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# Venezuela: Government makes latest debt payments, but may yet default

**Venezuelan investors had long been focused on two large debt repayments, one at the end of October (for US$1bn) and one at the beginning of November (for US$1.2bn), as an indication of whether the Caracas government led by may default. The consensus view was that if the payments were made, the risk of default would ease, as the repayment schedule thereafter is relatively light until next April. Yet President Nicolás Maduro's announcement, immediately after making the repayments, that he intended to restructure the country's external debt burden has reignited concerns that this might mean an imminent default.**

Part of the problem is that the Venezuelan government has been very unclear about what it is trying to achieve. President Maduro spoke of a need to "refinance and restructure all of Venezuela's external debt", calling bondholders to a hastily-arranged meeting in Caracas on 13 November.

Yet it is very unclear whether this will involve a refusal to service future repayments (implying a default), or whether the government is seeking to re-profile existing liabilities. Parallels have been drawn with Uruguay's successful voluntary debt exchange in 2003, which pushed back maturities on most of the existing public debt stock, with most bondholders choosing to participate. The operation eased immediate liquidity problems and did not result in Uruguay being shut out of capital markets for long.

## Venezuela is no Uruguay

Yet there are many reasons why Venezuela would struggle to pull off a similar restructuring. Firstly, bondholder interest is unlikely to be strong. The powerful vice president, Tarek El-Aissami, is leading the debt renegotiation process, but US authorities placed sanctions against him in February 2017, alleging his role in international narcotics trafficking. This means that US nationals are prevented from engaging in financial transactions or dealing directly with El-Aissami.

Given that he will be chairing the upcoming 13 November meeting, US bondholders are unlikely to attend. Whilst their physical absence does not in itself preclude participation in any bond swap, doing so potentially could be interpreted as engaging in financial transactions with the vice-president, even if indirectly. This is likely to mean that very few US bondholders participate.

Other investors will also be wary for different reasons. With US-dollar liquidity very low, there is virtually no likelihood that Venezuela will be able to avert default in the medium term (the credit default swap [CDS] market assigns a 99% probability to a default within the next five years), so non-US bondholders will be reluctant to agree to push back maturities when the Caracas government looks almost certain to default before then.

Furthermore, there is no indication that the government is either capable of or willing to alter its unorthodox economic policy stance, so deep economic distortions will continue.

Finally, investors holding debt that falls due in 2018 will be particularly reluctant to participate and will probably hold out for payment, on the assumption that Maduro would want to avoid a messy default before the next presidential election, which is due in December 2018.

### Smoke and mirrors

Although many accuse the Venezuelan government of burying its head in the sand in terms of economic policy, it will be aware of these international realities.

President Maduro will have known that by deliberately tasking El-Aissami with the restructuring process, any participation would be very low. This begs the question of what ulterior motive might lie behind the restructuring efforts. This has sparked speculation about whether the government is preparing the ground for a deliberate default, calling the Caracas meeting in order to provide grounds for arguing that it had sought in advance of that to 'co-operate' with bondholders on an orderly re-profiling.

The question then arises of what debt the government would choose to default on in such a scenario, with notes from the state oil company Petróleos de Venezuela (PDVSA) looking much less attractive than sovereign debt (or bonds issued by the state-owned Electricidad de Caracas, known as Elecar). This is because defaulting on PDVSA bonds would almost certainly prompt bondholders to seize PDVSA's overseas assets, which would severely compromise the country's oil-exporting capacity and therefore bring the government to its knees.

If the government does opt to default, it may therefore decide to hedge its bets and do so on sovereign or Elecar debt, in the hope that overseas PDVSA assets would not be liable for seizure.

This would not be without risk, however, with legal wrangles likely over exactly what constitutes overseas sovereign assets. The Canadian gold mining firm Crystallex is in the midst of such a debate, and is pressing US courts to authorise the transfer of shares from a US-based PDVSA subsidiary to its company accounts as part-payment for a US$1.4bn arbitration awarded by the World Bank in 2016, but which the Venezuelan government has not yet paid. The conclusion of this legal process will have implications for whether Venezuela decides to default on sovereign or Elecar liabilities.

### Accidental default is still a risk

If Venezuela does not default voluntarily, there is still a significant risk of an accidental default in the coming year. The government is already late on several of the smaller bond repayments that fell due in recent weeks, using the 30-day grace period to find the cash. International reserves have gone from US$10.2bn just prior to the US$1bn repayment on 27 October to US$9.7bn on 3 November (just after the US$1.2bn 2 November repayment).

Given that gold accounts for most of this, it is likely that the government has now exhausted virtually all of its cash reserves; recent months it appears to have set aside US dollars from oil sales to make these repayments, at the expense of ever-declining essential imports and the continuing deterioration of conditions on the ground.

As a result, assuming that few investors with debt falling due next year will agree to restructure, the government will have to find US$7bn to remain current on its 2018 obligations. That figure is significantly higher when incorporating the oil-for-debt agreements signed over the years, which do not show up in the official statistics, as well as arbitration payments.

The New-York and Caracas based fund Torino Capital has estimated that including these items, the government faces repayments totalling US$22.5bn next year, rising to US$25.2bn in 2019. These figures could fall if Russia agrees to restructure its oil-for-debt liabilities, but even assuming this is the case, it is difficult to see how the government will avoid a default for much longer. For example, on 8 November the Russian finance minister, Anton Siluanov, confirmed that a restructuring deal covering US$3bn in Venezuelan debts had been agreed, which will free up some money for redirection elsewhere, but in the grand scheme of things, this does not resolve Venezuela's position.

### IMF preparing for large-scale bailout

In this context, reports surfaced in mid-October that the IMF was beginning to prepare for a large-scale default. Fund officials reportedly have been calculating likely financing needs, with annual figures of around US$30bn mentioned, which would make it one of the IMF's largest-ever bailouts.

This preparation remains highly theoretical at present, with relations between the Fund and the Venezuelan authorities remaining highly strained. The last formal Article IV consultation was in 2004, and the IMF in early November drew attention to Venezuela's continued failure to provide basic economic data. The IMF's Executive Board stated that the Venezuelan government was in breach of its obligations to provide data on the social security institute, as well as merchandise trade statistics, and gave the government a six-month period to take remedial measures. The Executive Board did not state what would happen if Venezuela does not meet these data publication requirements, but it is possible that Venezuela could be expelled from the Fund if it continues to flout its membership terms.

This would not impact upon any subsequent IMF bailout, as a successor government likely would quickly restore official ties with the Fund. However, a wholesale reassessment of the country's borrowing needs would be required in the event of talks on a bailout deal. Notably, Venezuela's current IMF quota stands at SDR3,722.7bn (equivalent to around US$5.2bn); the Fund usually only allows countries to borrow 145% of its quota annually, with a cumulative cap of 435%.

In the meantime, the IMF's public expression of frustration with the gaping holes in the official macroeconomic data will only serve to reinforce the Maduro government's glaring lack of financing options, since other bilateral and multilateral lenders will also be loath to extend further credit to an administration that continues to teeter on the edge of default.

Fitch Ratings on 7 November downgraded PDVSA from 'CC' to 'C', which denotes that "a default or default-like process has begun". The Fitch revision is in line with that of Moody's Investors Service, which lowered its credit rating for PDVSA a day earlier. A Fitch statement said it now believed it "highly probable" that PDVSA would default on its bond payments, and considered it unlikely that the firm would receive any more aid from the cash-strapped Maduro government. Significantly, Fitch noted that it expected PDVSA investors to recover only 31% to 50% of their holdings in any restructuring, "and likely closer to the lower end of the range".

## MEXICO

### Nafta talks get stuck

**The fourth round of Nafta renegotiation talks, held in Arlington, Virginia on 10-17 October, did not go well. Four or five fundamental issues are separating the US, on one side, from Mexico and Canada on the other. As a result, the three countries agreed to a month-long pause to review their positions, with the fifth round now set for Mexico City on 17-21 November. The trade negotiators have also admitted that the talks won't conclude this year, as originally hoped, but will run on into early 2018. Some think the chances of the 1994 treaty being terminated now stand at over 50%.**

One source told the *Reuters* news agency that the atmosphere in the latest round of talks was tense and "horrible". There is deadlock on at least four major issues. In the automotive industry trade, the US reportedly is insisting on much tighter local content rules. To benefit from free trade within the block, vehicles currently have to have a minimum of 62.5% in Nafta-content by value. The US wants that proportion to be raised to 85%, and for there to be a further requirement for 50% specifically US-made content in its own domestic market. This demand is rejected by both Canada and Mexico.

A second sticking point is that under the Trump administration's 'Buy American' policy, the US wants to restrict the ability of Mexican and Canadian companies to bid for US government contracts. Thirdly, the US delegation wants to insert a so-called Sunset Clause, under which Nafta would automatically terminate every five years, unless specifically extended by the three signatories following a review. While Washington argues that this would create a valuable incentive to continually update and modernise the deal, Canada and Mexico say it would create unnecessary uncertainty and scare off long-term investors in the North American market. Fourthly, the US wants to scrap the current tripartite trade disputes procedure, a move particularly opposed by Canada. Other points of friction included the treatment of US-Canada trade in dairy and softwood lumber products, and the possibility of new restrictions on long haul trucking from Mexico into the US.

At the end of the talks, the US Trade Representative Robert Lighthizer said he "was surprised and disappointed" by the resistance to change coming from the other two countries. He claimed that the changes the US was seeking were necessary to make Nafta a fairer treaty. He also argued that the other two countries had a responsibility to help rebalance and reduce the size of the US trade deficit. Canada's foreign minister, Cynthia Freeland, said the US was trying "to turn back the clock" on trade relations, applying a "winner-takes-all" approach, which was "troubling". The leader of the Mexican delegation, Economy Minister Ildefonso Guajardo, avoided direct criticism of Lighthizer, but warned that "a bad deal would be against the interest of Mexico itself, and therefore you have my guarantee that there will not be a bad deal."

There is continuing speculation over US intentions. As in earlier rounds, this appears to have been deliberately fuelled by President Donald Trump. In an interview with *Forbes* magazine published the day the fourth round of talks began, Trump said, "I happen to think that Nafta will have to be terminated if we're going to make it good". Phil Levy, a senior fellow at the Chicago Council on Global Affairs, asked rhetorically whether the US delegation was going to work its way through the disagreements, or take them as a pretext to say, "we tried negotiations, they failed, now we need to blow this up". Like many, Levy says he now rates Nafta's chances of survival at less than 50%. Jorge Guajardo, a former Mexican ambassador to the US and now a director at consultancy McLarty Associates, took a similar approach. "Everybody in Mexico is ready for a walkout. Everybody's just going into Plan B mode, sort of in a 'Nafta is over, let's move on and figure out what's next'".

## Life after Nafta

**In the US, Mexico and the rest of Latin America, policy makers are beginning to focus on what might happen if Nafta collapses. It is not yet clear whether one of the world's largest free trade agreements will actually come to an end, but governments are reassessing the threats and opportunities that might exist in that scenario.**

In the US, there has been a long and highly political debate about the impact of Nafta. Opponents such as President Trump have insisted that it has sucked business and manufacturing jobs out of the US. But while this has certainly happened in some cases, it is also true that Nafta has also helped create jobs in the US. The precise balance between those two different effects is hard to disentangle. The non-partisan Congressional Research Service, in a review of academic studies carried out over the last two decades, concluded that Nafta had little or no effect on employment in the US. It has also been pointed out that Nafta trade flows, at US$1.2tn, represent only 6% of US GDP.

That said, a number of US business groups have begun to express concerns about the impact of leaving Nafta. The president of the powerful US Chamber of Commerce, Tom Donohue, described some of the US formal demands at the Nafta negotiating table – such as the request for increased local content in the automotive sector – as "poison pills". Lance Fritz, chief executive of the Union Pacific railway company (which operates many US-Mexico routes), said US withdrawal from Nafta would be "disastrous", with US businesses, consumers, and jobs all suffering. Caroline Freund of the Peterson Institute for International Trade notes that a whole string of trade tariffs and barriers would come back into effect, although some of the US imports tariffs might be relatively low. By contrast, Mexican tariffs on imports of US farm products would go up considerably – up to 37% ad valorem on maize. This explains the particular concern of US agriculture and farm lobbies over a Nafta-free future.

Clearly, the country that could suffer the biggest negative impact from the termination of Nafta is Mexico. In late October, the credit ratings agency Standard & Poor's (S&P) said that any termination of Nafta would force it to review Mexico's investment-grade sovereign rating (currently BBB+ with a stable outlook). Roughly 80% of Mexico's exports go the US market. Bilateral trade is currently running at an annual rate of US$525m. It is likely that Mexico's close integration with the US economy would not go into reverse overnight, but it would be affected at the margins. Going forward, future export-manufacturing growth rates – currently one of the most dynamic in the Mexican economy, could be affected

According to some analysts, if Mexico-US trade were to revert to World Trade Organisation (WTO) tariffs, Mexican exports to the US would probably pay lower tariffs overall than imports from the US. Many exports would continue to be zero or low-rated. Automotive exports would pay a 2.5% tariff, while commercial vehicles would pay up to 25%. In this scenario, it is expected that many companies would review the location of their production plants to minimise costs and tax liabilities. Given that presidential elections are due next year, Mexico might itself turn in a protectionist direction. In that scenario, cooperation on immigration and security issues covering the two countries and Central America would probably fall.

Mexico might remain pro-free trade, but try and perform a pivot intended to reduce its economic reliance on the US. That would probably involve reducing agricultural and beef imports from the US and switching instead to Brazil and Argentina as its favoured supplier. Perhaps as a small pilot project, Mexico has bought 30,000 tonnes of Argentine wheat due for delivery in December. This is tiny compared to the 12m tonnes the country imports from the US, but it might herald the beginnings of a diversification process. Likewise, according to Rubens Barbosa, a former Brazilian ambassador to the US, Mexico might try to export more of its manufactured products to South America.

## ARGENTINA

### Big reforms in the pipeline?

**President Mauricio Macri's ruling Cambiemos coalition did well in the October mid-term elections, strengthening its position in congress, although it still fell short of achieving an outright majority. Macri is now half-way through his four-year term, with analysts speculating that he may run for a second four-year term in 2019. In a keynote speech after the elections, he mapped out an ambitious programme of structural reforms.**

Two forces now seem to be influencing Argentine economic policymaking. There is a degree of tension between them. Firsly, with the mid-term elections behind it, the government is now committed to a substantial programme of economic reform and modernisation. Secondly, the Macri team recognises that that to get its reform agenda approved by congress, it will need to negotiate a number of deals with opposition political parties, trade unions and business lobbies. So there is both a sense of urgency and an awareness of the political realities and/or obstacles that might hold things back.

In his speech, delivered on 30 October, Macri outlined his agenda for change. He noted that with the exception of the internationally-competitive agricultural sector, Argentina remains a largely-closed and uncompetitive economy, with entrenched special interests opposed to modernisation (he called them "mafias"). To create a more open economy, everyone would have to cede something. Specifically, reforms were needed covering taxes, pensions, labour, competition policy, trade barriers, fiscal deficit reduction, inflation and competitiveness.

Ministers and officials are signalling a general consultative approach to this complex set of issues, with industry and other interested parties to be consulted before reform bills are submitted to congress. The government will also listen to the IMF, which has just sent a mission to Argentina under the now-reinstated Article IV consultation process (suspended for over a decade by the previous administration). Rather than a 'big bang' approach, the thinking is that reforms will be implemented gradually and in stages. Cabinet Chief Marcos Peña gave pension reform as an example, saying that much-needed reform of the loss-making state pension system could be introduced over a three-year timeframe, in set-by-step fashion, as and when agreements are reached.

There also seems to be agreement that tax reform is one of the top priorities. Argentina represents the worst of both worlds as far as taxation is concerned. The country has high taxation rates combined with comparatively low tax revenues – reflecting still widespread tax evasion. Finance Minister Nicolás Dujovne therefore is seeking an adjustment whereby tax rates will be cut on average (albeit some individual rates will be increased), but their scope will be widened, and evasion reduced.

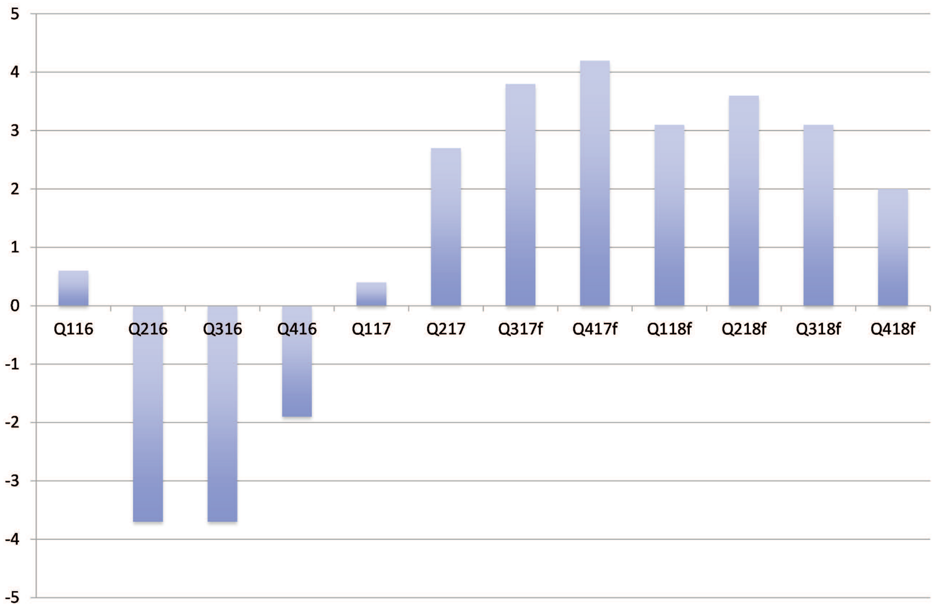
One significant innovation is that the government is planning to introduce a tax on interest-bearing deposits. Argentina is one of only a few countries where such deposits are still largely tax free. Some economists claim that this has encouraged the over-development of the *microcentro* – the financial district in Buenos Aires (also known as *La City*)– at the expense of investment in commercial and industrial investment.

According to reports, the government is looking to tax interest income from dollar deposits at a 15% rate. Fixed term peso deposits would be taxed at 5%. High taxes on some products (such as a 17% tax on mobile phones) may be reduced, while those on luxury cars and yachts may be increased.

Dujovne has admitted he will have to navigate a tricky path between cutting tax rates to boost consumption and enterprise and reducing the fiscal deficit to keep a lid on government debt. A significant challenge is that to reduce the deficit, the federal government will need the collaboration of the country's 23 provincial administrations. Different factions of the opposition Peronist party control 10 of those provinces. One of the reforms being sought will affect 'co-participación', the regulations setting out how federal tax revenues are shared out with the provinces.

**Argentina: an optimistic growth outlook?**

*GDP y-o-y % (actual to Q217, forecast from Q317)*




***Source:*** *INDEC and BBVA*

The markets have welcomed the results of the mid-terms and broadly interpreted them as strengthening the prospects for reform. Credit agency Standard & Poor's raised its Argentina rating to B+ from B, with a 'stable' outlook. It said it was expecting "moderate but sustained" real annual GDP growth of around 3% per annum over the next three years. Marcelo Capello of the Fundación Mediterránea/IERAL think tank said he wouldn't be surprised if GDP rose by 4% in 2018, although he warned that the big challenge for the Macri government was to create employment in those economic sectors most closely linked to international trade.

## Energy privatisation?

According to an official quoted off the record by *Reuters*, the government is considering plans to sell off its shareholding in a number of energy companies, with a view to raising up to US$1bn next year; which would be used to help fund infrastructure projects.

The companies slated for offer include the thermal power stations Central Térmica Guemes and Central Puerto, along with some power distribution companies. As part of a general restructuring, a new umbrella company – Integración Energética Argentina – would be set up to manage a variety of energy infrastructure investments, including two hydroelectric projects in Patagonia and four gas pipelines. So far, the Macri administration has denied intermittent opposition claims that it is planning large-scale privatisation.

In the 2015 elections, however, Macri specifically stated that he would not privatise either the national oil company, Yacimientos Petrolíferos Fiscales (YPF), or the country's airline, Aerolíneas Argentinas (AA), both of which had been renationalised by the preceding government.

## BRAZIL

### Pension reform back on the agenda

**On 25 October, the Chamber of Deputies voted 251-233 to dismiss the latest corruption charges against President Michel Temer, making it highly likely that he will be able to complete the remaining 14 months of his term in office. The decision means that pension reform – considered essential to reduce the country's endemic fiscal deficit and rising debt levels – is back on the agenda. But the outlook for pension reform remains cloudy.**

Pension reform is looking like "the big one" – perhaps the single most important issue determining Brazil's immediate economic future. The existing defined benefits state pension system is over-generous and is relentlessly clocking up unfunded liabilities. According to Planning Minister Dyogo Oliveira, pension payments already absorb 57% of primary government spending and represent 13% of GDP, one of the highest levels in the world. Brazil already spends more on pensions in GDP terms than Japan, a country with a more elderly population.

The national statistics institute (IBGE) projects that the elderly will represent one-third of the Brazilian population by 2060 and, absent any reforms, pension spending will have risen to 23% of GDP. A crunch point is likely to be faced much earlier, by the next government. General elections are due in October 2018 to choose an administration that will serve a four-year term in office (2019-2023). That administration will inherit a key constitutional amendment passed during the Temer presidency: a 20-year freeze on government spending (which cannot by law exceed the previous year's inflation rate).

That freeze is intended to place a ceiling on Brazil's rising debt levels, currently around 71% of GDP. The next government will not be able to honour both the spending cap and meet existing current pension commitments. One or the other will have to give. Jim Barrineau, joint head of emerging debt at Schroders, has commented that "pension reform is a key to Brazil getting its medium term fiscal house in order. Without it, there is almost no path to stabilising debt-to-GDP ratios over a five-year time frame, and we would expect the country to be a candidate for a credit rating downgrade."

But the politics of delivering pension reform under the current government is looking difficult. There have already been two versions of the pension reform bill. The first more far-reaching version implied achieving fiscal savings of around 2% of GDP over each of the next ten years. A second watered-down version cut that to around 1.2%.

Congressional support for the government has been eroding, and a third and further diluted version may be on the cards. Even then, its passage is not assured. The bill has the status of a constitutional reform, meaning that a special majority is required: 308 of 513 votes in the Chamber of Deputies and 48 of 81 votes in the Senate. Since only 251 deputies voted to preserve Temer's presidential immunity from prosecution over the corruption charges, mustering the extra votes to reach the minimum of 308 required will be a challenge.

There is also an extremely limited window of opportunity in terms of timescale. The Temer administration says it is hoping to have a vote in the lower chamber during the course of November, and to get it through the Senate before the last session of the year, which falls on 22 December. The expectation is that with the general election campaign effectively kicking off in January, it will be impossible to get pension reform approved in 2018. So, if it can't be done before the upcoming December deadline, pension reform will be kicked onto the sidelines for the next government to deal with in 2019.

Government officials say they are consulting with the parties in congress as to the best way forward. The finance ministry says any new version of the pension reform must preserve three key elements: first, the introduction of minimum retirement ages of 65 for men and 62 for women (most Brazilians currently retire earlier); second, a minimum paying-in period of at least 25 years' in order to qualify for a full pension; and third, a viable transition regime between the old and the new systems. Many analysts are sceptical of a successful outcome, meaning that the problem may end up being postponed. The credit ratings agency Moody's Investor Services believes that a major pension reform is not now looking likely, and that any fiscal savings at best will be around half of what was originally sought. Consultancy Capital Economics said in early November that the odds of the reform going ahead, previously at 50-50, had worsened. In similar vein, the Brasilia-based consultancy Arko Advice commented: "It is clear that a broad pension reform will not be approved in Congress by the Temer administration. But some changes are possible."

## MEXICO

### Tweaking the 2018 budget

**On 26 October, the Mexican Senate approved the revenue side of the 2018 budget proposal, tweaking both the oil price and exchange rate assumptions to gain some extra leeway, in part to accommodate additional spending on earthquake reconstruction.**

The upper house amended the draft 2018 budget bill in late October. Senators raised the expected price of Mexican oil exports by 5.4% (from US$46 to US$48.50 a barrel) and lifted the expected peso-dollar exchange rate by 1.7% (from MXN18.1 to MXN18.4). Taken together, the changes add MXN43.3bn (US$2.25bn) to the total budget, making additional funds available for earthquake reconstruction.

The total revenue side of the budget for 2018 now stands at MXN5.3trn (US$276bn). The budget now is back with the lower house, which must approve it by a 15 November deadline. President Enrique Peña Nieto has estimated the reconstruction bill for two earthquakes in September, which left a death toll of 471 people, at MXN48bn (US$2.5bn).

Further amendments on the spending side of the budget, representing around MXN100bn (US$5.2bn) have also been tabled in the lower house, but it is not yet clear whether any will be adopted.

Data for the current year shows that the government has been able to retain fairly tight budget control. The primary surplus in the third quarter was MXN416bn, up from MXN59.1bn in the year-earlier period. In the first nine months of the fiscal year, the primary surplus was 2.0% of GDP, ahead of the target level of 1.4% set by the ministry of finance and public credit (SHCP). The full year target for the primary surplus is 0.4% of GDP. If, as seems likely, this is achieved or over-achieved, it will be the first primary surplus registered in Mexico since 2008. Overall, the SCHP says that the current fiscal performance is "consistent" with the aim of reducing the country's debt-to-GDP ratio from 50.1% in 2016 to 48.0% in 2017.

Not everyone is impressed. Writing in *El Financiero*, analyst Luis Pazos argued that in recent years there has been little real attempt to control public spending growth. In his view, the government increased taxes to cover the slump in oil revenue caused by the oil price fall starting in 2015, but it overcorrected, bringing in extra funds totalling around four times the shortfall it was seeking to cover. So while there has been a fiscal improvement, it has all been on the revenue side, and not on the spending side.

In Pazos' view, the upward tweaks to the 2018 oil price and exchange rate forecasts, together with an over-optimistic growth assumption (the budget predicts real annual GDP growth of 2.5%, compared to the IMF's 1.9% forecast) are all really designed to allow the ruling Partido Revolucionario Institucional (PRI) to go on a politically-motivated spending spree ahead of the July 2018 presidential election. This implies that the next government, which takes office in December 2018, will have to wrestle with a deteriorated fiscal balance.

### Third quarter slowdown

Provisional GDP figures for the third quarter showed that the Mexican economy contracted by 0.2% quarter-on-quarter, while the year-on-year growth rate fell to 1.6%, down from 1.8% in the preceding quarter.

However, much of the slow-down was attributed to one-off natural disasters: Hurricane Harvey in August, which hit oil refineries, and two earthquakes in September, one in the South and one near Mexico City, which caused extensive damage. Weakness appears to have been concentrated in mining and manufacturing (Puebla, one of the regions affected by the earthquakes, is a significant manufacturing centre). Analysts expect that earthquake reconstruction spending will step up in Q4 of this year, stimulating economic activity.

## CHILE

## Recovery will be slow, say business lobbies

**With elections due this month, commodity prices on the mend, and a new government set to take office in March 2018, Chile is heading for recovery. But the consensus among business groups seems to be that the economy will take time to get moving.**

Unusually for Chile, investment will have contracted for the fourth year in a row in 2017. This is attributed to weak commodity prices, a lull in big mining investments, and a lack of investor enthusiasm for the reforms of the outgoing centre-left President Michelle Bachelet. Most of this is set to change, however. Commodity prices, and in particular the price of copper, are improving (in late October, copper stood at US$3.10/lb, up by 42.6% year-on-year). The markets are reasonably confident that former president Sebastián Piñera (2010-2014) a conservative and market friendly businessman, will win the November elections.

But the business community expects improvements to be slow. Economist Javier Hurtado of the construction sector's chamber of commerce (Cámara Chilena de la Construcción, CChC), says it will take time to reactivate big investment projects, particularly those where environmental impact studies and other approvals have lapsed and need to be reinitiated. The CChC sees only modest growth in the construction sector moving forward, coming in at somewhere between zero and 3% in 2018. According to Rafael Palacios, head of research at the manufacturing association Sociedad de Fomento Fabril (Sofofa), it would be premature to say that a new expansion cycle is about to begin. Palacios wants to see a reduction in red tape and regulations to help kick start manufacturing industry. Sofofa is predicting only 1% growth in manufacturing in 2018.

There is somewhat more optimism in mining, where the industry association is predicting that copper output will rise by 7.2% to 5.9m tonnes in 2018, up from an estimated 5.5m tonnes in 2017. According to the retail association Cámara de Comercio de Santiago (CCS), sales will grow by around 4% in 2018, with consumer credit expanding by around 3%. Elsewhere, agri-sector sources project agricultural growth of about 2.7%.

According to José Ignacio Zamorano of bank BTG Pactual Chile, the general consensus is that the economy will improve after the elections. This has been reflected by a stock market rally, with the IPSA index, which represents 40 key local companies, gaining 23% in the first ten months of the year.

### Piñera presents spending plan

Sebastián Piñera, the front runner in the election race, has presented a US$14bn spending plan for his expected four-year presidential term in 2018-2022. The top spending initiatives are provisions for pensions and ageing (US$3bn), measures to promote growth in quality employment (US$2.8bn), infrastructure and connectivity (US$2bn), and health and education (each receiving around an additional US$1.5bn). Lower sums are earmarked for agriculture, sport, science, innovation and entrepreneurship.

Half of the total money needed for this plan is to be raised by reassigning funds from existing and poorly-performing budget lines, and by various austerity measures, including reductions in public sector recruitment, travel and expenses. The other US$7bn is to come from higher tax revenues triggered by faster economic growth: Piñera is claiming that real annual GDP growth will rise from the 2.6% predicted in the 2018 budget to close to 3.5% by the end of his term in 2022.

# COLOMBIA

## Santos administration sends down its final budget

**In mid-October, the Colombian legislature approved the 2018 budget – the last under the tenure of President Juan Manuel Santos, who will step down in August next year. Given that President Santos is constitutionally barred from seeking another term, the budget was not a pre-election package designed to boost spending ahead of a re-election bid. Instead, the budget rose only gradually (by just 1% in nominal terms, to COP236bn), with plans to cut expenditure in some areas, and reduce external debt.**

The Santos administration touted the budget as an "austere" package. With only moderate increases pencilled in for total revenue and expenditure, the finance ministry is hoping to reduce the fiscal deficit from the 3.6% of GDP expected in 2017 to 3.1% next year. This is essentially an attempt by the Colombian authorities to avoid being downgraded by the main sovereign credit rating agencies. Colombia has investment-grade status, but with Standard & Poor's (S&P) rating it as BBB, and Moody's Investors Service as Baa2 – both one notch away from the lowest investment-grade rung – the government remains fearful of the sovereign being returned to speculative-grade status, which would make financing more difficult to get, and costlier.

### Some fiscal slippage is likely

The finance ministry's efforts are praiseworthy, but many believe that the macroeconomic assumptions underpinning the budget package are too optimistic, which will result in some fiscal slippage and a consequent increase in the public debt stock.

The budget is predicated on a real annual GDP growth forecast of 3%, which would mark a three-year high and is significantly above market expectations (as well as those of the central bank [Banrep] and the IMF), while end-2018 inflation is forecast at 3.5% (a level not seen since 2014).

The authorities are seeking to boost growth, with Banrep cutting interest rates again by 25 basis points in late October in an effort to stimulate domestic demand, but it is unclear whether this will prove sufficient to lift overall GDP growth towards 3%.

Based on this strong growth forecast, the Colombian authorities are expecting rapid growth in current revenue (14.1%), mainly on the back of double-digit rises in tax income. Given that most of the government's recent tax reform measures took effect in early 2017, it is difficult to see where such rapid growth next year would come from. The measures included in the 2016 reform, which went into effect early this year, including an increase in the rate of value added tax rate (VAT) from 16% to 19%, the imposition of a 4% tax on mobile phone services, and the re-imposition of the '4 x 1,000' tax on financial transactions, amongst other things. Even so, according to latest projections from Colombia's tax authority (Dian), fiscal revenue this year will fall 15% below the Col$126.9trn target set out in the 2017 budget. According to the Dian, this is due to the continued slowdown in domestic economic activity this year.

Meanwhile, on the expenditure side, the authorities are pencilling in some fairly large increases in current spending, including a 6.2% hike in transfers (mainly to finance pensions and healthcare shortfalls) and an 8% increase in wage costs (on the back of rising pressure for salary increases from public-sector workers).

This also includes financing various post-conflict programmes such as the provision of public services and public security improvements in post conflict areas. Total allocated funding for post-conflict programmes was set at Col$2.4trn. Finance Minister Mauricio Cárdenas boasted noted that the education sector received the biggest budget allocation in the 2018 draft budget (Col$37trn), followed by defence (Col$31.6trn).

In this context, the government is relying entirely on a massive 17.2% cut in capital spending to keep the overall expenditure bill under control. Given that many investment projects are already under way, it is unclear whether such a large cut is feasible; even if the authorities manage to reduce spending in this area by the budgeted amount, this would also hamper the country's growth potential. Given that infrastructure has traditionally been a comparatively weak point of the country's business environment, cutting capital spending is arguably not the best means of achieving fiscal consolidation.

### Authorities try to rein in debt

A budget deficit of around 3% of GDP would involve financing needs of around COP30bn (US$10bn). Some of this has already been pre-financed, with US$900m raised in a bond issue in August, with the finance ministry also going to put US$980m paid in fines by telecoms companies towards the deficit.

Cárdenas has stated that no international bond issuance is likely in 2018, in a bid to reduce external debt (which stands at around 40% of GDP), but with still-significant financing needs, domestic borrowing is instead likely to rise. With public debt still perilously close to the 50% of GDP mark (higher than the 'BBB' median of 42% of GDP, as Fitch Ratings noted in late October), Colombia is therefore likely to remain vulnerable to a credit ratings downgrade in the coming year.

# HONDURAS

## IMF completes final review with praise for Hernández

**The IMF has completed the final review of its three-year US$189m Stand-By Arrangement (SBA) with Honduras, conferring praise for the performance of the administration led by President Juan Orlando Hernández. Hernández to capitalise on the successful IMF rating as he heads into the final stages the end of his campaign for re-election on 26 November, which is expected to be successful. The Fund has indicated a willingness to discuss further arrangements with Honduras.**

Following executive board discussion of the fifth and sixth reviews of the SBA, Tao Zhang, the IMF's Acting Chair and Deputy Managing Director said that the authorities' commitment to their reform agenda had remained strong during the program, which had successfully stabilised the economy, restored confidence, and paved the way for accelerating growth and reducing poverty. "The program is on track and reforms are progressing as expected", he noted.

Zhang noted that the macroeconomic outlook is positive, with fiscal deficit is at historic low levels, international reserves are at historic highs, and inflation remains subdued. However, he emphasised the need for a continued effort to improve social indicators. Unemployment, he observer, "remains a challenge", while poverty affects more than half of the population. "Tackling these problems will require significant efforts to improve the coverage of social programs and to ensure adequate fiscal revenues, including by rationalizing tax exemptions and strengthening tax enforcement", he stressed.

Elsewhere, the Fund noted that Honduran authorities acknowledged the importance of modernising the monetary policy framework for macroeconomic stability, in support of which they have started the process to adopt inflation targeting. To this end, Honduras has introduced an interbank repo market and reduced the FX surrender requirements. "They recognize the need to continue with this process by amending the central bank law to give a clear mandate to achieve low and stable inflation", Zhang observed.

Finally, Zhang underlined the point that structural reforms are critical to promote private investment and create jobs. "Continuing to pursue reforms in the electricity sector, improving the efficiency of public spending, reducing corruption, closing the infrastructure gap, and working together in alliance with the private sector are critical for a sustained economic expansion with marked poverty reduction", the statement concluded.

The IMF projects real annual GDP growth of 4% this year, easing to 3.6% in 2018, with inflation easing down towards 4%. Helped by lower interest rates, private sector credit growth is running at almost 12%, underpinning a recovery in investment and economic activity. The current account deficit is steady at roughly 4% of GDP, down from a high of about 9% a few years back, as Honduran exports resume stronger growth in line with the recovery in the US, the country's dominant trading partner. Imports have benefitted from lower oil prices since 2014, which went some way towards eroding the high current account deficit. Thanks to the better export result, the international reserves position has strengthened to almost US$5bn, or almost 5 months of imports.

And finally, the fiscal deficit position has also improved to about 1.2% of GDP now, from a record 7.5% when Hernández took office in January 2014. The debt to GDP ratio so higher as the government borrowed (from the IMF and others) as part of its efforts to stabilise the economy, but at 44% of GDP, the overall position is manageable.

In sum, the Honduran macro-economic picture is in good shape, and the challenge moving forward is to stabilise also the micro economy, plagued still by deeply entrenched poverty and lack of opportunity.

Hernández, of the conservative traditional Partido Nacional (PN) has set out a plan of government focused on seven strategic pillars, including the use of innovation for growth and job creation, access to credit, the development of Honduras as a regional logistical hub, investment in support of a fully bilingual public education system, and measures to boost investor confidence including reductions in red tape and improvements in government transparency. His rather rosy vision for a modern Honduras, however, remains starkly at odds with the daily reality for 60% of his 8m fellow Hondurans.

While polls suggest that Hernández is on course for victory against a splintered and weak opposition, political complications surround this year's election. Hernández was only able to run because of a controversial April 2015 supreme court decision declaring inapplicable the constitutional ban on re-election. The political opposition still rejects that ruling and although it is taking part in the November ballot it says it will not accept the result if Hernández wins. Legal challenges thus are likely to ensue. While we do not believe that legal challenges will be successful, as the US, Mexico and other Latin American countries tacitly accepted the April 2015 supreme court decision, the process could result in civil unrest and a period of uncertainty and instability in the country.

**Honduras, IMF Selected Economic Indicators**

| | | Prel. | Proj. | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
| | | *(Annual percentage change unless otherwise indicated)* | | | | | | |
| **National income and prices** | | | | | | | | |
| | GDP at constant prices | 4.1 | 2.8 | 3.1 | 3.6 | 3.6 | 4 | 3.6 |
| | GDP deflator | 3.6 | 1.4 | 6.8 | 6.4 | 3.7 | 5.9 | 3.8 |
| | Consumer prices (eop) | 5.4 | 4.9 | 5.8 | 2.4 | 3.3 | 4.5 | 4 |
| **Exchange rate (eop, depreciation -)** | | | | | | | | |
| | Lempiras per U.S. dollar 1/ | 20 | 20.7 | 21.6 | 22.4 | 23.5 | 23.5 | … |
| | Real effective rate 2/ | -1.7 | 0.3 | 3.8 | 1.8 | -2.2 | -1.5 | … |
| **Money and credit** | | | | | | | | |
| | Private sector credit | 16.9 | 11.2 | 10.7 | 10.4 | 10.8 | 11.4 | 11.5 |
| | Broad money | 6.6 | 8.4 | 13.2 | 8.4 | 13.1 | 9.6 | 8.5 |
| | Lending rate (eop, in percent) | 16.7 | 16.9 | 15.9 | 14 | 14.3 | 14.2 | … |
| | Deposit rate (eop, in percent) | 11.4 | 11 | 10.4 | 8.8 | 8.2 | 8.4 | … |
| **Nonfinancial public sector** | | | | | | | | |
| | Primary balance (percent of GDP) | -4.5 | -7 | -3.4 | 0.1 | 0.3 | -0.1 | 0.1 |
| | Overall balance (percent of GDP) | -4.4 | -7.5 | -3.9 | -1 | -0.5 | -1.2 | -1.2 |
| | Gross debt (percent of GDP) | 32.4 | 41 | 41.3 | 41.2 | 42.5 | 43 | 44.1 |
| **Saving and investment** | | | | | | | | |
| | Gross fixed capital formation (percent of GDP) | 24.4 | 22.9 | 23 | 24.8 | 23.2 | 25.9 | 25.7 |
| | