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Understanding the bulls and the bears

The Brazilian economy represents almost 50% of Latin America's GDP and how well or how badly it performs affects investor sentiment towards the region as a whole. There is no doubt that the Brazilian political system is in crisis, with corruption allegations threatening President Michel Temer, and some calling for early elections (the scheduled date for the next general election is October 2018). There are different ways of reading this crisis. Optimists say the recovery will continue, with low asset prices creating an attractive buying opportunity for foreign investors. Pessimists fear the recovery may falter, with things getting worse before they can get better.

The Michel Temer administration can now be split into two periods, 'pre-Joesley' and 'post Joesley'. The turning point was 17 May, when incriminating audio tapes of a conversation between Temer and Joesley Batista, one of the owners of the meat-packing giant JBS, were leaked, suggesting the two were complicit in various bribery schemes. Before 17 May, Temer was an unpopular transitional president, who nevertheless seemed to have comfortable centre-right majority in the federal congress, which he was using to push through significant economic reforms. Since 17 May, he has been much more on the defensive, facing potential trial by the Federal Supreme Court (STF). His approval rating has dropped to 7%, the lowest of any Brazilian president in more than two decades. There are questions about his ability to complete the remaining 17 months of his term in office; some think the reforms will lose steam or be blocked. It is even possible that Brazil may find itself appointing yet another caretaker president.

What does this crisis mean for the economy? Ricardo Sennes of Prospective Consulting laid out the optimistic view in an interview with the US-based Americas Society/Council of the Americas. First, he argues that despite the charges against him, Temer will most probably complete his term and hand over to an elected successor on 1 January 2019. This is because he can only be placed on trial if two-thirds of congress agrees to remove his immunity from prosecution. Sennes says that with over 50% support in the lower house, Temer stands a good chance of fending off the threat (although, he could of course be prosecuted in 2019, after he has stepped down).

The second key point, according to Sennes, is that behind all the political noise, Temer has *already* made very important macro and micro-economic changes in Brazil. In this view, Temer has been able to ring-fence the economic team under Finance Minister Henrique Meirelles, letting the Meirelles team get on with its job. The economic recovery has begun. The central bank reported real GDP growth of 1% quarter-on-quarter in Q117, the first positive result after eight consecutive quarters of contraction. Inflation has come down. Sennes expects the benchmark Selic interest rate to

be cut to single digits (8-9%), by the end of this year. He projects real annual GDP growth of 0.3%-0.4% in calendar 2017, picking up to 2.0% in 2018.

Alongside this macro improvement, he says, have been a host of little-mentioned but positive microeconomic reforms. Local content rules in the oil and gas sector have been relaxed. Intellectual property regulations have also been made more flexible. The National Sanitary Surveillance Agency (Agencia Nacional de Vigilancia Sanitária, Anvisa) is no longer required to approve a new drug before patent registration can go ahead. Brazil has formally applied for accession to the Organisation for Economic Cooperation and Development (OECD), which means it has to commit to what Sennes calls "the basic standards of the more developed economies". Sennes sees all of these moves as positive signs. "Investors that take the crisis in Brazil not as general picture but as a mosaic made up of different pieces are really finding some quite good opportunities to invest and do business" he notes.

Within this mosaic, Sennes says, a number of sectors are now attracting investor interest, and despite the crisis, are showing signs of dynamism. These sectors include IT, health, pharmaceuticals, education services including language courses, FinTech, innovative start-ups, e-commerce, and infrastructure. The Lava Jato corruption crisis centred on the state oil company Petrobras and Brazil's top construction companies has led to some big changes – not all necessarily bad. In the past, these now-disgraced construction companies would form and lead consortia bidding for infrastructure projects. Now, Sennes says, the big construction companies are largely out of the picture, and institutional investors – with a different and more rigorous approach to business modelling and rates of return – are taking the lead in bids for airports, roads and energy projects. Foreign investor interest appears to be high, despite the crisis. Sennes expects total foreign direct investment (FDI) inflows to Brazil this year to be around US$70bn, which would make it one of the top ten FDI destinations in the world.

Finally, Sennes also suggests that contrary to some expectations, an outsider representing extremes of the Left or the Right will not necessarily win the next presidential election. Under electoral legislation, no corporate funding of election campaigns is allowed, with public money distributed according to a formula that takes into account existing parties' representation in congress. Free radio and television advertising is also distributed in way that favours incumbents and the formation of alliances. Finally, Sennes notes that the general/presidential election victor will need to have a truly national presence in Brazil. At the moment, only three parties have that: the leftist Partido dos Trabalhadores (PT, still weakened by corruption allegations and the 2016 impeachment of Dilma Rousseff), the centrist Partido do Movimento Democrático Brasileiro (PMDB, Temer's party) and the centre-right Partido da Social Democracia Brasileira (PDSB). Sennes' suggestion is that former president Luíz Inacio Lula de Silva (2003-2011) will not, in the end, run for the presidency (he may be banned in any case if found guilty in one or more of the corruption cases against him). Outsiders like Marina Silva of the environmental group Rede, or Jair Bolsonaro of the far-Right will fail, Sennes believes, with a centrist candidate like the current governor of Sao Paulo, Geraldo Alckmin (PSDB), among the most likely to be the next Brazilian president, in his view. If something like that kind of a scenario does indeed play out over the next 18 months, then it sets up a strong narrative for foreign companies to enter the Brazilian market now, when asset prices are low.

That is the optimistic view. While not necessarily predicting outright doom and gloom, other analysts emphasise the difficulties still facing the country as it struggles to emerge from recession. Some of these were highlighted at a June seminar held at the Brazil Institute in the Washington-based Wilson Centre in June entitled "What (and who) will emerge from the crisis in Brazil?"

Maurício Moura, chief executive of Ideia Big Data, presented opinion poll results in which a full 92% of respondents believed that Temer now would be unable to move his agenda forward. Interestingly, while 63% of those polled said they wanted to see the government's labour reforms approved, only 42% supported pension reform. Labour reform was assumed to be more popular because of the existence of a large informal sector and high unemployment. On the other hand, people were said to fear having to work longer top earn a pension. Moura commented, "In a country where the narrative is that corrupt politicians fill their own pockets, people have no trust in the system and have little desire to work longer." Sérgio Faust, of the Fundação Fernando Henrique Cardoso, described the Temer administration as "withering" and "fatally wounded," although not yet dead.

Monica Bolle of the Peterson Institute of International Economics questioned the strength of the current recovery, pointing out that the 1% q-on-q growth figure for the first quarter came after some methodological changes. Some economists calculate that growth was actually only 0.5%. She also stressed that much of this growth was due to agriculture, with every other sector contacting, bar some marginal growth in manufacturing. Pre-Joesley, there had been a "clear path forward with clear benchmarks", she noted, but post-Joesley there was significant economic uncertainty. Declaring an end to the recession in March-April had been premature, particularly since the usual benchmark is not one but two consecutive quarters of positive growth. Bolle made the additional point that the pension reform proposals have been watered down and as they stand currently offer no guarantee "that fiscal sustainability will be restored in the medium term."

Temer's administration's record on the fiscal front was far from impressive, she continued, noting it had not repealed a package of corporate tax breaks introduced by the previous Dilma Rousseff administration (2011-2016), nor cut back on subsidised lending by the national development back (BNDES). Ratings agencies, meanwhile, have put Brazil on negative watch for downgrade. "No fiscal plan exists and a sword hangs over the economy heading into the 2018 election," Bolle warned.

REGIONAL ECONOMY REVIEW

REGION

Recovery, uncertainty, elections

As a whole, the economy of Latin America and the Caribbean (LAC) is experiencing a moderate, some might say hesitant, recovery. Much will depend on the strength of global demand, interest rates, the commodity price cycle, and the fate of the US, Chinese and European economies. But there is a second domestic layer of events affecting LAC economies that also needs to be factored in: over the next 18 months there is a fairly heavy schedule of elections due across the continent, including general elections in the four largest regional economies (Brazil, Mexico, Argentina and Colombia).

At the current juncture, the broad consensus is that the LAC economies are emerging from recession at a slightly slower rate than originally hoped. In the Spring update of its bi-annual World Economic Outlook (WEO), released in April, the International Monetary Fund (IMF) said that after a 1% fall in regional GDP in 2016, it was expecting a rebound of 1.1% in LAC economies in 2017 (fractionally down from the 1.2% predicted in January), with the pace picking up to 2% in 2018.

This big picture included a lot of country-by-country variations, with positive growth in Brazil, Mexico, and Argentina, and a continuing drastic recession in Venezuela. In April, the UN's Economic Commission for Latin America and the Caribbean (ECLAC) was pretty much in step with the IMF view, also forecasting regional GDP growth of 1.1% this year. ECLAC noted that the South American economies were lagging a little because of the slow recovery in international commodity prices, while Mexico and Central America, more closely linked to US import demand, were doing slightly better. In June, ECLAC pointed to 17% year-on-year increase in LAC merchandise exports in the first-quarter of 2017 – the first in four years – as a sign of better things to come.

