when returns are measured in US dollars. MSCI's EM Latin America Index dropped by 32.9% – or by much more than the MSCI Emerging Markets Index (which also includes emerging markets in other parts of the world), which slipped by 17.0%. The MSCI Brazil and MSCI Colombia Indices fell by 43.5% and 43.9% respectively. By contrast, the MSCI Mexico Index dropped by 16.0%.

“Sluggish economic growth and fiscal deficits for all countries in Latin America mean that, for many, levels of public indebtedness will rise in the coming year.”

Sluggish economic growth and fiscal deficits for all countries in Latin America mean that, for many, levels of public indebtedness will rise in the coming year. The main exceptions are some countries in Central America and the Caribbean, where government revenues are benefiting from good economic growth and/or lower energy prices. As has been the case for a long time, the overall level of public indebtedness in the Caribbean countries is a lot higher than in other countries in the region **[2] [3]**.

Chart 2: Low(ish) debt burden for most

Gross public debt as % of GDP, 2015 - Latin America

Country	% of GDP
Brazil	66
Honduras	45
El Salvador	45
Argentina	44
Costa Rica	42
Colombia	40
Panama	39
Uruguay	38
Dom.Rep.	38
Haiti	37
Mexico	35
REGIONAL AVERAGE	**34**
Ecuador	31
Nicaragua	30
Bolivia	27
Guatemala	26
Venezuela	22
Paraguay	17
Peru	17
Chile	16

Source: *Eclac*

“Challenges such as the softness of the Chinese economy, rising geopolitical risk, weakness in commodity prices, and periodic volatility in financial markets are unlikely to disappear anytime soon. This points to continued softness in equity prices and yield spreads that – in most countries – are unlikely to narrow.”

Chart 3: Weighed down by debt	
Gross public debt as % of GDP, 2015 - Caribbean	
Jamaica	131
Barbados	111
Antigua & B.	103
Grenada	99
St. Lucia	82
REGIONAL AVERAGE	**82**
Belize	76
St Vincent & G.	76
Dominica	76
St Kitts & N.	74
Bahamas	62
Trinidad & T.	61
Guyana	54
Suriname	36
Source: *Eclac*	

Challenges such as the softness of the Chinese economy, rising geopolitical risk, weakness in commodity prices, and periodic volatility in financial markets are unlikely to disappear anytime soon. This points to continued softness in equity prices and yield spreads that – in most countries – are unlikely to narrow. Eclac assesses that the rise in corporate (ie as opposed to sovereign) debt is the largest source of concern looking forward. Citing data from Fitch, Eclac notes that private sector debt in Brazil rose from around 40% of GDP in 2005 to 93% of GDP in 2014.

POSTSCRIPT

The two canals

President Juan Carlos Varela has put the expected date for the completion of the US$5.3bn Panama Canal expansion project at “around May 2016”. His announcement follows continued uncertainty as to whether the deadline – already pushed back from October 2014 amid a dispute in late 2013 over cost overruns with the multinational consortium Grupo Unidos por el Canal (GUPC) – would be met.

During his state-of-the-nation address on 2 January President Varela himself acknowledged the question marks over the completion date amid ongoing legal wrangling and urged the GUPC (which, comprising Spain’s Sacyr Vallehermoso, Italy’s Impreglio, Belgium’s Jan de Nul and Panama’s Constructora Urbana S.A [Cusa], is in charge of constructing the third set of locks – the expansion plan’s biggest project) to leave legal disputes to the “competent authorities” and focus instead on completing its work on the waterway.

Varela’s call followed contradictory statements by the Panama Canal Authority (ACP) and the GUPC over the likely completion date for the project (which is 96% finished). While the two sides had reached an agree-

ment in 2014 over the cost dispute (which briefly led the GUPC to suspend work on the expansion plan early that year, the timeframe again was cast in doubt last year after localised seepage was found in the concrete sill between the lower and middle chamber of the Canal's expanded Pacific Locks.

After issuing a statement on 1 December that "work to reinforce the sills in the new locks will be completed in January 2016", on 18 December the ACP said the inauguration is expected to take place in the second quarter of 2016 with the commercial opening soon thereafter. However, the following day the GUPC issued a statement warning that "the time to reach that date depends on the willingness and availability of the ACP", which it accused of continuing to "delay any payment awarded under the contract, limiting the progress of the Project".

Meanwhile, the legal wrangling continues. On 31 December 2015 an independent arbitration panel, the Dispute Adjudication Board (DAB) (which a year earlier had awarded the GUPC US$233m of the US$463m it was seeking from the ACP in relation to the dispute), again found in favour of the consortium in relation to two further complaints related to extra labour costs and a workers' strike, for which it awarded the GUPC US$17m (out of US$45m initially demanded).

> "During his state-of-the-nation address on 2 January President Varela himself acknowledged the question marks over the completion date amid ongoing legal wrangling and urged the GUPC...to leave legal disputes to the "competent authorities" and focus instead on completing its work on the waterway."

The ACP, however, maintains that while this is the fifth such case in which the DAB has found in favour of GUPC (which received a total of US$283m – albeit less than the US$803m it was demanding for the five cases), the discrepancy between the GUPC's demands and the amount awarded provide grounds for questioning the consortium's methods for calculating costs – a point which has led one lawyer to file a criminal case.

The vice-president of Panama's national bar association, Juan Carlos Araúz, filed the criminal complaint in a personal capacity with Panama's attorney general's office against the GUPC. This was the first such criminal complaint filed against the multinational consortium in charge of constructing the third set of locks. According to the local press, the complaint calls for an investigation in order to establish whether the consortium had defrauded the State by artificially inflating costs.

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