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Argentina steps to the edge and back

Argentina's long drawn-out legal battle over its foreign debt in the US courts has come to an end. Its opponents – a group of US hedge funds (President Cristina Fernández prefers to call them 'vulture funds') – have won an almost complete victory after the US Supreme Court on 16 June published its decision not to review an earlier ruling by New York federal Judge Thomas Griesa that Argentina must pay a group of hold-out creditors, led by the hedge fund, NML Capital, a total of US$1.33bn.

Under the *pari passu* (equal treatment) principle affirmed by Griesa, Argentina is now obliged to make equal payments to holders of restructured bonds (those who accepted the debt reschedulings of 2005 and 2010) and to the holdouts. The next payment to the former is due on 30 June. The government has to decide what to do. It fears that if it pays the US$1.33bn – which it has so far refused to do – it will also face up to US$15bn in additional demands from other 'hold out' creditors that did not join the 2005 and 2010 bond swap deals, which followed on the country's default in early 2002. That is about half of its reserves; so by paying, the government would be risking a new financial crisis before next year's elections.

If it opts not to pay, the government faces the virtual certainty that its next debt service payments, due on 30 June, to restructured bond holders, which are made through US banks and under New York legal jurisdiction, will be sequestered under Griesa's order, triggering a default. That too would bring forth the spectre of another financial crisis. Perhaps the only viable option is to try and negotiate payment terms with the holdouts and Griesa himself, which might produce a viable way forward, but which would entail a big political climb-down. There seem to be no good options for the government, but what happens – including the possibility of a new default – essentially depends on political decisions.

Following clearer signs that Argentina is willing to negotiate with its holdout creditors, on 23 June Griesa appointed a mediator to try to resolve the dispute. On 18 June, Judge Griesa had lifted his stay of execution on his ruling that Argentina must pay NML Capital the US$1.33bn, piling on the pressure on Buenos Aires. Much can still go wrong, but the appointment of Daniel Pollack, an experienced New York lawyer, as 'special master' charged with brokering a deal between Argentina and the group of hedge funds led by NML Capital is an important step towards preventing a new default.

The hope is that Pollack, who has significant experience of financial litigation, will be able to steer the parties in a very complex dispute towards a mutually acceptable compromise. Argentina has oscillated between outright

defiance and reluctant acceptance of this order. Now that it seems to have settled for the latter, Pollack will have to get down to brass tacks.

Pollack will therefore have to probe what Argentina's real ability to pay is. Some analysts say the US$15bn number has been exaggerated for negotiating purposes and in reality it is closer to US$8bn.

Argentina's economy minister, Axel Kicillof, has requested that Judge Griesa reimpose the stay on his holdouts ruling, to give Argentina more time to come up with a payment plan. This may be granted, but Griesa, who famously commented that Argentina is a "uniquely recalcitrant debtor", will be on his guard to prevent any more stalling techniques.

Griesa clearly is losing patience with Argentina. President Fernández's 16 June speech in which she described his court's ruling as "extortionate" was "unfortunate", Griesa told lawyers in the case. "Now, that does not give me confidence in a good faith commitment to pay all the obligations of the Republic", he noted. Griesa says he is looking for a "legal mechanism" to prevent Argentina's constant stalling.

The immediate deadline remains 30 June, when payments are due to the restructured bondholders. Depending on Pollack's initial progress, Judge Griesa might or might not give Argentina more negotiating time. Robert Cohen, the attorney for NML Capital, welcomed the prospect of negotiations saying "in six weeks, much bigger problems have been solved".

The striking fact is that if the government is ignored for the moment, there seems to be a near-consensus in the country over what needs to be done. Buenos Aires governor Daniel Scioli, one of the presidential hopefuls seeking the nomination of the ruling Frente Para La Victoria (FPV) said there should be negotiations to achieve a "definitive" solution to the dispute with the hedge funds: "when there is a willingness to pay we should seek options to negotiate and agree".

Dissident Peronist Sergio Massa (FR- Frente Renovador) said "we have a government which is stepping down in 500 days, but Argentina needs to normalise its situation in the markets now". The centre-right mayor of Buenos Aires, Mauricio Macri (Propuesta Republicana [PRO]) also called for negotiations, and accused Fernández of reacting "in a traditional manner, isolating inwards and blaming others". Socialist presidential hopeful Hermes Binner said "this is the result of complete improvisation by the government's economic team".

Whether a debt deal is done or not has major political consequences in Argentina. Assuming one is reached, President Cristina Fernández will try to sell it to the electorate as a major achievement, while the opposition will argue that the government has been incompetent in letting Argentina once again get so close to a damaging default. Meanwhile, the domestic economy has entered recession, with the national statistics institute (Indec) reporting that GDP fell by 0.2% in January-March, the second consecutive quarterly contraction.

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Significantly, almost all the major presidential hopefuls have a strong interest in ending the dispute with the holdouts, not least because the provinces or cities they lead urgently need to borrow money. Buenos Aires province (led by Daniel Scioli) needs to raise US$1.2bn next year; the federal capital (led by Mayor Mauricio Macri) is looking for US$600m.

FOREIGN DIRECT INVESTMENT

Remaining resilient

The latest ECLAC annual report on foreign direct investment (FDI) highlights the general resilience of regional economies in face of several well-documented challenges.

Gross FDI inflows in 2013 amounted to US$185bn, according to the annual report on foreign direct investment (FDI) into and out of the region compiled by the United Nations' Economic Commission for Latin America & the Caribbean (ECLAC), released in late May. This represented a nominal increase of 5% relative to FDI inflows of 2012, and a record high.

ECLAC noted that the total was boosted by the US$19.76bn acquisition by the Belgium-based Anheuser Busch InBev of a 65% stake in the Mexican brewer Modelo. After allowing for the subsequent divestment of some assets of the Mexican company, the net contribution of this transaction to FDI inflows to Mexico in 2013 was US$13.25bn. It was one of the largest-ever corporate deals to have taken place in the region.

Excluding the Modelo deal, overall FDI inflows into Latin America and the Caribbean actuall fell a little in 2013. Globally, FDI flows rose 11% to US$1.46trn last year. The main driver of this growth was the gathering economic recovery in the US, accompanied by expansion in some other developed countries. Across emerging markets as a whole, FDI flows grew 7% to US$756bn. Perhaps because of the slowing of economic activity in China, flows to emerging markets in Asia were stagnant at US$406bn. Flows to Africa rose 6% to US$56bn. Flows to financial centres in the Caribbean soared 54% to US$106bn: however, much of this would have been a part of investment into developed countries (and some emerging markets).

Chart 1 (*overleaf*) shows the evolution in recent years of FDI inflows to Latin America as a regional whole, and by individual economy. A key development in 2013 was the focus by global investors on the comparative strength of the US economy and on the expected 'tapering' of asset purchases by the US Federal Reserve. This served to increase the cost of funds available in general for emerging markets. It also contributed to the general strength of the US dollar during 2013 vis-à-vis many Latin American currencies. A second major trend during 2013, and one that we have commented on at length in recent months, was the slowing of China's economy (together with mounting evidence of problems in China’s shadow finance sector).

Although the slippage in Latin American currencies would have reduced the effective cost of assets across the region, these factors almost certainly served to reduce FDI to Latin America and the Caribbean relative to what they would otherwise have been. Overall though, FDI inflows were resilient, suggesting that foreign investors are prepared to look beyond the short-term (and well publicised) problems of particular countries.

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Brazil

For instance, ECLAC's figures indicate that Brazil continued to account for about one-third of all flows into the region. This was in spite of the softness in much of the economy throughout 2013, the tightening of monetary policy by the central bank and the continuing high costs to business of inadequate infrastructure and excessive regulation. ECLAC notes that the US$64.06bn in inflows to Brazil actually understates the true amount. This is because official data from Brazil does not include multinationals’ reinvestment of retained earnings; in some countries, this has accounted for nearly half of all inflows in recent years.

Chart 1: Latin America & Caribbean: 20 largest mergers and acquisitions, 2013						
Company	Origin	Target	Target's location	Vendor's location	Sector	Amount (US$mn)
Anheuser Busch Inbev	Belgium	Grupo Modelo SAB (65%)	Mexico	Mexico	Food & Beverages	19,763
UnitedHealth Group	USA	Amil Participações (41%)	Brazil	Brazil	Healthcare	2,322
Bancolombia	Colombia	HSBC Panama	Panama	UK	Finance	2,234
Coca-Cola FEMSA	Mexico	Spaipa	Brazil	Brazil	Food & Beverages	1,855
MetLife	USA	AFP Provida (90%)	Chile	Spain	Finance	1,841
Royal Dutch Shell	Neth./UK	BC-10 Block (23%)	Brazil	Brazil	Oil	1,000
Nutresa	Colombia	Tresmontes Lucchetti	Chile	Chile	Food & Beverages	758
Yara Internatinoal	Norway	Fertilizer production assets	Brazil	USA	Agriculture	750
E.ON	Germany	Eneva (25%)	Brazil	Brzil	Utilities	703
Blackstone	USA	AlphaVille Urbanismo	Brazil	Brazil	Construction	661
Koninklijke DSM	Netherlands	Tortuga Co Zootecnica	Brazil	Brazil	Agriculture	583
Cementos Argos	Colombia	Lafarge Cementos Honduras (53%)	Honduras	France	Cement	573
EIG Management	USA	Prumo Logistica	Brazil	Brazil	Infrastructure	562
Oil & Natural Gas Corp.	India	BC-10 Block (12%)	Brazil	Brazil	Oil	529
Canada Pension Plan	Canada	Aliansce Shopping Centers (28%)	Brazil	USA	Real Estate	480
Coca-Cola FEMSA	Mexico	Cia. Fluminense de Refrigerantes	Brazil	Brazil	Food & Beverages	448
ENTEL	Chile	Nextel del Perú	Peru	USA	Telecommunications	400
Enagas	spain	GNL Quintero (40%)	Chile	UK	Infrastructure	352
ACE	Switzerland	Fianzas Monterrey	Mexico	USA	Finance	293
CORPESCA	Chile	Sementes Selecta (60%)	Brazil	Brazil	Food & Beverages	260
Source: *ECLAC, on basis of Bloomberg data*						

Inwards FDI into Brazil's oil sector more than doubled to US$10.9bn in 2013: this increase more than offset a contraction in the services sector and (especially) in manufacturing. Within the manufacturing sector, the totals for 2012 had been boosted by large projects in Brazil's steel industry and acquisitions in the food industry, according to ECLAC: however, FDI flows to the computer equipment and automotive industries actually increased in 2013.

Mexico

Without the Modelo deal, FDI flows to Mexico last year would have been around US$23bn, in line with the long-term average. ECLAC notes that the FDI flows were widely spread over the main sectors. Within the major export-oriented industries, the main recipient of inwards FDI was the auto industry, where flows increased by 23% to US$2.9bn.

Looking forward, we suggest that FDI into Mexico in 2014 and 2015 should be above the long-term average of US$23bn. This is partly because of the continuing growth in the US economy: of all the larger Latin American economies, Mexico is most obviously the main beneficiary of this. It is also because of the likelihood of greater involvement by foreign investors in Mexico's energy sector, on the back of the current government's reforms, which should end the current monopoly held by the state-owned Petróleos

Mexicanos (Pemex) and encourage more foreign participation. As we noted last month, China could emerge as a major source of funding for Mexico's energy sector. At the end of May, press reports indicated that a subsidiary of Pemex was in negotiations with Chinese interests to establish an investment fund with assets under management of up to US$4bn.

Colombia

FDI flows into Colombia rose by 8% to US$16.78bn in 2013. About half of this flowed to extractive industries, with the mining and oil sectors receiving around US$5bn and US$3bn respectively. There were strong increases in FDI flows to Colombia's manufacturing sector: while inflows into the country's services sector have risen to record high levels.

Argentina

By contrast, FDI flows into Argentina slipped from US$12.12bn in 2012 to US$9.08bn in 2013. ECLAC noted that the reinvestment of earnings rose sharply in importance because of restrictions on access to foreign exchange: reinvested earnings accounted for just over three quarters of FDI inflows to Argentina last year. "Capital inflows were down by 24% and intra-company loans were slightly negative in the first half of [2013], but figures for 2013 overall had not been released [as of late May 2014]. Mergers and acquisitions in Argentina were limited to a few deals between foreign companies in the energy sector", the report noted.

"At the end of May, China National Petroleum Corporation (CNPC - one of the four predominantly state-owned energy companies) announced plans to invest US$2bn in Peru over the next decade. ECLAC notes that, according to the Chilean Copper Commission (COCHILCO), mining investment in Chile between now and 2021 should amount to US$112bn, with three quarters of the money destined for copper-related projects."

Venezuela

In Venezuela, there were virtually no capital investments in FDI inflows. Half of the inflows were accounted for by reinvested earnings; the other half, by intra-company loans.

Peru and Chile

Inwards FDI to Peru and Chile fell sharply in 2013, thanks in part to the slippage in the price of copper - itself a consequence of slowing economic growth in China. In Peru, sentiment may also have been affected by the fall in gold prices and the reduction in output linked to social unrest in Catamarca. In both countries though, the clear trend in inwards FDI is upwards: indeed, in Peru, the US$10.17bn of inwards FDI was the second highest for a single year (the record having been set in 2012). In both cases, investment in the extractive industries should continue to grow over the medium term.

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Central America

FDI into Central America in 2013 focused on Panama (US$4.65bn, up 61% over 2012) and Costa Rica (US$2.68bnn, up 15%). In Panama, FDI has focused on the services sector. According to ECLAC, some US$583m was invested in the Colón Free Zone, while over US$1.1bn found its way to the financial services industry. Almost half of inwards FDI to Costa Rica was destined for the real estate sector, "on the back of several hotel, shopping mall and office complex developments, mostly by companies from other Central American countries", ECLAC commented.

While FDI in the region as a whole have grown quite consistently, inflows to Caribbean countries have been fairly volatile and can reasonably be described as having tracked sideways for some years, at around US$6.0bn annually. FDI has tended to focus on tourism-related projects, or energy projects, which are 'lumpy' in that they boost FDI in a certain year, relative to

the preceding and following years. Inflows to Trinidad & Tobago, mainly focused on extractive industries, slipped from US$2.45bn in 2012 to US$1.9bn in 2013. Lower investment in mining, and the inflation of the 2012 total by Anheuser-Busch Inbev's purchase of Cervecería Nacional Dominicana, accounted for much of the fall in FDI to the Dominican Republic, the largest economy in the sub-region, from US$3.14bn to US$1.99bn.

Aside from Anheuser-Busch Inbev's purchase of Modelo, there were 13 merger & acquisition (M&A) deals in Latin America involving a cross-border purchase of a target in the region for consideration of over US$500m. **Chart 2** shows the details. The variety of industries involved attests to the diversity and resilience of Latin American economies. In spite of the global competitiveness of Latin America as a supplier of energy and minerals, the extractive industries accounted for relatively few of the large transactions. A number of deals, such as New York Life's sale of Finanzas Monterrey to the multinational insurance giant ACE; and HSBC's sale of its Panamanian operation to BanColombia, were driven in part by the vendor's desire to dispose of a non-core business.

Chart 2: Latin America & Caribbean: Foreign Direct Investment inflows by receiving country or territory (US$mn)

	2004-07	2008	2009	2010	2011	2012	2013
Argentina	5,350	9,726	4,017	11,333	10,720	12,116	9,082
Bolivia	618	1,302	687	936	1,033	1,505	2,030
Brazil	21,655	45,058	25,949	48,506	66,660	65,272	64,046
Central America	5,042	7,651	4,533	5,881	8,535	8,809	10,691
Chile	8,584	15,518	12,887	15,373	23,444	28,542	20,258
Colombia	7,243	10,596	7,137	6,746	13,405	15,529	16,772
Ecuador	449	1,058	308	163	644	585	703
Mexico	25,647	28,337	17,055	23,027	23,009	17,628	38,286
Paraguay	95	209	95	216	557	480	382
Peru	3,284	6,924	6,431	8,455	8,233	12,240	10,172
The Caribbean	4,818	9,617	5,264	4,654	7,015	8,413	6,052
Uruguay	1,001	2,106	1,529	2,289	2,504	2,687	2,796
Venezuela	1,267	1,741	-2,169	1,849	3,778	3,216	3,649
TOTAL	**85,053**	**139,842**	**83,723**	**129,427**	**169,538**	**177,021**	**184,920**

Source: *ECLAC, on basis of official figures and estimates as of 8 May 2014.*

Outwards FDI

To the extent that Latin American groups are expanding overseas, they are tending to focus on opportunities in other countries in Latin America or Europe. The largest exception was Coca-Cola FEMSA's purchase of a 51% stake in Coca-Cola Bottlers Philippines for US$689m.

Chart 3: Major economies of Latin America & Caribbean: outwards foreign direct investment

	2000-05	2006	2007	2008	2009	2010	2011	2012	2013
Argentina	533	2,439	1,504	1,391	712	965	1,488	1,052	1,225
Brazil	2,513	28,202	7,067	20,457	-10,084	11,588	-1,029	-2,821	-3,495
Chile	1,988	2,212	4,852	9,151	7,233	9,461	20,252	22,330	10,923
Colombia	1,157	1,098	913	2,486	3,348	6,893	8,304	-606	7,652
Venezuela	809	1,524	43	1,598	2,236	1,776	-1,141	2,460	1,285
Mexico	2,909	5,758	8,256	1,157	9,604	15,050	12,636	22,470	12,937
Latin America / Caribbean	**10,131**	**41,560**	**23,179**	**37,352**	**13,690**	**46,282**	**42,179**	**47,186**	**31,611**

Source: *ECLAC, on basis of official figures and estimates as of 8 May 2014.*

Aside from Mexico's Coca-Cola FEMSA, those Latin American companies that have been carrying out the larger cross-border deals in the region have come from Colombia (especially) and Chile. In fact, the region has long been the source of substantial outwards FDI, although the absolute amounts of money have fluctuated wildly from year to year, as **Chart 3** shows. ECLAC notes that outwards FDI from Brazilian multinationals was negative for the third consecutive year in 2013. This was because the amounts borrowed from overseas subsidiaries to finance activities within Brazil exceeded gross outwards investment. ECLAC suggests that Brazilian multinationals borrowed US$18.3bn from their foreign subsidiaries over the course of last year; their investment into other countries amounted to US$14.76bn.

Chart 4: Main cross-border acquisitions by Latin American multi-nationals, 2013

Company	Origin	Assets Bought	Assets' location	Vendor's location	Sector	Amount (US$mn)
Bancolombia	Colombia	HSBC Panama	Panama	UK	Finance	2,234
Coca-Cola FEMSA	Mexico	Spaipa SA	Brazil	Brazil	Food & Beverages	1,856
Grupo BTG Pactual	Brazil	Stake in oil exploration (50%)	Africa	Brazil	Oil	1,525
Grupo Nutresa	Colombia	Tresmontes Lucchetti	Chile	Chile	Food & Beverages	758
Banco Safra	Brazil	Bank J Safra Sarasin (50%)	Switzerland	Switzerland	Finance	700
Coca-Cola FEMSA	Mexico	Coca-Cola Bottlers Phils. (51%)	Philippines	USA	Food & Beverages	689
Grupo Aval	Colombia	Banco Bilbao Vizcaya Panamá	Panama	Spain	Finance	688
Grupo Aeropuerto del Sureste	Mexico	LMM Airport	Puerto Rico	Puerto Rico	Transport	615
Cementos Argos	Colombia	Lafarge Cementos Honduras	Honduras	France	Cement	573
Coca-Cola FEMSA	Mexico	Cia. Fluminense de Refrigerantes	Brazil	Brazil	Food & Beverages	448
ENTEL	Chile	Nextel del Perú	Peru	USA	Telecommuni-cations	400
Investor Group	Mexico	ISC Fresh Water	Spain	UK	Real estate	394
Alfa SAB	Mexico	Campofrio Food Group (45%)	Spain	Spain	Food & Beverages	309
Corpesca	Chile	Sementes Selecta (60%)	Brazil	Brazil	Agriculture	260
Mexichem SAB	Mexico	Resin production assets	USA	USA	Chemicals	250
Bancolombia	Colombia	Grupo Agromercantil Holding (40%)	Guatemala	USA	Agriculture	217
Vale SA	Brazil	Belvedere coal mine (25%)	Australia	Australia	Mining	156
Pluspetrol	Argentina	Harvest Vinccler (29%)	Venezuela	USA	Oil	135
Marcopolo	Brazil	New Flyer (20%)	Canada	Canada	Automotive	116
Amil Participações	Brazil	Hospitais Privados de Portugal	Portugal	Portugal	Healthcare	110

Source: *ECLAC, on basis of Bloomberg data*

Chart 4 confirms that the multinationals based in Latin America and undertaking cross-border deals are disproportionately from Mexico, Colombia and Chile. Nevertheless, one of the largest transactions in 2013 was the purchase of oil exploration assets in Africa by Brazil's Grupo BTG Pactual.

The number, scale and diversity of deals taking place point to the general resilience of Latin America's economies. This is in spite of the slowdown in China and the rise in the overall cost of funds that is the logical consequence of the change in monetary policy by the US Federal Reserve. It is also in spite of a number of well-documented problems specific to particular countries. In

Argentina, for instance, many of the foreign multinationals present have operations that are sufficiently large and profitable that they can fund their businesses through retained earnings. In Brazil, the largest companies are able to access funds on relatively attractive terms - in part because of the generation of cash by subsidiaries outside the country.

Looking forward, total FDI flows into Latin America may fall in 2014, but this is mainly because of the size of the Modelo deal in Mexico last year. It is easier to identify positive than negative wildcards. Chinese firms are likely to see the mineral sectors in Peru and Brazil as offering attractive opportunities, and may well increase investment flows. As Pemex's new investment fund indicates, Chinese majors may also emerge as important new players in Mexico's energy sector. In the event that the US economy is stronger in the second half of 2014 than most observers currently estimate, inwards FDI to Mexico - focused on manufacturing and services - could expand sharply. Meanwhile, we expect that multi-nationals from Mexico, Colombia and Chile will continue to set the pace in terms of outbound deal-making.

ICT

Broadband availability: still a long way to go

As web-based information and communications technology (ICT) grows in economic importance, the degree of connectivity achieved by different countries becomes a proxy for their ability to compete. A recent study by the Inter-American Development Bank (IDB) suggests broadband penetration remains uneven in Latin America and the Caribbean, and despite some efforts to catch up, still lags behind the Organisation for Economic Co-operation and Development (OECD).

"In a modern society, broadband is the key ingredient in the public policy agenda to accelerate growth and reduce inequality" says Antonio García Zaballos, a telecoms researcher at the IDB. If he is right, it seems there is not yet enough of this key ingredient around. The IDB has created a measure of its availability that it calls the IDBA (Índice de Desarrollo de la Banda Ancha), and scored Latin American countries on a scale of 1 to 8 measuring actual broadband penetration. The index is a compilation of 37 variables making up an effective broadband service, grouped into four main clusters relating to public policies, strategic regulation, infrastructure, and knowledge. The results are in some ways predictable. Overall, the 26 countries in the region score an average of 4.37, lagging considerably behind the 34 developed countries in the OECD, which score 6.14 (two Latin American countries, Mexico and Chile, are also OECD members). The gap between the two groups – 1.77 points in 2012 – has narrowed a little, down from 1.79 in 2011 and 1.91 in 2010. If a catch-up process is under way however, it is a painfully slow one.

The IDB makes a powerful case for why all this matters. It notes that the 26 countries in the region have a combined population of 580m people, roughly one quarter – 25% – of which lives in rural areas. Overall, only one of every eight households has access to broadband provision. Around 100m people have no access whatsoever. And those that do seem to have to pay up to 30 times more for their service than in the OECD countries, and get internet access speeds up to three times slower. Broadband supply is growing, at between 16%-18% per annum, but the high cost is a real problem. The economic impact of improving broadband provision on the other hand, is potentially very significant. According to the IDB, a 10% increase in broadband penetration rates can boost a country's GDP by 3.19% – a very attractive return on investment. It also suggests that bringing isolated municipalities online can cut education and health costs very sharply.

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Within the region, the ranking is led by Chile (5.57), followed by Barbados (5.47), Brazil (5.32), Panama (5.05), Uruguay (4.81), Colombia (4.77) and, in

seventh place, Mexico (4.62). The implication is that it is among some of these countries, either individually or collectively, that high-tech industries may develop. At the bottom end of the broadband ranking come countries like Haiti (1.71), Belize (3.11) and Suriname (3.12). When grouped by regions, the Southern Cone leads with an average of 4.87, followed by Central America (4.26) and the Andean countries (4.13). The lowest scoring region is the Caribbean (3.72).

Of course, broadband provision on its own is not enough. A recent study by the Instituto Mexicano de la Competitividad (IMCO) suggested that to capture the full potential of ICT, a country – and by implication many of its regional neighbours – needs to be more innovative, diversify financing, promote a culture of entrepreneurship and simplify and reduce bureaucracy. The IMCO found that Mexico had a poor record for innovation. It has half as many researchers as Chile 1.0m inhabitants; Mexican investors are said to receive one-fifth of the royalties of their Chilean counterparts and one half as much as those in Brazil. Cultural factors are also important, the IMCO suggested. In Mexico "it is looked down upon that researchers create businesses, but that leaves them far behind compared to the rest of the world" noted IMCO director Rodrigo Gallegos.

BRAZIL

Big engineering on the attack

Before, during, and after Brazil's World Cup, another game has been in play. The world may be familiar with names like Neymar, Oscar, Hulk, Fred and David Luiz. But does it recognise a different group of players, who go by names like Odebrecht, Camargo Corrêa, Andrade Gutierrez, OAS, and Queiroz Galvão? These have been involved in a different competition, with its own set of big prizes - and some yellow cards.

It is proving to be a dramatic year for Brazil's big *empreiteiros*, the country's large civil engineering and construction contractors. Their role in the World Cup infrastructure projects has brought them profitable business and negative press. But they are looking far beyond this particular event, with aggressive expansion plans in Latin America and further afield.

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The 2014 FIFA World Cup opened at the new Itaquera stadium in São Paulo, and is set to close in Rio's famous Maracanã. The former was built and the latter upgraded by Odebrecht, now the country's second largest privately held non-financial company. For construction work on four stadiums, Odebrecht received various payments including BRL1.5bn (US$447m) in subsidised loans from BNDES, Brazil's national development bank. Whether it did a good job or not is subject to ongoing controversy. The cost of building Itaquera increased to BRL1.0bn (US$449mn) as Odebrecht and Corinthians Football Club had a two-year argument over financial guarantees. On the same day that President Dilma Rousseff came to visit the nearly-ready Itaquera stadium, complete with a 'mission accomplished' banner, demonstrators protested at Odebrecht corporate headquarters in São Paulo, spraying graffiti that accusing the company of "making billions on the blood of the workers and the money of the people".

Itaquera was delivered late and over budget, and was still suffering teething problems during the opening match on 12 June. In November 2013, a 1,500-ton crane lifting a section of the roof had collapsed, killing two workers. A third died in another accident in March. Odebrecht said it was not responsible for the accidents, which involved sub-contractors.

The company does have supporters. Peter Lannigan of brokers CRT Capital Group argues that "Odebrecht is one of those companies that gets the contracts and dominates the industry. But at the end of the day, they continue to do what they've always done, which is to get things done".

Norberto Odebrecht set up the company in 1941, initially building shipyards, shopping centres, and a terminal for Salvador airport. At the age of 93, he is now estimated by *Bloomberg* to have asserts worth over US$4.0bn. His son, Emilio, chairs the board and his grandson, Marcelo, is the chief executive. Like many of its competitors, the company grew strongly by developing close links with the Brazilian military regime of 1964-1985. According to Pedro Campos of Universidade Federal Rural Rio de Janeiro, "Odebrecht was the most efficient of the builders at transitioning from the dictatorship to democracy, and now it is showing. The company may have been the biggest beneficiary of the World Cup".

Odebrecht group revenue was up by 16% in 2013 to reach BRL96.9bn (US$43.4bn); it employs 175,000 people and has a pipeline of contracts worth around BRL30bn (US$13.4bn). It reported a BRL491m (US$220m) profit last year (after a loss in 2012). Because of a bunching of new projects, borrowing has, however, increased sharply, up 29% to BRL73.2bn (US$32.8bn).

The other companies in the sector are also significant. The number two slot is held by Camargo Corrêa, which operates in 18 countries and employs around 54,000 people. In Brazil, its main business units are active in cement production, energy concessions, highway concessions and big building projects. Founded in 1939, the company played an important role in the construction of Brasília, the country's new capital, in the 1950s. Consolidated net revenues in 2012 were reported at BRL23.4bn (US$10.5bn), up 35% from the previous year. The family matriarch, Dirce Navarro de Camargo, died last April at the age of 100, leaving a family fortune worth a reported US$13.8bn. She is succeeded by her three daughters (Regina, Renata, and Rosana), who retain control of the company.

Camargo Corrêa also has had its share of controversy. In March 2009, some of its managers were arrested on money laundering and fraud charges. More recently, courts have investigated claims that Camargo Corrêa systematically overcharged the state oil company Petrobras for construction work on the Abreu e Lima refinery project – which is also at the centre of a separate congressional investigation into money laundering.

Critics and academics have drawn attention to the political campaign contributions made by the construction giants. According to data from the Brazilian electoral tribunal, Odebrecht campaign donations rose to BRL39.9m in 2012, sharply up from BRL8.1m ten years previously. Other *empreiteiros* such as OAS, Queiroz Galvão and UTC Engenharia were among the top ten contributors. Research by Daniel Hidalgo at the Massachusetts Institute of Technology in the US suggests that in the 2002, 2006 and 2010 elections, for every Real's worth of political contributions by construction companies, they were assigned 14 to 39 Reais worth of government contracts in the ensuing three years.

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Concerns over a perceived conflict of interests between companies making big contributions to the ruling Partido dos Trabalhadores (PT), and then getting big contracts back from a PT government, has led to attempts, channelled through the federal supreme court (STF), to ban corporate political donations. The outgoing STF president, Joaquim Barbosa, has stated that corporate campaign finance is having a "pernicious influence' on Brazilian politics. Marcus Vinicius Coelho, president of the Brazilian lawyers' association (Ordem dos Advogados do Brasil [OAB]), says that, "contributions are very concentrated in public works firms". But Sergio Bourroul, an Odebrecht spokesman, has said "Odebrecht promotes its donations as part of a democratic vision and while respecting the law, without adopting any partisan position or ideology."

The tendency for the industry to be dominated by a handful of large and powerful *empreiteiros* has raised eyebrows, but on the whole not caused

them too many regulatory problems. That said, in May the Brazilian anti-trust regulator (Conselho Administrativo de Defesa Econômica [Cade]), singled out a group of six companies that were said to be running a "cement cartel" coordinating their bids and inflating costs in submissions for highway construction and other contracts. Cade said the six companies, including Holcim Brasil, Votorantim Cimentos, Camargo Corrêa Cimentos, Cimpor Cimentos do Brasil, Itabira Agro Industrial, and Companhia de Cimento Itambé, had together caused the state BRL28bn (US$12.7bn) of losses over the last 20 years. They have been fined a total of BRL3.1bn (US$1.4bn), and are being forced to divest 20% of their production capacity in cities where they own more than one cement plant, in an attempt to make the industry more competitive.

One of the most attractive markets for the Brazilian *empreiteiros* is the rest of Latin America, where there is a big infrastructure investment deficit. Odebrecht is strongly focused on opportunities in Peru, where it is involved in the Chaglla hydroelectric project, the Lima overhead railway, and the Belo Horizonte hydropower plant. It is also bidding for the US$3.6bn Southern Peruvian gas pipeline.

Elsewhere, the company in June won a 50-year concession to run the US$1.05bn Chan II power plant in Bocas del Toro, Panama. Mexico is expected to be a big growth market, given the current government's ambitious plans to develop infrastructure and liberalise the energy sector. To date, Odebrecht has invested US$1.8bn of a planned US$8.1bn target in Mexico.

"...a question sometimes raised is whether the Brazilian civil engineering companies, with strong backing and financial support from their government, have an unfair advantage in the battle for contracts in Latin America."

Odebrecht is also involved in bidding for the construction of the new US$546m Louis Armstrong International airport in New Orleans (although the contracting process has run into legal difficulties) and is making plans to increase its presence in Africa. With international partners, OAS recently won the contract to build a 2.6km bridge over the Chacao Canal in Chile (linking Chiloé island to the mainland). It is also involved in the US$4bn Inambari dam project in Peru. Camargo Corrêa is building Venezuela's Tuy IV System, a massive hydroelectric complex and aqueduct.

Queiroz Galvão is involved in the US$1.1bn Tumarín hydro project in Nicaragua. Galvão is one of the newer companies in the sector. According to the company, "we are working on our strategic plan, but our board has already decided to consolidate our operations in Peru". It notes that one of its drivers has been to compete against Spanish, Italian and Chinese civil engineering rivals that are hunting for business around Latin America. A company source noted that "China and Spain are offering zero percent financing. We have to compete on the quality of our engineering".

While this may be so, a question sometimes raised is whether the Brazilian civil engineering companies, with strong backing and financial support from their government, have an unfair advantage in the battle for contracts in Latin America. Over the last five years, BNDES annual financial support for infrastructure projects in Latin America, usually tied to contracts for Brazilian companies, has doubled from US$726m to US$1.4bn. The biggest beneficiaries have been Argentina, Venezuela, Cuba, the Dominican Republic and Peru.

Odebrecht has shown it is not afraid of political controversy around its business activities, and perhaps one of its most controversial projects is the expansion and modernisation of the port of Mariel in Cuba. The Mariel project was agreed in direct talks between the Brazilian and Cuban governments. The total value of the work is around US$1bn. Odebrecht has the lion's share, but a total of 400 Brazilian companies are involved in the wider port works and associated new free zone. BNDES is financing no less than 70% of the total cost of the project, which is part of the Cuban government's plans to create a special development zone. From various political perspec-

tives, critics have expressed discomfort over what they see as a sweetheart deal linking big government, big business, and an undemocratic regime in Havana, almost entirely financed by Brazilian taxpayers. Even the leftist former environment minister Marina Silva, the third-placed presidential candidate in 2010 and presumptive vice presidential candidate for the Partido Socialista Brasileiro (PSB) in this October's general election, has argued that Brazil should not be so closely involved with the Cuban regime.

The experience in other World Cup host countries has been for business to fall off after the competition ends. But the Brazilian construction companies are clearly trying to keep their revenues on an upward curve by diversifying and going after infrastructure projects elsewhere in the region. Odebrecht earns roughly 56% of its revenues from the home market, with the rest coming from operations in 26 other countries. At home, it seems close to entering a battle with rivals Camargo Corrêa and Andrade Gutierrez over airport concessions. Last year, Odebrecht won the BRL19bn (US$8.5bn) concession to run Rio's Galeão International airport for 25 years, in partnership with the operator of Singapore's Changi airport. But it is objecting to plans for a new BRL5.3bn (US$2.32bn) airport in Caieiras, just north of São Paulo, involving Camargo Corrêa and Andrade Gutierrez, on the grounds that they will have a negative effect on passenger numbers at the Rio hub. Camargo Corrêa executive Vítor Hallack has countered that the risk of a fall in passenger numbers caused by the emergence of new airport infrastructure should be shouldered by the concession holder.

"Last year, Odebrecht won the BRL19bn (US$8.5bn) concession to run Rio's Galeão International airport for 25 years, in partnership with the operator of Singapore's Changi airport. But it is objecting to plans for a new BRL5.3bn (US$2.32bn) airport in Caieiras, just north of São Paulo, involving Camargo Corrêa and Andrade Gutierrez, on the grounds that they will have a negative effect on passenger numbers at the Rio hub."

VENEZUELA

Government and airlines in dogfight

A stand-off between the government and most international airlines, complete with threats and a degree of bluster, was partially resolved through a somewhat messy compromise reached on 12 June.

The problem goes back a number of years when the government stopped allowing airlines to repatriate the dollar value of their ticket sales in Venezuela. Tickets were sold to Venezuelan passengers at the very low official exchange rate (of BF6.3/US$1), recently replaced by the Sicad I secondary rate (roughly BF10/US$1). Worried that they might not ever get their revenue out of the country, earlier this year a string of airlines began reducing their flights to Caracas. According to the International Air Transport Association (IATA), by May the Venezuelan government owed 25 air carriers just over US$4bn in pending foreign currency debts.

Air Canada stopped flights in March; 12 others including the Panama-based Copa (which says it is owed nearly US$500m) and Germany's Lufthansa said they were cutting back the frequency of their flights. On 22 May President Nicolás Maduro weighed in to say that any airline that pulled out of Venezuela would not be allowed to return. He also suggested that airlines were simply diverting services to Brazil for the World Cup. In response, IATA's Director General Tony Tyler said: "the Venezuelan government takes the prize for wilful irresponsibility."

Despite the fighting words, a deal of sorts was done. The government clearly has decided to try and keep the airlines serving Caracas, not least because of the importance of tourism for the troubled Venezuelan economy. According to Humberto Figuera of the Asociación de Líneas Aéreas de Venezuela (ALAV), "they're going to pay some airlines 70%, others 80%, and so on, of what's due. It all depends on which airline, and on various factors".

On 26 May Venezuela's finance minister, Rodolfo Marco, announced that the government had settled some of the estimated US$4.0bn debt. Marco *tweeted* that Colombia's Avianca and partner airline Taca were paid for debts

“From 2 July...American Airlines, the biggest foreign carrier serving Venezuela, will operate only 10 flights a week in and out of the country, from 48 currently. “Since we are owed a substantial outstanding amount ($750m to March 2014) and have been unable to reach resolution on the debt, we will significantly reduce our flights to the country after 1 July,” the airline said in a statement in mid June. American will only fly to Venezuela from Miami, suspending flights from New York, Dallas and Puerto Rico.”

incurred in 2012, while four other airlines including Aeroméxico were paid 2013 debts. President Maduro duly tweeted “Efficiency!” and “We continue to support airlines!”

It was also announced that as of 1 July, air ticket sales henceforth would be charged at the Sicad 2 exchange rate of BF50/US$1 (up from the Sicad 1 rate of BF10.8/US$1), effectively amounting to a very steep increase in prices for Venezuelan passengers purchasing flights using Bolivares. Asdrubal Oliveros, of the Caracas-based private consultancy Ecoanalítica, commented: “The devaluation gets bigger as the government moves more sectors to Sicad II. This measure will affect the middle class and business people who had been benefitting from a rate far below the market rate for dollars”.

The government nevertheless said that there would be negotiations on prices with the airlines on a “mutual approval” basis, taking into account factors such as costs, destinations, routes, and season of year.

Despite partial settlements with some airlines, a string of other carriers including Alitalia, Air Canada, Lufthansa, Air France, American Airlines and Copa have been unable to repatriate billions of dollars from Venezuela and have sharply reduced services to the country as a result.

From 2 July for instance, American Airlines, the biggest foreign carrier serving Venezuela, will operate only 10 flights a week in and out of the country, from 48 currently. “Since we are owed a substantial outstanding amount ($750m to March 2014) and have been unable to reach resolution on the debt, we will significantly reduce our flights to the country after 1 July,” the airline said in a statement in mid June. American will only fly to Venezuela from Miami, suspending flights from New York, Dallas and Puerto Rico.

REGIONAL ECONOMIC REVIEW

NEW BROOMS

It’s the economy, Señores Presidentes

Four new presidents (all men in this case) are in the process of settling in as the new chief executives in Colombia, Costa Rica, El Salvador and Panama. Here, we identify the prospects and main challenges for each country.

PANAMA | Juan Carlos Varela, a surprise victor in the 4 May general elections, is due to take office on 1 July for a five-year term.

Panama overview			
Population	3.6m	**Most problematic factors for business**	**% of responses**
GDP	US$36.3b	1. Inadequately educated workforce	16.80%
GDP per capita	US$9,919	2. Inefficient govt bureaucracy	16.10%
Annual GDP growth, 2013	8.00%	3. Corruption	15.80%
Avg. GDP growth 2008-13	8.10%	4. Restrictive labour regulations	9.20%
Global Competitiveness Rank	40	5. Crime and Theft	6.20%

***Source:** World Economic Forum, Global Competitiveness Report 2013-14 National statistics*

SWOT Analysis: The good news for President-elect Varela is that Panama has some very important **strengths**. Although only a small country, it is strategically located on the Central American isthmus between the Atlantic and the Pacific, and has a massively important asset for world trade, the

Panama Canal. Economic growth has been in the high single percentage digits and foreign investment flows are strong. The country has a young population, rich mineral deposits, and a well-developed banking and services sector.

Weaknesses include a history of corruption and money laundering, along with poor quality education. Further back in the past there has been serious political instability. While some might argue the contrary, Panama is also constrained by the lack of its own currency or a central bank (all business is effectively transacted in US dollars).

Among the country's great **opportunities** are the current widening of the Canal, the potential for reforms to bring in greater transparency and investor confidence, and the chance to develop greater trade and investment links with China.

Threats include inflation, the large current account deficit, the ability of powerful drug and criminal cartels to buy influence, and some doubts about the independence of the judiciary.

Political baggage: Varela can be described as a conservative member of the country's political establishment, coming from a populist tradition. He is a member of the Partido Panameñista (PPA), part of the El Pueblo Primero (EPP) alliance forged for the 2014 elections. A difficulty facing the new president is that the EPP will have only 13 of the 71 seats in the single-chamber legislature. He is in talks, therefore, with the Partido Revolucionario Democrático (PRD) – which will have 24 seats – to try to secure a working majority. We expect some tough haggling. During the campaign, Varela promised to strengthen pension provision, expand the Panama City Metro, develop other infrastructure programmes, and apply "emergency price controls" to 22 basic products. Strikes by teachers and construction workers have now ended, but industrial relations are still fragile. Varela has made a number of key ministerial appointments, including naming Dulcidio de la Guardia to the economy and finance portfolio. De la Guardia was deputy finance minister for a time under outgoing President Ricardo Martinelli.

Issues: While the country is an outperformer in the growth stakes, there is clearly a case for institutional reform in Panama. In its 2013-2014 Global Competitiveness Report, the World Economic Forum (WEF) said that the country needed to strengthen those institutions engaged in "fighting corruption and crime" and boost "the independence of the judiciary". Varela has promised to convene a constitutional assembly to look at reform, but he may be hamstrung by the strength of the other parties. There is also a danger that he may be drawn into a political struggle with Martinelli, whose appointees are well-represented in the judiciary (Martinelli and Varela, former allies, fell out in 2011 after a political-electoral deal fell apart). Some quick and effective moves against corruption are needed: the danger with a constituent assembly process is that it could be lengthy and ultimately held back by political deadlock. The new president also will need to ensure that his more populist promises can be funded without creating further fiscal imbalance. A priority for Varela will be to ensure that the delayed expansion of the Panama Canal is concluded by the revised date of 2016, as promised, again to ensure that the right signals are sent to the international financial and investment community.

"A priority for Varela will be to ensure the delayed expansion of the Panama Canal is concluded by the revised date of 2016, as promised, again to ensure that the right signals are sent to the international financial and investment community."

A suggestion: Varela should look at small and successful countries such as the United Arab Emirates (UAE) and Singapore to see how their education policies have worked.

EL SALVADOR | Salvador Sánchez Cerén, a former guerrilla and member of the left-wing ruling Frente Farabundo Martí para la Liberación Nacional (FMLN), took office on1 June for a 5-year term, following two rounds of closely-contested presidential elections in April and March.

El Salvador overview			
Population	6.2m	**Most problematic factors for business**	**% of responses**
GDP	US$23.8b	1. Access to financing	22.80%
GDP per capita	US$3,823	2. Restrictive labour regulations	12.30%
Annual growth 2013	1.70%	3. Corruption	11.90%
Avg. GDP growth 2008-13	0.80%	4. Policy instability	11.90%
Global Competitiveness Rank	97	5. Crime & theft	6.80%
Source: *World Economic Forum, Global Competitiveness Report 2013-14 National statistics*			

SWOT Analysis: As a small, high population-density Central American country, El Salvador's **strengths** include a young labour force, competitive labour costs, and a dynamic and entrepreneurial business community. Agriculture and coffee exports help form the backbone of the economy, although there is an important assembly and manufacturing sector.

The problem for the president-elect is that the country also faces daunting **weaknesses**. It is one of the poorest economies in Central America, with one of the most unequal distributions of income, and the lowest real annual GDP growth rate in the region last year. According to the United Nations (UN), El Salvador is the fourth most dangerous country in the world, as measured by the very high homicide rate (about 40 per 100,000 inhabitants last year). Although the bitter civil war of the 1980s is a thing of the past, the country is now gripped by warfare between rival gangs, or *maras*. Like Panama, El Salvador has dollarised its economy and as such is not able to follow an independent monetary policy.

Opportunities include the productivity and output surge that would follow the achievement of greater security, and the potential to attract foreign direct investment, currently at very low levels.

Threats include the possibility of further Left-Right political deadlock and the advance of the coffee rust disease, which has seriously impacted the coffee harvest.

Political baggage: In his inaugural speech, Sánchez Cerén made a bid to be what business gurus would call a consensual or participative leader. Like Varela in Panama, he lacks control of the legislature and will need to reach some kind of deal with the main opposition party, the right-wing Alianza Republicana Nacionalista (Arena). Legislative elections will be held in March 2015, but the underlying balance of forces may not change much. As Sánchez Cerén put it, "the reality we live in demands that we seek consensus, agreements and solutions".

While clearly a man who has had a lifetime on the Left, the president implied that his policy approach would be closer to the pragmatism of the current Uruguayan president, José Mujíca (another former guerrilla) than to the radical left-wing and politically confrontational style of Venezuela's late Hugo Chávez (1999-2013). To make the point absolutely clear, Sánchez Cerén has mixed elements of continuity in his ministerial team (keeping on the finance minister, Carlos Cáceres) with boldness (appointing businessman Tharsis Salomón López as the new economy minister). The new president has also gone out of his way to reassure the country that there will be no unnecessarily divisive initiatives. Unlike Panama, there will be no talk of a constituent assembly (feared in El Salvador as a mechanism used by incumbents to prolong their hold on power). Nor will there be a move to de-dollarise and relaunch the Colón, the former national currency, which has been promoted by some as a way of achieving a more pro-growth monetary policy.

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Issues: Sánchez Cerén arguably faces one of the most daunting challenges of this batch of incoming presidents. His country is the poorest, with the most

unequal distribution of income, and crucially with a level of gang violence so high that the economic growth rate is effectively repressed. The question then becomes where to begin to make the change. The president will seek to use his negotiating skills to try to achieve domestic gang pacification (a previous truce between the two main *maras*, agreed in March 2012, has fallen apart).

A suggestion: There is a potential peace dividend to be had. But to stabilise the situation and achieve his aim of eradicating poverty and inequality, Sánchez Cerén will also need to invest in improving health and education levels. The previous administration sought to raise extra funds by proposing tax reform, but ran into determined opposition from the business community, backed by Arena. Sánchez Cerén will need to broker a deal whereby fiscal reforms are accepted; and timed in such a way that they do not derail any putative recovery in the weakened Salvadorean economy.

COSTA RICA | Luis Guillermo Solís of the centre-left Partido Acción Ciudadana (PAC) was sworn in on 8 May as Costa Rica's new president for a four-year term, having won a second round run-off on 6 April (the first round was on 2 February).

Costa Rica overview			
Population	4.7m	**Most problematic factors for business**	**% of responses**
GDP	US$45.1b	1. Inefficient government bureaucracy	24.30%
GDP per capita	US$9,673	2. Inadequate supply of infrastructure	20.40%
Annual growth 2013	3.50%	3. Access to financing	10.00%
Avg. GDP growth 2008-13	3.40%	4. Tax regulations	7.50%
Global Competitiveness Rank	54	5. Corruption	7.40%
Source: *World Economic Forum, Global Competitiveness Report 2013-14 National statistics*			

"Just before he took office, Solís was given an unpleasant reminder of the types of threat his country faces. The US semi-conductor manufacturer Intel announced a decision to close its chip assembly operations in Costa Rica, with the loss of 1,500 jobs. BA Continuum, a subsidiary of Bank of America, had earlier also announced a similar number of job closures."

SWOT Analysis: Costa Rica stands out among its Central American neighbours for its long-term political and institutional stability, and its higher levels of economic development and income. These are among the country's **strengths**, along with a diversified economy built around tourism, agriculture, light manufacturing and electronics.

Weaknesses include the fact that with a relative small population and economy, the country is very exposed to any downturn in the global economy. In some ways, Costa Rica is a victim of its own success: comparatively more generous salaries, social welfare and pension provisions have eroded competitiveness and persuaded some investors to look elsewhere in pursuit of lower labour costs.

Opportunities facing the country include the development of trade with China. Costa Rica is the only country in the region with full diplomatic relations with China (rather than Taiwan). The newly-appointed foreign minister, Manuel González Sanz, says there is "enormous potential" for boosting collaboration with China. One proposal under study is the creation of a Chinese exclusive economic zone in the country.

Just before he took office, Solís was given an unpleasant reminder of the types of **threat** his country faces. The US semi-conductor manufacturer Intel announced a decision to close its chip assembly operations in Costa Rica, with the loss of 1,500 jobs. BA Continuum, a subsidiary of Bank of America, had earlier also announced a similar number of job closures. Other threats include the proximity to drug smuggling routes through Central America, with the associated risk of a 'spill over' effect from violent drug gangs.

Political baggage: President Solís and his PAC represent the launch of a 'new brand' in Costa Rican politics. His victory breaks a long duopoly in power between the Partido de Liberación Nacional (PLN) and the Partido de Unidad Social Cristiana (PUSC). Solís has identified the fiscal deficit, corruption, and

the unequal distribution of income as the three big problems inherited from the previous PLN government led by Laura Chinchilla (2010-2014). But he is not entirely free of political baggage or limitations as he sets out to grapple with these challenges. The PAC is a centre-left organisation and, at least during the election campaign, it was accused of being inclined towards protectionism. According to the critics, a PAC government would be unwilling to advance Costa Rica's bid for membership of the Pacific Alliance trade grouping. Most importantly, rather like President-elect Varela in Panama, Solís will be able to count on only a minority of seats in congress. In fact, the PAC has 13 seats, against 18 for the PLN, nine for the left-wing Frente Amplio (FA), and eight for the PUSC. Not surprisingly perhaps, the new president's ministerial team has one PLN member and two from the PUSC. He has also signed informal collaboration deals with the FA and the PUSC.

Issues: Having said a lot of things during the election campaign, Solís now faces the task of all new leaders: explaining and demonstrating how his proposals are all going to fit together and be achievable. A case in point is the fiscal deficit which, at an expected 6% of GDP in 2014, will be the second highest in Central America (after Honduras). Solís is committed to reducing it to zero by 2016, but he says he won't be relying on comprehensive fiscal reforms until the second half of his administration (2016 onwards). This is maybe because he doesn't want to repeat his predecessor's experience: Laura Chinchilla's opening attempt at a comprehensive fiscal reform was ultimately struck down on procedural issues by the supreme court and failed. As a result, Solís will rely primarily on a newly tabled bill to reduce tax evasion, alongside traditional budget austerity measures. Given that he also faces wage pressures from restless public sector unions, this will be a difficult circle to square.

"It is clear that the Intel decision to close manufacturing in Costa Rica has been a serious blow. Intel accounts for roughly 20% of Costa Rica's total exports."

It is clear that the Intel decision to close manufacturing in Costa Rica has been a serious blow. Intel accounts for roughly 20% of Costa Rica's total exports. To his credit Solís responded pro-actively, travelling to the US for a visit to Silicon Valley in June, where he sought to attract other high-tech companies to invest in the country. Intel itself softened the blow somewhat by announcing that it would open a new product-testing lab in Costa Rica, expected to employ some 350 people. But as the new president makes his pitch to international tech companies, he will be forced to do something about the factors that may scare them away.

Despite Costa Rica's good levels of institutional stability and security, energy costs have emerged as a big problem, for example. In a survey of 200 companies in May, 80% cited high-energy tariffs (electricity charges have risen by 33% in the past six years) as the main obstacle to economic growth.

President Solís would do well to welcome the lessons to be learnt from the Intel experience, and find ways to claw back Costa Rica's position as an attractive foreign investment destination.

COLOMBIA | The incumbent, President Juan Manuel Santos of the Partido de La U, won the second-round run-off election on 15 June (having come second in the first round on 25 May). His second consecutive four-year term in office will begin in August.

Colombia overview			
Population	46.9m	**Most problematic factors for business**	**% of responses**
GDP	US$366.0b	1. Corruption	20.20%
GDP per capita	US$7,855	2. Inadequate supply of infrastructure	14.60%
Annual growth 2013	4.30%	3. Inefficient government bureaucracy	12.20%
Avg. GDP growth 2008-13	4.10%	4. Access to financing	8.10%
Global Competitiveness Rank	69	5. Crime and theft	8.10%
Source: *World Economic Forum, Global Competitiveness Report 2013-14 National statistics*			

SWOT Analysis: Because of its geographical location (with Pacific and Atlantic coasts), size, mineral resources and population, Colombia is a more significant player on the regional scene than any of the other three counties discussed here.

Its **strengths** include what are seen as sound and stable market-friendly policies, particularly in areas such as the treatment of foreign investment. Also important are the country's rich mineral resources, including iron ore, coal, nickel oil and gas, and precious metals such as gold, silver and platinum. Colombia has a diversified economy ranging from agriculture, the export of flowers to nearby destinations such as the US, significant manufacturing, and services including tourism and call centres.

Yet Colombia's **weaknesses** are also substantial. Perhaps the single most important is over half a century of left-wing guerrilla insurgencies that have turned significant parts of the country into no-go areas for normal business activity, and added major security costs to what gets done elsewhere. To this are added the major negatives of drug production and export, corruption, and the activities of well-organised criminal gangs. Underlying these phenomena are high levels of poverty, unequal income distribution, and poor levels of education.

"But we caution that Colombia's economic policy challenges will not fade into the background. One key reason for this is that left-wing parties helped swing the vote in Santos' favour in the second ballot, and retain an influential presence in congress."

The major **opportunities** facing the country include pacification. The debate on how to achieve it, through negotiation with, or military containment of, the guerrilla movements has been raging for over a decade, and was at the core of this latest election contest. However achieved, it is widely held that the result would be a major peace dividend, allowing a significant acceleration of the annual rate of GDP growth.

Threats include the ever-recurring possibility of an intensification of the cycle of violence. On a more narrowly economic level, Colombia is exposed to the negative effects of a downturn in commodity prices and an over-expansion of credit, with inflationary consequences.

Political baggage: On the surface, this election was about one issue over all others – the current peace talks with Colombia's main guerrilla movement, Fuerzas Armadas Revolucionarias de Colombia (Farc); talks with the second, Ejército de Liberación Nacional [ELN] are in the pipeline also – and not about economic policy at all. Santos, who favours the continuation and conclusion of the peace talks with the Farc being hosted in Havana by the Cuban government, defeated his more conservative rival, Oscar Iván Zuluaga, who was much less enthusiastic about a settlement. Both men had served as ministers under the former two-term president Alvaro Uribe (2002-2010, Santos in defence, Zuluaga in finance) and both seemed to be offering a continuation of the market-friendly policies that Uribe had pursued. Under Uribe, who launched a sustained and largely successful heavy military assault on the Farc and drug trafficking in the country, with the support of the US, real annual growth averaged 4.5% per annum, a rate that rose to 4.8% during his successor's first term. Santos, who once in office broke with the hard-line Uribe, was able to launch social programmes that have begun to ease inequality: he also boosted trade and moved to tackle the country's infrastructure investment deficit. So the conventional wisdom says that economic policy will remain unchanged, but overshadowed by politics, as the peace talks occupy centre-stage.

But we caution that Colombia's economic policy challenges will not fade into the background. One key reason for this is that left-wing parties helped swing the vote in Santos' favour in the second ballot, and retain an influential presence in congress. Although centrist parties aligned with Santos's coalition, Nueva Mayoría, control roughly 55% of the seats in congress, a group of smaller and left-wing parties, with about 10% of the votes, may be

essential to get legislation approved (bearing in mind that a two-thirds majority is needed for constitutional reforms). This group of parties will not automatically sign up to an orthodox economic policy view; they will be seeking more action on redistribution.

Issues: The temptation for Santos will be to disregard the need for structural economic reforms and concentrate instead on achieving peace, in the hope that it will eventually produce an economic dividend. While the need to settle over half a century of near-civil war is obviously a priority, we would caution that the need for economic reforms is likely to become more, rather than less acute. The outline peace agreement reached so far – on agricultural development, political representation for demobilising guerrillas, and the Farc's pledge to get out of the illegal drugs business, all require a combination of faster economic growth and greater redistribution of income. Meanwhile, with the peak of the commodity export boom having passed, Colombia's growth rate is set to ease down, rather than up. One of Santos' top priorities should be to revert this trend.

HONDURAS

In a vicious cycle

The economic imbalances in Honduras remain large, particularly for a country where institutions are weak and where the rule of law is absent.

Alarming statistics about Honduras are easy to find. According to the US State State Department's 2014 International Narcotics Control Strategy Report (INCSR), some 86% of all cocaine entering the US is believed to have come through the Mexico-Central America corridor. Not all the cocaine travels by air (and Caribbean Sea routes have recently been revived, according to the US military's Southern Command). However, some three quarters of all planes smuggling cocaine out of South America first land in Honduras. "The Caribbean coastal region of Honduras is a primary landing zone for drug-carrying flights and maritime traffic. The region is vulnerable to narcotics trafficking due to its remoteness, limited infrastructure, lack of government presence and weak law enforcement institutions. Drug trans-shipment to points north from the Caribbean coastal region is facilitated by subsequent flights north as well as by maritime and riverine traffic and land movement on the Pan American Highway", notes the INCSR.

Widespread poverty is a key element. According to the United Nation's Economic Commission for Latin America and the Caribbean (ECLAC), the overall population and the urban population are growing at 1.9% and 2.9% annually. For Honduras as a whole, the poverty rate was 67.4% in 2010 (the latest year for which ECLAC publishes the data). In the countryside, the figure was 76%. Some 42.8% of Hondurans, and 56.8% of rural Hondurans were living in extreme poverty, on the ECLAC 2010 data. Social public expenditure was only 12% of GDP. Since then, the situation has deteriorated to the point that on some estimates by local NGOs, for instance, the overall poverty rate has hit 70% or more.

"According to the United Nation's Economic Commission for Latin America and the Caribbean (ECLAC), the overall population and the urban population are growing at 1.9% and 2.9% annually. For Honduras as a whole, the poverty rate was 67.4% in 2010 (the latest year for which ECLAC publishes the data)."

As **chart 1** (*overleaf*) indicates, crime and poverty have a profoundly negative impact on perceptions of Honduras as a place in which to do business. According to the World Economic Forum (WEF)'s 2013/14 Global Competitiveness Report, Honduras ranked well down at number 111 – of the 148 countries assessed – for overall competitiveness. It ranked last – 148/148 – for the business costs of crime and violence. The country had similarly bad rankings for the wastefulness of government spending (145/148) and the reliability of police services (142/148). Unsurprisingly then, inefficient government bureaucracy, corruption and crime & theft are the three factors that businesses operating in Honduras say they find most problematic.

NB
Overall ranking of Honduras in 2013/14: 111/148

Institutions: 134/148

Favouritism in government officials' decisions: 135/148

Wastefulness of government spending: 145/148

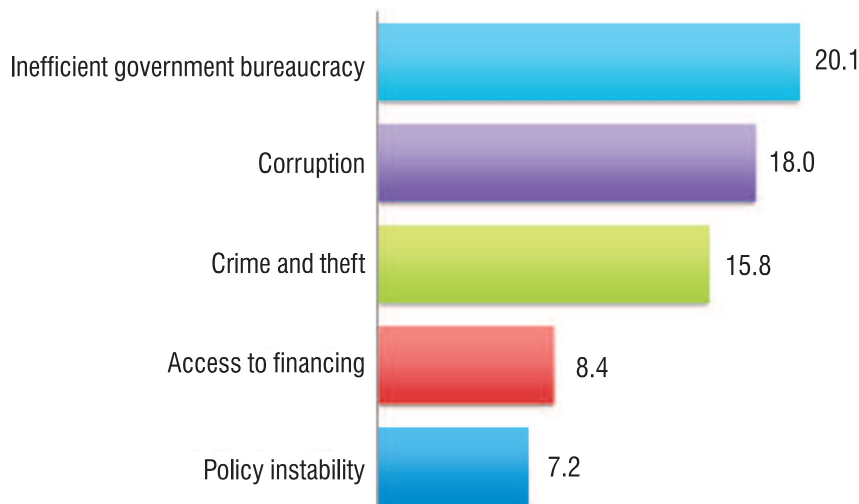
Business costs of crime and violence: 148/148

Reiiability of police services: 142/148

Efficacy of corporate boards: 69/148

Business sophistication: 90/148

Chart 1: The most problematic factors for business



Source: WEF Global Competitiveness Report 2013/14, weighted responses

Honduras is not the only country in the region in which bureaucracy, corruption and weak institutions are seen as major challenges. However, most of the other countries are characterised by macroeconomic environments that are, if not improving, then at least clearly stable. The final two problematic factors identified on **chart 2** – access to financing and policy instability – are worrying indicators that this is not the case in Honduras.

In mid-June 2014, the International Monetary Fund (IMF) concluded its regular Article IV consultation with the government. The IMF's views of the country's prospects are summarised in **chart 2**. The IMF noted that many of the challenges facing policy-makers in Honduras through 2013 originated from outside the country. Economic growth slowed from around 4% in 2012 to 2.6% in 2013 "owing to lower private investment, a drop in coffee output due to leaf-rust disease, and weaker trade partner growth.

Chart 2: Honduras' economy – as the IMF sees it

	2012	2013e	2014e	2015e	2016e	2017e	2018e
Gross domestic product, constant prices (% change)	3.9	2.6	3.0	3.1	3.2	3.0	3.0
Gross domestic product, current prices (US$bn)	18.5	18.8	19.6	20.4	21.1	21.7	22.3
Gross domestic product per capita, current prices (US$)	2,331.2	2,323.1	2,367.8	2,421.7	2,453.7	2,474.9	2,484.1
Total investment (% GDP)	25.9	24.4	23.9	22.7	22.5	22.0	21.9
Gross national savings (% GDP)	17.3	15.7	16.4	16.7	16.9	16.4	16.3
Inflation, end of period consumer prices (%)	5.4	4.9	7.0	6.0	5.5	5.5	5.5
Volume of imports of goods and services (% change)	7.3	-1.3	6.7	4.0	4.1	4.1	4.1
Volume of exports of goods and services (% change)	10.6	-0.8	3.8	3.8	4.1	4.1	4.0
Unemployment rate (% labour force)	4.4	4.4	4.5	4.5	4.5	4.5	4.5
Population (mn)	7.9	8.1	8.3	8.4	8.6	8.8	9.0
General government revenue (% GDP)	22.5	22.4	24.6	24.7	25.6	25.8	25.9
General government total expenditure (% GDP)	26.6	29.8	30.9	30.7	31.3	31.6	31.8
General government gross debt (% GDP)	34.4	40.2	44.9	48.6	52.0	55.5	59.2
Current account balance (% GDP)	-8.6	-8.8	-7.4	-6.0	-5.6	-5.6	-5.6

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

Inflation declined to 5%...driven by softer commodity prices, weaker economic activity, and lower currency depreciation. On the external front, the current account deficit rose to about 9% of GDP in 2013, reflecting less favourable terms of trade and a drop in coffee exports". International reserves rose to 3.7 months of imports, thanks to inflows of foreign direct investment (FDI) and the raising of US$1bn through two global bond issues.

The current account deficit is sufficiently small in absolute terms that it should usually be financed. The main problems stem from public finances. In spite of some moves to improve the tax administration and to control public spending, it appears likely that the government will be running a deficit of around 5%-6% of GDP in calendar 2014 and over each of the next four years. On its own, this would not normally be a problem. However, the lack of competitiveness of the economy means that it is only likely to grow at around 3% annually: further, gross government debt already amounts to around 40% of GDP. According to the IMF's forecasts, the debt/GDP ratio will probably grow steadily through the forecast period to reach 59% by the end of 2018.

> "Newsflow over the last three months or so has been positive, but has generally alluded to particular initiatives to increase the competitiveness of the economy – and not to wholesale reforms of Honduras' unbalanced public finances. Hondutel, the state owned telecoms operator, has eliminated over half of its management positions as a part of a restructuring process."

Newsflow over the last three months or so has been positive, but has generally alluded to particular initiatives to increase the competitiveness of the economy – and not to wholesale reforms of Honduras' unbalanced public finances. Hondutel, the state owned telecoms operator, has eliminated over half of its management positions as a part of a restructuring process. The company suffered net losses in 2013 of around US$30mn. It only has 146,000 subscribers, while Claro and Tigo – its main private sector competitors – serve a combined 7m. For its part, the government announced that it had received 790m lempiras (US$41.4mn) from Tigo in consideration for a seven-year extension to that company's concession. At the beginning of June, the port authority ENP announced that it is looking for an external consultant to undertake an environmental audit of the expansion of the port of Cortés. The audit will be a part of a wider project to modernise the port, which is being funded by the Inter-American Development Bank (IDB).

In short, our view is that Honduras remains trapped in a vicious cycle of poverty, poor governance, low competitiveness and low growth. Although a financial crisis is not imminent, the risks are growing steadily. The absence of the rule of law and the weakness of Honduras' institutions are exacerbating the economic problems, and vice versa. Over recent years, this has been the challenge in Jamaica too, but in few other countries in the region.

DOMINICAN REPUBLIC

Steady as she goes: Institutional reform continues

At the end of August last year, the Banco Central de la República Dominicana (BCRD – the central bank) chose to hike its key policy rate by 200 basis points to 6.25%, in response to currency volatility. It had previously reduced the rate by 75 basis points in late May 2013 in order to counter the general softness of economic activity.

As of mid-June 2014, the latest commentary and data indicate that neither the slippage in the Dominican peso nor the BCRD's response, have had a lasting and adverse impact. In the commentary following its latest monetary policy meeting in late May, when the rate was held constant at 6.25%, the BCRD noted that inflation remains under control. Year-on-year inflation in April was 3.49%, or at the lower end of the central bank's target band of 3.50%-5.50%.

In addition, the latest readings from the BCRD's Monthly Economic Activity Indictor suggest that domestic demand could grow faster than the central bank anticipates. As of the end of May, broader monetary aggregates had been rising at a year-on-year rate of 10% or so, while credit to the private sector was up by 13%. Public sector investment has been broadly in line with the government's budget, and at a time that tax collections have greater than anticipated. During the first three months of 2014, the Dominican Republic ran a current account surplus.

The International Monetary Fund (IMF) was similarly upbeat in mid-2014 following the conclusion of its regular Article IV consultation. The large increase in the fiscal deficit in 2012 was partially reversed in 2013. The deficit of the consolidated public sector declined by almost 3 percentage points of GDP, to 5%, owing the lower investment expenditure, the yield of the 2012 tax reform and the negotiation of new payment terms [with Canada's Barrick Gold].

The IMF noted that the public-debt to GDP ratio had risen from 35% in 2008 to nearly 48% as at the end of 2013. "The government's fiscal targets for 2014 envisage a further decline in the overall public sector deficit to 4.2% of GDP, but this may not be sufficient to place the public debt ratio on a downward trajectory". The challenge of funding the deficit, at a time that the global economy is still growing fairly slowly, is seen as a major source of downside risk for the Dominican Republic over the medium term.

Chart 1: The Dominican Republic's economy – as the IMF sees it

	2012	2013	2014e	2015e	2016e	2017e	2018e
Gross domestic product, constant prices (% change)	3.9	4.1	4.5	4.1	4.1	4.0	4.0
Gross domestic product, current prices (US$bn)	59.0	60.8	62.8	65.1	68.4	71.8	75.4
Gross domestic product per capita, current prices (US$)	5,765.0	5,834.4	5,922.6	6,031.5	6,228.1	6,424.8	6,627.8
Total investment (% GDP)	16.4	15.8	15.8	15.7	15.5	15.3	15.1
Gross national savings (% GDP)	9.6	11.6	11.3	10.5	11.1	11.6	11.3
Inflation, end of period consumer prices (%)	3.9	3.9	4.5	4.0	4.0	4.0	4.0
Volume of imports of goods and services (% change)	0.7	-2.8	6.3	7.6	1.6	1.9	4.0
Volume of exports of goods and services (% change)	6.9	6.2	7.2	5.9	3.7	3.7	3.7
Unemployment rate (% labour force)	6.4	7.0	6.1	5.9	5.7	5.7	5.7
Population (mn)	10.2	10.4	10.6	10.8	11.0	11.2	11.4
General government revenue (% GDP)	14.0	14.7	15.2	14.6	14.4	14.4	14.4
General government total expenditure (% GDP)	20.7	18.3	18.0	18.0	18.1	17.4	17.4
General government net debt (% GDP)	30.2	33.8	35.4	36.7	38.4	39.4	40.3
General government gross debt (% GDP)	30.2	33.8	35.4	36.7	38.4	39.4	40.3
Current account balance (% GDP)	-6.8	-4.2	-4.5	-5.2	-4.4	-3.7	-3.8

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

Chart 1 highlights a number of key aspects of the economy, as the IMF sees them. The gap between government revenue and expenses is the main imbalance in an economy that should achieve stable growth with low inflation, and unemployment that is, by many standards, quite low. Investment is expected to run at around 16% of GDP over the coming years. This is consistently in excess of overall savings: however, at 4%-5% of GDP over the next three years or so, the current account deficit is manageable. What the table does not show is that poverty and extreme poverty affected 41% and 11% of the population, respectively, in 2012. Job creation and boosting household incomes should be a priority for the government.

NB

Overall ranking of the DR in 2013/14: 105/148

Institutions: 124/148

Favouritism in government officials' decisions: 145/148

Wastefulness of government spending: 138/148

Reliability of police services: 143/148

Business costs of crime and violence: 131/148

Protection of minority shareholders' interests: 66/148

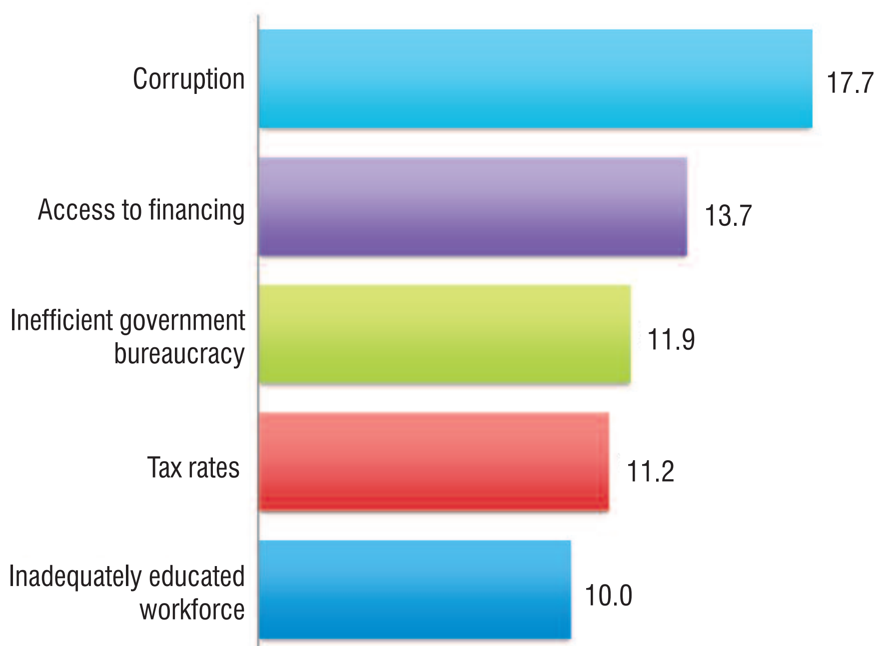
Business sophistication: 71/148

For its part, the IMF advocated the acceleration of structural reforms. These include "the authorities' plans to invest in electricity generation provided they do not undermine public finances". The IMF also advocates flexibility in power tariffs (so that they can move in line with energy costs): this should encourage private investment into the Dominican Republic's energy sector.

Over recent weeks, a number of announcements from the government have been consistent with greater private sector participation in utilities and infrastructure. In early May 2014, for instance, water agency Inapa launched a tender for the installation of water metering systems, as part of a project being financed by the Inter-American Development Bank (IDB) and the Fondo Español de Cooperación para Agua y Saneamiento en América Latina y el Caribe (FECASALC). Inapa separately announced a tender for waterworks consultancy services at the end of May.

The latest (2013-14) World Economic Forum (WEF)'s Global Competiveness Report indicates that the move towards privatisation should deliver positive results. As **chart 2** shows, businesses perceive corruption and inefficient government bureaucracy to be among the most problematic factors for doing business in the Dominican Republic. While the Dominican Republic is assessed by the WEF as being the 105th most competitive economy overall (out of 148), it ranks 124th in terms of its institutions. The country receives particularly low ratings for favouritism in government officials' decisions (145/148), reliability of police services (143/148), and wastefulness of government spending (138/148). Conversely, the Dominican Republic is the 71st ranked country in terms of overall business sophistication and 66th in terms of the protection of minority shareholders' interests.

Chart 2: The most problematic factors for business



Source: *WEF Global Competitiveness Report 2013/14, weighted responses*

Looking forward, we would agree with the broadly optimistic view of the IMF and the BCRD, especially as the Dominican Republic is an obvious beneficiary of the steady recovery of the US economy. It is possible that the US achieves real growth in 2014 that exceeds the 2.8% envisaged by the IMF: not all the risks to the Dominican Republic are on the downside. We would see further announcements by the government in relation to the liberalisation of utility tariffs and use of private sector solutions over the coming months as also being good news.

CUBA

Market experiment on a (smaller) island

At the beginning of June, the Cuban government started another liberalisation experiment, by allowing the creation of a private agricultural wholesale market, where farmers can buy and sell agricultural supplies. Initially, the experiment is confined to Isla Juventud, a small island off the south-west coast, with a population of 60,000. Depending on the results, it may then be rolled out nationally.

Although there has been some liberalisation of the agriculture sector nationally, with farmers allowed to grow their own crops, the authorities clearly think more needs to be done. Agricultural output has not increased significantly since liberalisation began six years ago. Cuba still has to import 60% of its food. And farmers must still buy inputs such as fertilisers and fuel from the state, usually at subsidised, centrally-controlled prices.

The *Reuters* news agency has reported that the Isla Juventud pilot programme is allowing farmers to buy and sale inputs freely, in effect creating Cuba's first agricultural wholesale market since the 1959 Revolution. It cited local economist Armando Nova, who noted that, "agriculture is cyclical. You need to close the cycle for reforms to work and that now means the inputs". But initial reactions have been sceptical, with one farmer noting drily, "nothing works like they say it will". Another was impressed with the first price lists for fertilisers and herbicides, but noted that "they didn't include the most important agricultural input, diesel fuel".

"Cuba still has to import 60% of its food. And farmers must still buy inputs such as fertilisers and fuel from the state, usually at subsidised, centrally-controlled prices."

The experiment coincided with an unusual event: a three-day visit to Cuba by a delegation from the US Chamber of Commerce. The first since 1999, it was billed as a chance to assess the pace of Cuban private sector growth and the development of foreign investment opportunities. The delegation included senior executives from Cargill, the giant US commodity trading company. Cuba already sources much of its food imports from the US under a special provision in the economic embargo; the US agri-lobby is one of the strongest advocates on Capitol Hill for an end to the half-century old embargo.

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