A little more 2017 data is now available, with many countries reporting first quarter national accounts. Based on these numbers, the London-based consultancy Capital Economics estimates that after two years of contraction, Latin American GDP turned positive in year-on-year terms in the first quarter. Economic conditions in Brazil (the largest economy) and Argentina improved dramatically, but growth in the Andean economies slowed. However, this weaker Andean performance largely reflected one-off factors: a copper strike in Chile, floods and mudslides in Peru relating to heavy coastal El Niño, and a three-percentage point increase in the rate of Value-Added Tax (VAT) in Colombia. A second half rebound in these economies therefore seems possible. Capital Economics flagged up some early encouraging signs for the Q2 performances in both Brazil, despite the worsening political crisis there; and also in Mexico, which is recovering some confidence after 'the Trump shock' and uncertainty relating to the future of the North American Free Trade Agreement (NAFTA, comprising Canada, the US and Mexico). Finally, with inflation low in a number of countries, interest rates look set to ease further (for example in Colombia, Brazil, Chile and Peru), stimulating activity.

Capital Economics sees two major risks to the regional recovery. The first and lesser of the two would be a sharper-than expected economic slowdown in China. The consultancy assigns this a low probability, noting that the region is also better placed to cope with external shocks, amid lower current account deficits. With Chinese growth expected to hold up, it believes that commodity prices are likely to continue edging up over the next few years.

The second and more serious risk concerns domestic politics. The consultancy highlights a possible intensification of the Brazilian political and corruption crisis, potentially leading to the early departure of President Michel Temer and the collapse of planned fiscal and pension reforms. It adds that the outcome of the October mid-term congressional elections in Argentina could be negative for the government's fiscal deficit reduction programme.

Despite that, Capital Economics has a relatively benign view of this year, stating: "While there clearly are risks to the outlook – particularly on the political front – we expect Latin America's economic recovery to broaden out over the remainder of this year; and regional GDP to grow by about 1.5% in 2017".

Elsewhere, a report by the US-based Fitch Ratings highlights the significance of the upcoming electoral timetable over the next 18 months. It notes that elections should not of themselves affect ratings "unless accompanied by marked shifts in policies". In all, as well as the mid-term congressional polls in Argentina in October, presidential and general elections are imminent in eight countries in 2017-2018 (Brazil, Chile, Colombia, Costa Rica, Honduras, Mexico, Paraguay and Venezuela). Fitch notes that ratings could be affected by the results of some of these polls. In its view, fiscal consolidation will be a key challenge moving forward, "as new governments face low economic growth and reduced revenues, especially related to commodities, making it even more difficult to stem adverse debt dynamics".

Latin America: Some key elections in the next 18 months		
Country	**Date**	**Type of election**
Argentina	October 2017	Congressional
Honduras	November 2017	Presidential + Congressional
Chile	November 2017	Presidential + Congressional
Costa Rica	February 2018	Presidential + Congressional
Colombia	March and May 2018	Congressional (March) + Presidential (May)
El Salvador	March 2018	Presidential + Congressional
Paraguay	April 2018	Presidential + Congressional
Mexico	June - July 2018	Presidential + Congressional
Brazil	October 2018	Presidential + Congressional
Venezuela	December 2018	Presidential
Source: *Fitch, National electoral bodies*		

Fitch highlights the risks in three countries already assigned a negative ratings outlook – Chile, Brazil and Mexico. It notes that a combination of low growth and higher fiscal deficits has led to a doubling of Chile's debt burden over the last five years. The corruption scandals in Brazil are seen as having "engulfed" the political establishment and heightened uncertainty, therefore requiring strong political leadership to pass structural reforms to boost the outlook for growth and public finances. In Mexico, Fitch highlights the combination of low economic growth and the perception of increased corruption, which together have eroded the popularity of the Enrique Peña Nieto administration, now approaching its final 18 months in office. The renegotiation of the NAFTA is another element of potential uncertainty in Mexico. However, Fitch notes that uncertainty is highest in Venezuela, where amid a deep political crisis, the government has called for a constituent assembly, which could end up altering the date of the presidential elections, currently due in December 2018. Any new government in Venezuela "could lead to policy changes aimed at eliminating severe economic distortions, but the probability of default remains high".

It is also possible in some cases that elections could lead to credit rating upgrades. Possible candidates for upgrades include Costa Rica and El Salvador, where new governments might be able to break existing political deadlocks, which have stymied fiscal reform measures. Finally, new governments in both Chile and Colombia will also need to tackle fiscal consolidation. In summary then, the future pace of the Latin American recovery may depend on what happen in key elections in a handful of the larger economies, notably including Brazil, Mexico, Argentina and Colombia.

ARGENTINA

Not in 100 years?

As far as the federal government led by President Maurico Macri was concerned, floating a US$2.75bn 'century bond' on 19 June was a roaring success. But it left some investors and locally-based economists tut-tutting darkly about irresponsible borrowing and lending.

The 100-year bond – only the second of its kind in recent Latin American history (the other was issued by Mexico in 2010) – was snapped up quickly. The issue was 3.5 times oversubscribed, with over US$9.7bn offered. The bond carries an annual coupon equivalent to 7.125% of face value. As it launched at a discount, the actual yield was higher at 7.9%.

The Macri government hailed the issue as recognition of Argentina's restored international market credibility and renewed investor confidence in

its economic prospects. Analysts noted that the timing was also good, since it raised money to help cover the country's ongoing fiscal deficit (approx. 4.2% of GDP) well in advance of the mid-term congressional elections in October, which may create increased political noise and uncertainty.

The big concern from the creditor side concerned the advisability of buying a 100-year sovereign bond from a country that is currently without an investment grade credit rating, has regularly defaulted, and which, not that long ago, was described by a US judge as a "uniquely recalcitrant debtor." In fact, Argentina has defaulted six times in the last 100 years – in other words, an average of once in just under every 17 years. That point clearly worried Jorge Piedrahita of Puma Investments, who said, "It is awfully premature for Argentina to issue 100-year premium bonds. When you look back in history, I'm not sure we can find a 20-year period when Argentina has not defaulted". A degree of scepticism also came from Edgardo Sternberg, an emerging debt portfolio manager at Loomis Sayles. "Implicitly, this shows market confidence that the government will be able to change the idiosyncrasy of the country and will end the borrow-and-default cycles. Will it?" he questioned.

Against those views, a number of analysts pointed out that at an 8% yield, an investor gets their money back in 12 years – so this doesn't necessarily have to be a bet that Argentina will be stable and credit-worthy for the next century. Writing in the *Financial Times*, Gillian Tett suggested that the bigger reason for the success of the bond might be excess global liquidity. "Quantitative easing has pumped so much liquidity into the markets that investors are frantically – desperately – chasing any investment that might produce a return" she said, going on to suggest that the century bond might actually be the sign of a financial bubble peak.

From inside Argentina, there were similar discussions. Critics detected a worrying hint of a return to the days of *plata dulce* ('sweet money'), which heralded subsequent crashes. For some, the government is taking on too much debt as an alternative to the unpopular business of reining in spending and reducing the deficit. Analyst Augustín Monteverde commented, "the interest rate may seem low in relation to our recent past, but it is actually extraordinarily high. We are taking on debt at a high rate, and for 100 years". Supporters of the Macri government, nevertheless, pointed out that depending on future global interest rate movements, the bonds include clauses that would allow a buy-back and swap.

Because Argentina was partially cut off from international capital markets in 2001-2015, its current debt burden is not considered excessive (government debt stood at 54.2% of GDP at end-2016). But it is true that the Macri government has borrowed heavily, and it is not yet clear whether that borrowing is stimulating real growth in the economy. It would be very premature to declare the country's 'boom and default' cycle a thing of the past, in other words.

CHILE

Sovereign retains investor confidence despite larger fiscal deficit

June was busy month in terms of bond issuance for the Chilean government. On 13 June, the finance ministry raised a total of US$2.3bn on international capital markets through the re-opening of a previously-issued 2030 bond, together with the issuance of a new 2047 bond. This was followed on 21 June with the re-opening of bonds expiring in 2021 and 2035, which together raised just over US$2bn. This latter sale was also made available to local investors, who purchased 21% of the bonds. The funds from these operations will be used partly to finance the budget deficit.

The Chilean authorities have been particularly active in financial markets in the first half of 2017, with this most recent spate of bond issuances following similar activity in January, which raised US$1.5bn.

Reflecting Chile's solid credit rating (AA- by Standard & Poor's, A+ by Fitch and Aa3 by Moody's [quivalent to AA-]) financing costs were low, with the coupons generally standing at around 3.5%-4.5%, and the longer-dating instruments having a higher rate.

Reinforcing Chile's strong credit rating, the country's EMBI+ spread – an index that measures the difference between the return on locally-issued sovereign bonds and US treasuries – has fallen steadily over the year, from 150 basis points in January to 133 basis points in May, which is significantly lower than the Latin America average of well over 400 basis points.

Public debt is set to rise

Despite Chile's enviable global financial reputation, these new issuances will push up public debt levels. According to the Dirección de Presupuestos (Dipres, the budget office), total public-sector debt rose to over US$54bn at the end of March – up by over US$1bn in the space of just three months and the highest level in over two decades.

As a share of GDP, Dipres reported that public debt levels had reached 21.5% at the end of March, up from 21.3% at end-2016. The latest issuance in June will boost this further. While on the GDP measure, public debt remains low by international comparisons, the pace of growth is notable (public debt accounted for just 4% of GDP as recently as 2007), and has sparked speculation as to whether Chile could be downgraded by one of the main credit ratings agencies. Fitch and S&P have both had Chile on negative outlook for around six months, raising the possibility of a downgrade.

To avoid this, the government is trying to reduce the fiscal deficit by one-quarter of a percentage point each year – a goal likely to be retained in the 2018 budget, (to be drafted over the coming three months). Yet this is likely to require a degree of expenditure restraint that will prove difficult given the government's efforts to bolster economic growth and increase spending on infrastructure and education.

It will also be complicated by the fact that fiscal revenues are unlikely to expand much. Copper prices have picked up from 2016 lows, but have staged only a partial recovery and are expected to level out overall in 2017. With the Chinese economy still weaker, there is little prospect of a significant rise in commodity prices. Meanwhile, weak domestic demand will hamper growth in domestic tax income.

In this context, the budget deficit is unlikely to come down as rapidly as the authorities would like. This in turn could lead to continued bond issuances, and a further increase in the public debt stock. While Chile's underlying economic fundamentals remain comparatively strong, this increase in public indebtedness will not trigger concern about the sovereign's creditworthiness. Nonetheless, a credit ratings downgrade seems highly possible.

PERU

Zavala takes over the top economic job

June was a month of big changes for Peru's business community. Amid ongoing worries over sluggish economic growth, the opposition *Fujimorista*-dominated congress passed a vote of no-confidence in

Economy and Finance minister, Alfredo Thorne, forcing his resignation. President Pedro Pablo Kuczynski then asked Prime Minister Fernando Zavala to double-up and look after the economy portfolio, in addition to his existing responsibilities, apparently as an interim measure until a more permanent replacement is found. Despite a giant workload, Zavala has indicated he wants to tweak existing policies to try and inject some more stimuli into the economy.

The manner of Thorne's departure was indicative of the rather toxic relations that have developed between President Kuczynski and the Fuerza Popular (FP) majority in congress, led by the narrowly-defeated 2016 presidential run-off candidate, Keiko Fujimori. FP deputies said that a secretly taped and subsequently-leaked recording of a meeting between Thorne and the comptroller-general, Edgar Alarcón, evidenced undue pressure by Thorne, who was interpreted by the FP as suggesting that funding for the comptroller-general's office would be increased if Alarcón "accelerated" the approval of various public investment projects (some under audit).

These projects notably included the controversial US$520m Chinchero international airport project in Cusco, awarded under the previous government in 2014 but later stalled, and which Kuczynski had promised to get underway in his election campaign. Thorne denied any impropriety and said the audio had been maliciously edited to take his words out of context. But the FP congressional bench was unmoved and voted by 88-11 to express no confidence in the minister. Thorne had no choice but to resign. Those who believe that the FP is simply flexing its muscles (this is the fourth Kuczynski minister it has forced out) point to the fact that Alarcón, appointed by the previous, also FP-dominated congress, himself faces corruption charges.

The loss of Thorne, a long-standing and close confidant of Kuczynski, with similar international financial experience (including a role at JP Morgan etc) is clearly a big blow. But Kuczynski's approach so far has been to replace ministers as they fall victim to an apparent *Fujimorista* onslaught, trying to maintain policy continuity. This seems to be the current plan for the economy & finance ministry (Ministerio de Economía y Finanzas, MEF), traditionally regarded as a kind of super-ministry at the heart of government. That said, Zavala has indicated that there are going to be some tweaks.

The problem is after nearly a year in office, the Kuczynski administration has a relatively poor economic situation on its hands, certainly when compared to Peru's prior years of strong growth. To some extent, this is due to factors beyond the new government's control. It inherited the Odebrecht corruption scandal, which has obliged a delay in the country's largest infrastructure project, the US$7bn Gasoducto del Sur Peruano (GSP). And it is also dealing with the economic losses caused by an extreme coastal El Niño, starting in late December and lasting until April, which resulted in months of torrential rains, severe flooding and mudslides, devastating northern regions in particular but also reaching down as far as the economically-dominant capital province of Lima.

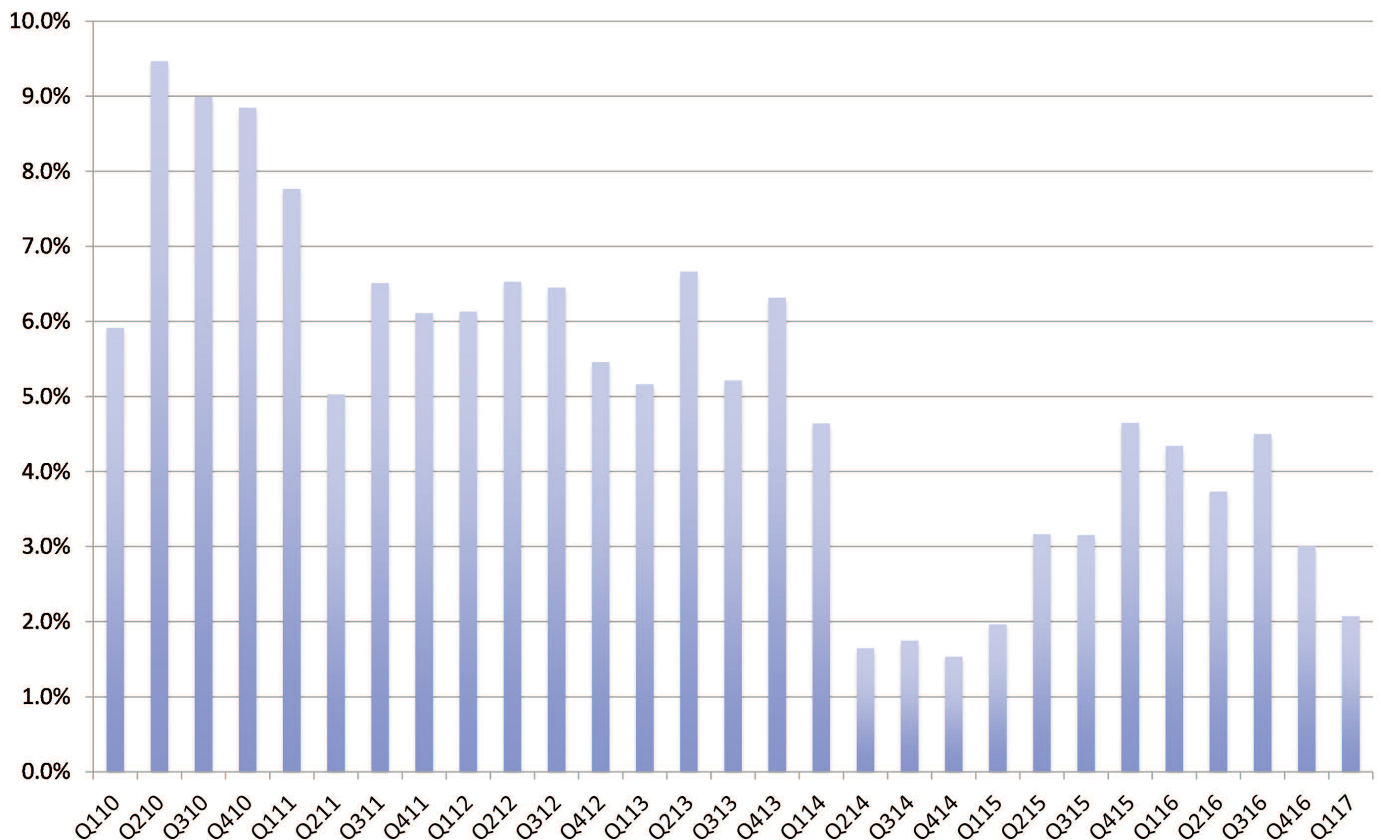
The latest data is indeed disappointing. Real annual GDP growth slowed to 2.1% in the first quarter, down from 3.0% in Q416. The weakness continued into the second quarter. The monthly economic activity indicator compiled by the national statistics institute (INEI) came in at just +0.2% y-o-y in April, a deceleration on the +0.7% rate registered in March. In the three months to May, according to the INEI, 55,400 jobs were lost in metropolitan Lima. Activity levels looked particularly weak in the construction and manufacturing sectors, but most sectors looked to suffering from the ongoing after-effects of the floods. Before Thorne's departure, the government had already announced

extra spending on reconstruction. The central bank (BCRP) cut interest rates by 25bps to 4.0% in May. While it held rates steady in June, it is widely expected to ease monetary policy a little further in coming months.

The business community remains impatient. In an interview with the daily *El Comercio*, Gianfranco Castagnola of Apoyo Consultoría said the economy had worsened over the last year, with GDP growth decelerating to around 2%. Retail sales had contracted by 1%, he noted, while employment and real wages had also dropped. "Attributing 100% of this to Thorne would be excessive, but there have been mistakes", he said. His main criticism was that Thorne had cut back public investment by a "brutal" 30% in the last quarter 2016. A rebound had failed to materialise in 2017. In fact, there had been a further 9% contraction in investment, on Apoyo estimates. Castagnola insisted that in the second half of 2017 public sector investment needed to grow by "10%, 15% or 20%". He was also worried that congressional populism would overrule the MEF's longstanding fiscal responsibility, pointing among other things to draft legislation to bring army and police pensions up to the salary levels of those in active service.

Kuczynski's economic problem

Year-on-year % changes in quarterly GDP, real terms



Source: *INEI*

Zavala, who was head of the MEF in 2005-2006, during the presidency of Alejandro Toledo, has said that his objectives while in office will be economic recovery, employment and public sector investment. Pablo Nano, an economist at Scotiabank Perú, says that Zavala's key challenge will be to unlock stalled investment projects (a problem that also faced Thorne). Zavala seems ready to take that on. He told the *Panorama* TV programme, "I will make some adjustments, there are things we can do, private investment has not grown in 14 quarters, that is three and a half years, the problem goes back to before this government, but we have to turn it around quickly."

In his first media interviews as head of the MEF, Zavala also said that the national investment agency Proinversión had projects on its books which

required spending of US$4bn in the second half of this year, targeted on waterways, roads, sanitation and other disaster reconstruction work. The potential project total for the year as a whole was put at US$9bn, excluding the stalled GSP pipeline.

Zavala also noted June new legislation took effect in June allowing for more flexible environmental standards on extractive projects. The Kuczynski government and business lobbies had argued that previous permits and processes had been too restrictive and onerous (a problem known as '*permisolgía*') and were holding back investment projects.

Zavala was also keen to highlight the potential of rising inward tourism to help revive demand. He said he expected the number of foreign visitors to Peru to push past the 4m mark this year.

Elsewhere, a new housing subsidy programme, Bono del Buen Pagador (BBP), will be targeted on low income groups. The government is seeking the construction of 100,000 housing units in an attempt to stimulate the construction sector. Other plans include expanding the Obras por Impuestos scheme, which encourages companies to make tax-deductible infrastructure investments in local communities. Coordination with local and regional governments, in the past patchy, is to be stepped up, an important move, since a lot of the public-sector investment spend has been decentralised.

Latest poverty data

In the 12 years between 2004 and 2016, the proportion of the Peruvian population living in poverty fell from 58% to 20.7%, according to data published by the ministry of development and social inclusion (Midis). Deputy Midis Minister María Eugenia Mujica reported that malnutrition in children under the age of five had also fallen, while 75% of the population now have form of insurance cover. Officials acknowledge, however, that the pace of poverty reduction has slowed down as the commodities-driven economic boom has subsided. In 2014-2016, poverty levels fell by only two percentage points. Mujica said there was still a lot of work to be done. She noted that 17% of Peruvian young people aged 15-24 are '*ni-nis*' ('*neither-nors*'), meaning that they are neither in work nor education. And strikingly, a full 46% of the population is still living in makeshift settlements, underling the country's major problem with inadequate housing.

CUBA

Trump rolls back some of Obama's Cuba changes

Given US President Donald Trump's policy flip-flopping, his difficulty in securing congressional support for planned reforms and overall uncertainty over the White House policy stance, it was unclear whether Trump planned on following through on his 2016 campaign pledges to reverse the changes introduced by Barack Obama with regard to Cuba policy. A speech on June 16th appears to have cleared up any uncertainty, with a number of measures set to unpick some of the legislation passed by Obama. Although the diplomatic rapprochement is clearly on hold, the planned changes are in fact relatively limited in nature and rather than push the Cuban economy into recession, the changes simply means that a rapid economic expansion in Cuba is unlikely.

Essentially, the policy changes involve tighter restrictions on travel by US citizens, as well as on business transactions with the Cuban government and state-run firms. Individual people-to-people travel will now be prohibited, with travellers wishing to engage in people-to-people travel now required to

do so in a managed group and via a US-government approved travel agency. The changes announced by Trump also prevent US companies (as well as individuals) from any financial dealings with the Cuban military and firms aligned with the government and/or the security apparatus.

Some of the Obama reforms will remain in place

Equally as important as the areas that will change, are those that will not. Rather than roll back all of Obama's Cuba reforms, Trump's changes represent a partial reversal. Airports and seaports are exempt from the ban on doing business with Cuban government companies, meaning that US airlines and cruise ship companies can continue to operate existing routes to Cuba.

There has been no mention of reintroducing any restrictions on remittances sent by Cuban Americans, nor on the telecommunications and internet access programmes introduced under the Obama administration. In addition, the reforms introduced by Obama just before the 2016 presidential election that eased restrictions on bilateral trade, mainly on agricultural and pharmaceutical products, will remain in place.

Moreover, Trump's changes will not come into effect immediately, as the agencies responsible for drawing up the new legislation (including the Office of Foreign Assets Control, or OFAC, and the Commerce Department) have not yet begun drafting the reforms. The process of crafting new legislation, submitting it to congress and subsequently debating and voting on the measures will take several months, particularly given the five-week summer recess that begins in late July and runs to early September.

In the meantime, the existing legislation will remain in place, meaning that travel and commercial plans that have already been arranged will be permitted to continue. The Sheraton Hotels and Resorts group, for example, will not be required to abandon a deal to open another two hotels in Cuba, following the opening of the new 'Four Points' hotel in Havana last year.

Questions over enforceability and economic impact

Significant questions remain about whether the new measures are enforceable in practical terms. The Trump administration has made it clear that the driving force behind the changes is the desire to prevent US citizens from spending money in outlets affiliated with either the Cuban government or the military, but this is likely to prove extremely difficult to prevent, given that many hotels and sights are run by the Cuban state.

Grupo de Administracion Empresarial SA (Gaesa), a Cuban military conglomerate, owns 57 of the (mainly foreign-operated) hotels in Cuba and most retail chains. Even the international chains, like Spain's Melía, are in collaboration with the Cuban government through joint ventures. The guest houses that proliferate on sights like Airbnb are run by Cubans with no direct link to the government, but few cater to more than a few people at a time and would therefore be unable to host an organised tour of American tourists. Critics have also pointed out the Cuban military also has a stake in some of the financial systems that clear Airbnb payments.

There are also questions over the likely impact on the local economy. While there is a broad consensus that the new measures outlined by President Trump are negative for Cuban economic prospects, it is unclear when the impact will be felt, who will be affected and to what extent. The most immediate impact is likely to be on the tourism sector, with demand for hotels and restaurants set to fall, most likely from 2018. The number of tourist arrivals is still likely to rise in 2017, as arrivals grew by 22% year on year in the first half of the year, before the low season (May-November), meaning that any decline towards the end of 2017 is unlikely to offset the earlier strong growth.

Americans still only account for a small share of the total number of tourists visiting Cuba (285,000 in 2016, accounting for around 7% of total tourist arrivals, but the rapid growth in the number of US visitors has accounted for much of the overall increase in tourist numbers in recent years. This implies that the sector is likely to grow at a much slower pace in the coming years, without the stimulus of an influx of US tourists. That said, Cuba's main source markets – Canada and Europe – are all faring well economically, with improved consumer spending and accelerating economic growth boding well for outward tourism, which should benefit Cuba. A sharp fall in tourism earnings, which are a crucial source of foreign exchange, is therefore unlikely.

Lower investment will hamper potential GDP growth

The implications for medium-term growth are more significant, however, with Trump's new measures set to have a major impact on US investment in Cuba. Many US firms had established a foothold in Cuba during Obama's tenure, with minimum investment and little activity, but with the intention of ramping up their presence on the expectation that trade and investment sanctions would be eventually lifted. Given that there is no question of a lifting of sanctions anytime soon, these firms are likely to either mothball their operations or withdraw from Cuba entirely. Even firms that had agreed firmer investment plans (including Sheraton's other two hotel projects) might now falter, as lower projected inflows of visitors might dissuade the company from proceeding with construction.

The US airline Southwest has already announced its plans to end flights to Varadero and Santa Clara from September, instead retaining just its Havana route. The company stated that its decision was based on the belief that the routes were not financially sustainable, particularly with the ongoing prohibition on US tourist travel. Southwest did not directly mention President Trump's new restrictions, but the timing of the announcement, just two weeks after the reforms were unveiled, was telling.

The danger is that the widely-hoped-for acceleration in medium-term economic growth will not materialise. In recent years, agriculture and industry have both performed erratically, suffering from a lack of investment and exposure to swings in external demand, with services helping to prop up otherwise-feeble rates of growth (or, in some cases, preventing the economy from dipping into recession). If the tourism sector grows at a much slower pace, weaker stimulus from services will undoubtedly hamper overall GDP growth.

The danger is particularly heightened given that Cuba's main trading partner – Venezuela – remains in a critical state. Oil exports to Cuba have plummeted from a long-running 100,000 barrels per day (b/d), forcing Cuba to look for other sources of oil. The authorities are looking to tap their own offshore wells, but in the meantime Cuba are having to import oil at market prices (the Venezuelan agreement, by contrast, involved a swap for Cuban medical services and therefore had less of an impact on the public purse, as well as on scare foreign exchange).

The medium-term outlook for the Cuban economy therefore appears somewhat weaker than had previously been the case, characterised by lower services revenue and investment, combining to reduce the pace of medium-term GDP growth.

ECUADOR

Trimming Correa's legacy

President Lenín Moreno's new finance minister, Carlos de la Torre, has signalled that a major change in fiscal policy is on the cards, with mooted plans for the largest budget cut in a decade.

De la Torre has been using language that would have been wholly anathema to the previous government led by Rafael Correa (2007-2017). For example, the new minister says that the State's 'protagonistic' role in the economy will be reduced, and that a line will be drawn under a decade of heavy public investment, particularly in infrastructure. Henceforth, the private sector is to be 'the motor of growth', the new finance minister has stated. Correa, meanwhile, has been tweeting his not-so-tacit disapproval of all this from the sidelines.

As this was a general election year, the new government cannot bring in a new budget, but it is permitted to make revisions to the existing plan (which was effectively rolled over from last year). Full details were still pending release in early July, but in advance of that, De la Torre had suggested that this year's budget spend should not exceed US$24.5bn. This would mean a 22% reduction over the approved US$29.8bn 2016 budget, a very dramatic adjustment, and one that may be politically difficult to sell.

However, having inherited a worse-than-expected fiscal deficit, estimated at some US$7.3bn (or roughly 7% of GDP), De la Torre apparently aims to get that down to US$4.6bn this year, or 4.6% of GDP. By any measure, that is an ambitious target. Without a doubt, squaring the budget circle will not be easy, financially or politically, for the new administration.

The newly installed finance team reportedly is working towards budget outgoings of US$24.5bn, comprising US$15.9bn in current expenditure and US$8.6bn in capital expenditure. If those figures are accurate, this would take nominal budget spending back to 2011 levels.

Of the US$17.4bn in current expenditure approved under the 2016 budget, US$8.8bn was destined for wages and salaries; by far the biggest item. In its bid to reduce current outgoings by a hefty US$1.5bn, the Moreno team is 'evaluating' the 480,475 existing public sector staff, among other measures. There were 800 posts alone associated with the various 'coordinating ministries' introduced by the Correa administration, which in recent weeks have been eliminated (albeit with some of the staff absorbed by other ministries).

The treasury puts estimated income, meanwhile, at US$19.9bn, comprising US$2.2bn in oil earnings and US$17.7bn in non-oil earnings (i.e. taxes). Tax earnings are reported to be recovering, with a 10% year on year increase in the first five months of 2017 to US$5.6bn, according to the internal revenue service (SRI), which also reported that the intake in May was the best in 46 months. Some of the increase in current tax revenue is related to a package of emergency taxes introduced after last year's earthquake. However, these are set to expire shortly and thus will fall out of equation. Moreover, the head of the SRI, Leonardo Orlando, forecasts a total tax take of US$13.5bn overall this year, which appears some way off the finance ministry's projected figure.

De la Torre has made no mention, as yet, of tax reform. Immediately upon taking office however, the new Moreno government issued a fresh US$2bn in sovereign bonds, the fifth placement in a year. As well as providing reassurances that dollarisation will remain in place, De la Torre has insisted that Ecuador will strictly comply with its external debt obligations. But a debt restructuring is under consideration, he acknowledges, in order to lengthen maturities and secure more favourable interest rates. Another option, of course, is a lending programme with the IMF (which would come with fiscal conditions attached). Again, this would mark a very sharp break with Ecuador's recent policy stance.

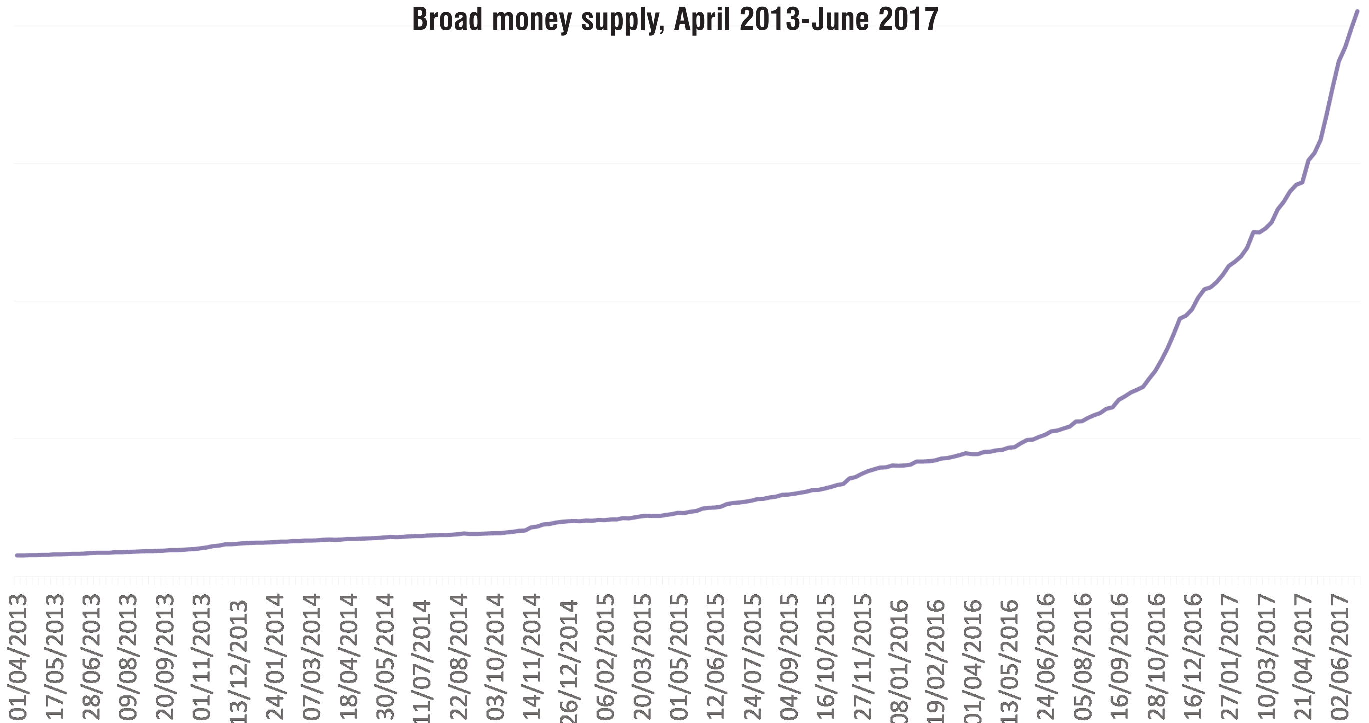
Bills on steroids

President Nicolás Maduro announced a 50% increase in the minimum wage as of 1 July, the third to date this year. Maduro has now increased Venezuela's minimum salary (and associated benefits including food stamps and pension payments) by 140% in total since February. Yet, opposition economists point out that the daily minimum wage is barely enough buy a packet of biscuits, while an average hamburger would eat up six days' of the basic wage.

Officially, the monthly minimum wage rose to BOL97,532 on 1 July. At the widely used (albeit illegal) black-market exchange rate, that is US$12.50 a month. US media outlets lost no time in pointing out that this was the same as the *hourly* minimum wage in Seattle, Oregon.

Including food stamps, the total minimum wage increased to BOL250,53 on 1 July; or roughly US$32/month at the black-market rate. However, in dollar terms, the latest pay award is down 17% in dollar terms since the last increase –just eight weeks prior on 1 May (Labour Day) – at which point the total package was worth the equivalent of US$46.7. That discrepancy alone is a telling sign of the price and monetary distortions in Venezuela's domestic economy.

While dollar shortages have obliged a massive reduction in imports of essential goods (including food and medicine), much of the monetary distortion in the country is being fuelled by the government's incessant money printing to fund its (previously expansive) public expenditure commitments, which has led to soaring money supply and runaway inflation. On latest central bank (BCV) data, the annual growth in the broadest measure of Venezuela's money supply was running at about 300%, up from 160% in January.



Broad money supply, April 2013-June 2017

Source: *BCV*

While the BCV no longer publishes inflation data, the opposition-controlled national assembly this year has begun releasing its own inflation estimates, calculated by the respected economist José Guerra, head of the assembly's finance commission, and using similar methodology to that of the BCV. On

this measure, Guerra reported month-on-month inflation of 16.2% in March, 16.5% in April and 18.3% in March, to give year-to-date (ytd) accumulated inflation of 127.8%. With money supply rising, inflation can be expected to be higher again in June. In response to the latest minimum wage increase, Guerra said that it would only bring about more inflation, on the basis that it would be financed by money printing. “The lesson not learned in Venezuela”, he tweeted. Guerra now suggests year-end inflation of between 700% and 800%. By any measure, that is hyperinflation.

María Carolina Uzcátegui, president of the national council for commerce and services (Consecomercio), publically stated in early July that Venezuela “is now a hyperinflationary economy”. But it was the US professor Steve Hanke, director of the Troubled Currencies Project at the Cato Institute, who first called out signs of hyperinflation in Venezuela back in November 2016. He continues to argue for a currency board as an effective ‘shock’ potential solution, even as he admits that this, almost certainly, would be anathema to the left-wing Maduro government. And indeed, currency boards have a bad reputation in the region, with Argentina cited as the prime example against.

In surreal territory

The parallel exchange rate was trading at BOL7,679/US$ on 5 July, according to the US-run website DolarToday.com, which claims to base the rate on trade levels at the Venezuela/Colombia border. The black-market rate may look surreal, but it reflects the recent maxi-devaluation in the official secondary FX rate, the Dicom (used for private sector non-essential imports). The Maduro government dismisses DolarToday.com as a US-backed conspiracy, and has sought to prosecute the site, to date unsuccessfully.

Goldman Sachs quickly cashes in Venezuelan bonds

A *Wall Street Journal* (*WSJ*) report in late June suggested that the US investment bank Goldman Sachs had begun selling – at a small profit – some of the US$2.8bn in Venezuelan bonds it had purchased in May.

News of the May acquisition by Goldman Sachs Asset Management (GASM) was something of a PR disaster for the firm, with the Venezuelan Harvard professor, Ricardo Hausmann, dubbing the instruments, originally issued by the state oil company Pdvsa, “hunger bonds”; while angry expat Venezuelans protested outside Goldman Sachs’ HQ in New York wearing unflattering masks. No stranger to controversy, Goldman Sachs shrugged off the purchase as a routine financial transaction. By way of added explanation, financial analysts pointed to the desperate search of global capital for yield in the context of subdued global interest rates.

The *WSJ* now has reported that the bank recently has sold some US$300m-worth of the bonds to a small group of hedge funds, via a boutique brokerage identified as Liquidity Finance; reporting that “four or five hedge funds in London and New York” bought the Pdvsa 2022 instruments for about 32.5 cents on the dollar, slightly more than the 31 cents GASM paid for the bonds in May; continuing evidence (as if any were needed) of the insatiable investor appetite for return, regardless of its provenance.

REGIONAL BUSINESS REVIEW

BRAZIL

Beef back in trouble

The Brazilian beef industry is suffering from a double or perhaps triple whammy. The latest blow was the US government’s decision, on 22 June, to suspend all imports of fresh Brazilian beef. This has put the focus on the industry’s health standards.

The first setback for an industry with estimated total sales of US$13bn, and which employs as many as 6m people across the country, came in March, when federal police reported on an operation code-named 'carne fraca' ('weak meat'). This police operation had revealed that inspectors at up to 30 meat-packing plants were being bribed to approve the sale of beef that was either sub-standard or past its sell-by date.

This meat safety scandal was followed in May and June with the front-page news that JBS, the market leader in Brazil and the world's largest meat exporter, appeared to have been deeply involved in a political bribery scandal, which could yet end up toppling President Michel Temer. This scandal is likely to have a major and negative impact on JBS's business – not least because its owners and top executives, the Batista brothers (Joesley and Wesley), have admitted to their guilt as part of a plea-bargaining deal.

The company now is trying to sell US$1.8bn worth of assets in anticipation of the fines and compensation demands. But in June, a federal judge blocked the proposed US$300m sale of JBS Latin American subsidiaries to a rival Brazilian group, Minerva SA, on the grounds that this might complicate and prevent further investigations into the JBS corruption scandals.

The third and possibly the biggest setback was the US decision to ban imports of Brazilian beef. The US Agriculture Secretary Sonny Perdue, in a letter to his Brazilian opposite number Blairo Maggi, said that since the 'carne fraca' episode the USDA had stepped up its inspections of Brazilian beef imports, rejecting 11% of all shipments for failing health and safety checks. This compared very badly to an average 1% rejection rate for imports from other countries. The cited problems have included abscesses, blood clots, bones, and what was described as "unidentified foreign material of raw intact beef product".

In Brazil, part of the problem is being attributed to budget cuts leading to reduced numbers of health inspectors at the country's nearly 5,000 meat-processing plants. According to the national union of agricultural and livestock auditors (Sindicato Nacional dos Auditores Fiscais Federais Agropecuários, ANFFA), 270 Brazilian meat-processing plants are currently operating without any inspectors at all.

The Brazilian cattle-ranchers' association (Conselho Nacional de Pecuária de Corte, CNPC), suspects that the abscesses may be caused by an adverse reaction to vaccinations for Foot and Mouth Disease (FMD). The CNPC has called on the government to halve the doses of the FMD vaccination, to change the way it is administered, and to remove a vaccine ingredient called saponin. Other industry players suggest that the use of dirty needles to administer vaccines is a more likely cause of the problem. One precautionary measure has been to ban the export of the front part of each cow as a whole piece, requiring instead that it be sliced into cuts. This adds to operating costs at the meat plants, but makes it more likely that the packers will find any defective meat.

The US currently takes only 2.8% of Brazil's total beef exports, but the fear in Brazil is that the ban will spread to other countries including China, which is the number one export destination for Brazilian beef. The ban is all the more frustrating for Brazilian exporters since it was only in July last year that the US authorised fresh beef imports from Brazil after more than a decade-long ban because of FMD concerns. While not denying the health and safety issues, Minister Maggi implied that commercial factors might have also been in play. "We have a health problem, but also pressure from US beef cattle ranchers who don't want to see Brazilian beef in their market. We are competitors at a global level and we're selling beef into their own market," he said.

Good start to Round 2

Mexico had the misfortune of launching its first round (Round 1) of auctions for oil and gas exploration & production (E&P) licences in 2015/16, just after a major slump in international hydrocarbons prices. Because of the slump there were mixed results, but there was still investor interest. The results of the first phase of Round 2, announced in June, show continuing interest. Ten of the 15 offshore shallow-water blocks on offer were awarded, for expected total investment of US$8.2bn over 35 years.

Mexican officials are very encouraged by the results of Round 2.1. ENI of Italy and Citla Energy (a Mexican-US joint venture) were the two most successful bidders, winning three blocks each, both individually and as members of consortia. In March, ENI had announced a significant discovery at a block it was awarded in Round 1.

Elsewhere, the state-owned Pemex, Ecopetrol of Colombia, and Scotland-based Capricorn (a subsidiary of Cairn Energy) won two blocks apiece, in various partnerships. Royal Dutch Shell won a Mexican block for the first time, in partnership with Total of France. With a stand-alone bid, Russia's Lukoil also won its first Mexican E&P block. Across all ten blocks awarded, the share of royalties offered to the Mexican state averaged 57.3% of the per barrel price. But finance ministry officials note that the government's share of the pie will be higher, at 77.4%, once income tax (ISR) other royalties, and state-level taxes are taken into account. As the contracts also have provisions for higher royalties triggered by price or production windfalls, in theory there could be even further upside for government revenues.

According to Juan Carlos Zepeda, head of the national hydrocarbons commission (Comisión Nacional de Hidrocarburos, CNH) it will take about seven years before the first oil starts flowing from some of these blocks. Energy Minister Pedro Joaquín Coldwell said the 10 allocated blocks should be able to ramp up to a production peak of around 170,000 barrels per day (bpd) within the next decade. As he put it, "There are 73 similar shallow-water blocks available around the world to the ones which we have just auctioned, so the results show investor confidence in the adjudication processes and in the resources we have to offer, even at a time of depressed petroleum prices".

Ricardo García Moreno of US-based corporate law firm Haynes and Boone agreed, saying: "This round showed a lot of interest from majors around the world. Mexico is offering competitive terms and contracts, and people are responding". Other analysts highlighted the involvement of oil majors in what were previously seen as generally unexciting shallow water plays. "High interest in a shallow water auction with low oil prices can only be described as a success for Mexico," commented the sector website oilprice.com.

Five blocks were not allocated in the latest round – three of them in Tampico-Misantla, one gas prospect in Veracruz and one heavy crude prospect in the south-eastern basin. Officials attributed the lack of interest to the effect of low international prices. Four blocks had only a single bid, and were awarded without competition – among them a gas block given to a Shell-Total consortium that offered the State a relatively low royalty share of only 30%. Pemex, Mexico's struggling state-owned company, was enthusiastic about winning two blocks in partnership with Ecopetrol and a German company, Dea Deutsche Erdoel. Pemex will be the operator of both blocks, which according to director of exploration José Antonio Escalera, shows that the company can be competitive within the newly liberalised energy market.

Forthcoming Round 2 phases – 2.2 and 2.3 – are running concurrently, with the results for both due to be announced in July. The CNH has said that Round 2.2 will be reduced from 12 to 10 onshore blocks. This is because the auction of two blocks in the southern state of Chiapas is being delayed to give more time for consultations with local Zoque and Tzotzil indigenous communities. The blocks involved are prospects for light and super-light crude oil, each covering around 400 square kms. Round 2.3 covers a total of a further 14 onshore blocks. The CNH has reported that a total of 28 companies have registered for Rounds 2.2 and 2.3. These include Mexico's Grupo Carso (controlled by businessman Carlos Slim), which has not yet won any blocks, along with PetroBal and various other locally based groups. Further ahead, in December, more deepwater blocks are due to be auctioned.

Given the latest results, it is possible that the government led by President Enrique Peña Nieto, battling with low approval ratings on various fronts, may nevertheless come to the end of its six-year term in 2018 with its landmark energy reform of 2013/14 being vindicated. The initial hope that the reforms might add one or two percentage points to Mexico's GDP growth rate by 2018 now looks excessively optimistic. However, the influx of foreign oil investment may yet boost growth, albeit some years later than planned. Oil production, in lengthy decline, fell to 2.5m barrels last year, and the latest auction suggests an eventual change in that trend too.

VENEZUELA

Paraguay calls on the US to 'consider' its Venezuelan oil purchases

The US, as Venezuela's longstanding main oil customer, should rethink its oil purchases, and should also consider the application of sanctions against the country's key sector (accounting for 95% of total exports), Paraguay's foreign minister Eladio Loizaga told a Madrid conference on 4 July.

Loizaga was quick to acknowledge that, in general, economic sanctions on a country often tend to have less of a negative impact on governments than on ordinary citizens. Yet, he argued, given the rapidly deteriorating crisis in Venezuela, the time has come for the US to re-examine its options.

In fact, US authorities have not been shy about imposing targeted individual sanctions on an array of Venezuelan government officials, including cabinet ministers and members of the heavily militarised security forces. Most recently (on 18 May), the Department of Justice (DOJ) imposed sanctions on the president of the supreme court, Maikel Moreno, and the seven magistrates that comprise the court's highly controversial constitutional chamber, in this instance for interfering with the democratically-elected and opposition-controlled legislature (national assembly).

US media reports subsequently suggested that the administration led by President Donald Trump was indeed considering levying broader sanctions on the Venezuelan oil sector, with Secretary of State Rex Tillerson telling the US senate that "tough measures" were being examined, with "all options" on the table.

Oil analysts suggest that sanctions could range from a ban on the Venezuelan state oil company Pdvsa from bidding from US contracts, to – in the most extreme circumstance – an outright blanket ban on oil imports from Venezuela and a prohibition on US companies from trading or doing any business with Pdvsa.

Separately, and independently of successive US governments, the DOJ has been investigating corruption at Pdvsa for several years now, with its enquiries said to reach back to 2005. In late 2015, the *Wall Street Journal* (*WSJ*) reported that US authorities were probing Pdvsa for "allegedly looting billions through kickbacks, over-invoicing and scamming currency controls and then moving the profits via American banks", with the money then also used to purchase property and other assets in the US. That makes these activities of strong legal interest to the US. The *WSJ* also reported that US investigators were also looking at the potential use of Pdvsa to launder the proceeds of drug trafficking.

There have been a series of arrests, asset seizures and criminal indictments in the US as part of these ongoing various investigations, most recently in January 2017, when two US-based businessmen (one of them Venezuelan) pleaded guilty to foreign bribery and fraud charges relating to an estimated US$1bn corruption scheme involving Pdvsa. In October 2016, Switzerland said it had transferred US$51m of US$11m in assets previously ordered frozen to the US in connection with that investigation.

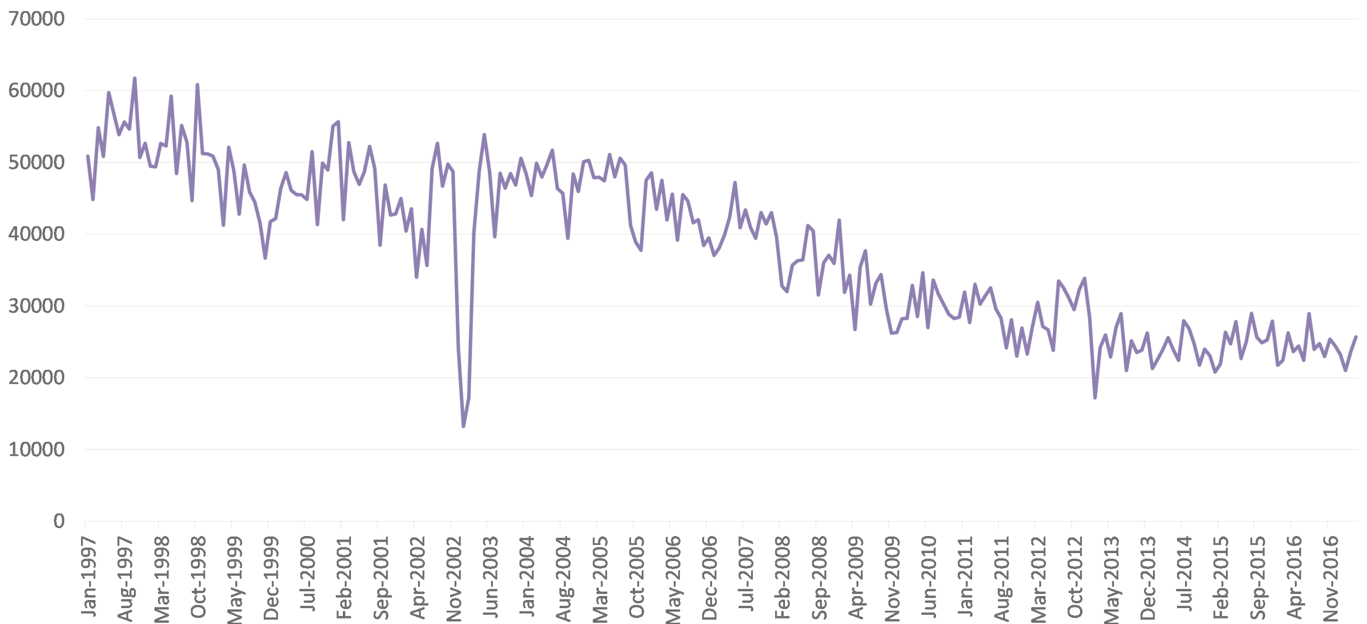
And an extensive report by *Bloomberg Markets* that same month said that US authorities were investigating "at least a dozen Venezuelans", including former Pdvsa executives, "suspected of having taken bribes from middlemen to award contracts at inflated prices, helping to siphon more than US$11bn billion out of the country, some of which may have been stashed offshore in Panama.

The Venezuelan Harvard Professor, Ricardo Hausmann, a strong critic of the Caracas government, told *Bloomberg* that US leadership on this issue could prove important. "If the US were to say, 'We've identified billions of dollars,' it would have a devastating political effect at home," he noted. (The US would also earn goodwill with future Venezuelan governments if it later returned any stolen funds, he suggested.)

While the US is Venezuela's main oil customer, the relationship runs both ways -Venezuela is the third most important foreign oil supplier to the US. The US reliance on Venezuelan oil peaked at just over 647,000 barrels annually in 1997 (before the left-wing government led by Hugo Chávez took power [in early 1998], but as of last year, Venezuela was still supplying the US with 291,366 barrels of crude oil and petroleum products, according to latest data from the US Energy Information Administration (EIA). While 45% of the 1997 level, this still is no small amount. Venezuela was ranked the third biggest US supplier after its top provider Canada (1.39m barrels in 2016) and Saudi Arabia (404,260 barrels in 2016). And while the US is becoming less reliant on foreign oil as domestic supply enjoys a new surge (mostly drive by intensive shale activity), replacing Venezuela as a supplier would not be an overnight job.

Price and production falls

Venezuela certainly would be hard hit by the loss of the US as a customer, not least because the US, rather ironically, is one of Venezuela's only full market price-paying clients. With most other strategic customers, notably including China, the tightly government-controlled Pdvsa has rather opaque oil trading arrangements in place, often in the form of complex cash-for-oil financing deals that serve the Caracas government, but not Pdvsa, which, according to the Venezuelan opposition, effectively has been mortgaged, potentially for decades to come, under these deals with China, Russia and other 'friends' of the Venezuelan government. Pdvsa has also played a central role in Venezuela's generous 'petro-diplomacy' around the region, a strategy that continues to pay dividends to this day, with the country's small island Caribbean oil clients loyally refusing to condemn it at the main hemispheric Organisation of American States (OAS), much to the chagrin of regional heavyweights such as the US, Canada, Brazil, Mexico, Chile and Argentina.



Source: *US Energy Information Administration (EIA)*

In the output side, the decade-long oil price boom of 2004-2013 not only encouraged wholesale corruption at Pdvsa, it also masked the deep structural cracks that penetrated the company after it was stripped of senior and mid-level management and technical staff after a crippling 2003 anti-government strike; Management was replaced across the board with political appointees, with the oil workers' unions also taken under government control.

The upshot was weak, inefficient (and corrupt) management, and the gradual stagnation of output. While oil was trading at US$100 a barrel, Pdsva could coast along despite this situation and the Venezuelan government, happily gorging itself on Pdvsa, the cash cow for the Bolivarian Socialist Revolution, appeared oblivious to the stagnant output. However, once prices collapsed, the problems at Pdvsa became all too clear.

According to the International Energy Agency, Venezuelan oil production stood at 2.02m barrels/day (b/d) in April, down from 2.05m b/d in January and from 2.3m b/d in mid 2016. At this output level, Venezuela continues to exceed its latest production quota of 1.97m b/d, as set by the Organisation of Petroleum Exporting Countries (OPEC) in late 2016 in an effort to put a floor under weak global oil prices.

While OPEC has now rolled over its production quotas to March 2018, prices have not recovered to anywhere near the levels Venezuela previously enjoyed – and probably never will. The 'new normal' is oil at US$50/b, experts believe. Brent crude is set to average about US$55/b in 2017-2018, with West Texas Intermediate (WTI), the reference price for Latin American oil, projected at about US$52/b. According to the Caracas energy ministry, Venezuelan heavy crude prices (which trade at a discount to WTI) have averaged US$43.6/b to date in 2017, recovering from just US$35.2/b in 2016. Yet the trend in the first half was anything but positive, with prices falling every month from February, after a short-lived upswing in January as the OPEC quotas took effect.

Analysts are mixed on the price outlook for the rest of 2017, which will include the Northern Hemisphere Winter (peak season for global oil demand). Some experts say the OPEC quotas are slowly starting to take effect on global supply – pointing to a dip in US output in June – and should therefore lead to higher prices in the second half. Others say global supplies

are still rising faster than demand and so are more cautious on the price outlook moving forward.

Either way, Venezuela needs oil prices at twice the current levels (or more) to pull itself out of its current deep rut. The Maduro government appears determined to remain current on sovereign and Pdvsa external debt obligations at all costs – as evidenced by the severe hardship being endured by Venezuelan citizens. The question for the US government therefore is not whether the imposition of US sanctions on Pdvsa would force a default – inevitably it would – but whether this 'tough love' would ultimately serve to dislodge the current government and restore a functioning democratic government to Venezuela.

REGION

Container port activity dips

The throughput of containerised cargo in the ports of Latin America and the Caribbean (LAC) fell by 0.9% in 2016, according to a report released on 6 June by the United Nations' Economic Commission for Latin America and the Caribbean (ECLAC). ECLAC said that this regional average continued a "negative trend of deceleration" observed in the previous few years and, problematically, was the biggest loss since the 2009 crisis.

In its latest 'Maritime and Logistics Profile', ECLAC said it had re-confirmed two trends recorded in the region in recent years: an overall steepening of the deceleration of foreign trade in container terminals, but yet a high degree of heterogeneity in this activity's growth rates within the region.

The deceleration in the regional average of port throughput began several years ago, ECLAC noted, with regional growth averages going from 6.0% in 2012, to 1.3% in 2013, 2.4% in 2014 and 2.5% in 2015. It observed that the latest deterioration (in 2016) was determined mainly by a decline in activity in five countries: Brazil (-4.4%), Panama (-9.1%), Colombia (-3.6%), Argentina (-6.1%) and The Bahamas (-14.3%). These drops, however, were mitigated by increases in the likes of Mexico (with a 3.2% rise in throughput), Chile (+4.8%), Peru (+8.4%), Ecuador (+4.5%), the Dominican Republic (+8.3%), Guatemala (+8.8%), Costa Rica (+7.3%) and Uruguay (+9.5%).

The total volume of activity in 2016 was approximately 47.5m TEU*. The first 40 ports in the ranking represented almost 90% of operations with this type of cargo in the region. The following 100 ports moved the remaining 10% (4.4m TEU).

*TEU (Twenty-foot Equivalent Unit) is the standard unit of measurement, equivalent to a container of a length of 20 feet, or 6.25 meters, meaning it is a standard-sized metallic box that can be easily transferred between different modes of transportation, such as ships, trains and trucks.

ECLAC noted that container port traffic on a global level also showed little dynamism in 2016. According to estimates by Alphaliner, volumes in the world's top 100 container ports rose by just 1.8% last year, to 555.6m TEU.

ECLAC also noted that its data threw up strong heterogeneity in the performance of port throughput, both at a sub-regional level and by country. By way of example, in 2016 the East coast of South America experienced a decline in activity (-3.7%) more pronounced than in 2015 (-0.7%), due to the steeper drops recorded in the ports of Brazil and Argentina. By contrast, the West coast registered a rebound in container activity (+4.5% annually) over 2015 (+0.4%), due to the positive evolution of port terminals in Chile (+4.8%), Peru (+8.4%) and Ecuador (+4.5%). At the same time, Central America went from a positive growth rate in 2015 (3.4%) to a 3.5% decline in total volumes in 2016, mainly due to reduced throughput in Panama (-9.1%).

As in the past, the drivers of growth, deceleration or decline in activity in individual ports varied, the ECLAC report noted. For example, the ports of Callao in Peru (8.1%), Guayaquil in Ecuador (6.9%), Caucedo in the Dominican Republic (11.1%), and San Antonio (10.0%) and Lirquén (60.1%) in Chile, showed the highest rises in volume, which ECLAC said owed to "the success of their projects and their commercial management".

By contrast, the sharpest declines port activity volumes were recorded by the terminals of Buenos Aires in Argentina (-5.7%), Kingston in Jamaica (-5.2%), Freeport in The Bahamas (-14.3%), Santos in Brazil (-6.9%), Cartagena in Colombia (-4.0%), and Colón (-8.9%) and Balboa (-9.2%) in Panama.

REGION

Corporate Radar

Trouble at YPFB

On 28 June Bolivia's state-owned oil company, Yacimientos Petrolíferos Fiscales Bolivianos (YPFB), said it was cancelling a US$2.2bn contract with Tecnimont of Italy and Técnicas Reunidas of Spain to build a polypropylene plant. In a statement, Energy Minister Luis Sánchez said that "administrative errors were found". "That means we'll draft a new contract. We'll need to take some time", he added.

Earlier, on 15 June, the YPFB president, Guillermo Achá, was sacked on suspicion of irregularities in a US$149m contract for drilling equipment awarded to Drillmec of Italy.

President Evo Morales appointed Javier Barriga the new YPFB president and said there would be a detailed investigation of tender procedures. Seven middle-ranking YPFB managers have been arrested, pending further investigations.

Electric taxis for Mexico City?

Giant Motors, a company set up by the Mexican telecoms billionaire Carlos Slim, said in June that it had been developing a prototype electric car that could potentially replace regular carbon-emitting taxis in Mexico City, the sprawling capital, which suffers from high pollution levels. Giant Motors CEO Elías Massri commented: "We are developing prototypes, and hope this year to find a viable solution, an electric vehicle, that genuinely replaces gasoline-using cars."

Giant, which is controlled by Inbursa, Slim's financial conglomerate, in February first revealed this electric taxi project, which is a joint venture with the electric vehicle maker Moldex, a subsidiary of Grupo Bimbo, one of the world's largest bread-making companies. At that stage, Massri said Giant Motors would seek government funding and cooperation to help promote this new 'designed-and made-in-Mexico' taxi as an environmentally-sound alternative. Massri stresses that the viability of electric taxis will depend crucially on fast-charging and long-lasting batteries.

There are 130,000 taxis in Mexico City, of an estimated 5.4m vehicles in circulation. In May, city authorities declared a five-day "environmental emergency" because of extremely high levels of ozone and nitrogen oxide in the atmosphere. As a result, factory production levels were cut, traffic reduction measures came into effect and schoolchildren were banned from eating lunch outdoors.

The US$1.5bn Agua Negra tunnel

Argentina and Chile have finalised details for construction of Latin America's biggest-ever road tunnel. The proposed 14-km 'Agua Negra' tunnel cuts through the Andes mountains and joins Chile's northern region of Coquimbo and Argentina's northern province of San Juan. Completing such an ambitious infrastructure project, slated to begin in 2019, should take between eight to ten years.

The estimate construction cost is US$1.5bn. The project is to be financed by the Argentine and Chilean governments and the Inter-American Development Bank (IDB). The latter has already pledged US$40m towards the project. Argentina will pay most of the outstanding sum, since 72% of the tunnel runs through its territory, while Chile will pay for the remainder.

Ten consortiums, including Chinese, European, and US groups, have expressed an early interest in the project. The tender will take place in September or October, according to Chile's public works minister, Alberto Undurraga. If successful, government officials hope the tunnel could be a way to convince international companies to invest in other major infrastructure projects in the region. "We are not just constructing a tunnel but also building our future. The tender will pave the way for other projects across Latin America", said San Juan Governor Sergio Uñac during a public works conference in Chile held on 31 May.

The Agua Negra tunnel will form part of the wider bi-oceanic corridor running all the way from Chile's Pacific port city of Coquimbo (located in the eponymous region) to the Brazilian city of Porto Alegre, Rio Grande do Sul state, which lies on the Atlantic coast. Better transport links between Brazil, Argentina, and Chile should pave the way for increased trade within the Southern Common Market (Mercosur) regional bloc. The proposed tunnel should also allow Mercosur countries better access to Asian markets via the port of Coquimbo.

However, the project is still in its initial phases and some are sceptical about whether it will ever be completed. Another road tunnel to be approved by the Argentine and Chilean governments back in 2007 was the Corredor Bioceánico Aconcagua, which never reached fruition. It was also billed as Latin America's biggest tunnel at an ambitious 52km long, but "in ten years, the project did not advance a single step", José Octavio Bordón, Argentina's ambassador to Chile, said in an interview with *BBC Mundo*. Another factor which threatens to derail the Agua Negra project is the perceived risk of corruption after recent scandals linked to major construction companies such as Brazil's Odebrecht gave the industry a bad name. However, in an interview with Argentine daily *La Nación*, Argentina's President Mauricio Macri insisted that the new project would help restore public confidence in the infrastructure sector. These public works "are a synonym of hope not corruption", Macri said.

Chile tops innovation index for Latin America

Chile was named the most innovative Latin American country in the 2017 Global Innovation Index compiled by the World Intellectual Property Organization (WIPO) and released on 15 June. Overall, Chile was rated as the 45th most innovative country out of 130 nations evaluated. The second and third most innovative countries in Latin America were Costa Rica and Mexico, which came 53rd and 58th in the global rankings. The results are based on each country's capacity to drive social and economic growth using criteria such as the quality of local institutions and potential for business development.

FMD outbreak in Colombia

On 24 June Colombia's agricultural institute (ICA) reported that it had detected an outbreak of foot-and-mouth disease (FMD) in a herd of bovine cattle in a ranch in the north-eastern department of Arauca, on the border with Venezuela. Colombia was declared FMD free in 2009, so the ICA's report forced the agriculture ministry to notify the World Organization for Animal Health (OIE) immediately of the outbreak of the disease, which could lead to a review of Colombia's status. The loss of the FMD free status would lead to the imposition of restrictions on Colombian beef exports in international markets.

Agriculture Minister Aurelio Iragorri said that seven cows of a 136-head herd had tested positive for FMD and that the entire herd would now have to be sacrificed. But Iragorri emphasised that the outbreak was localised and that the authorities did not believe that there was a risk of the virus spreading to other areas, which he said may have been introduced from Venezuela, which does not have FMD-free status.

Iragorri lamented the fact that the outbreak comes at a time when Colombia has been seeking to secure increased international market access for its beef, with the opening of eight new markets last year alone, and said that this would be a setback. Pointedly, after news of the outbreak spread the animal health authorities in Peru, Ecuador, Panama, and Chile all announced the imposition of temporary bans on the import of Colombian beef and cow's milk dairy products until the Colombian authorities can certify that the FMD outbreak in Arauca has been contained.

Meanwhile the OIE has also suspended Colombia's FMD free certification until it sends a technical mission to the country to certify that the outbreak has been dealt with properly (which could take up to four months). In response to all of this Colombia's trade, industry & tourism minister, María Claudia Lacouture, said that Colombia's beef exports this year, which were estimated to reach US$206.5m after the country exported US$93.4m of beef in 2016, would suffer.

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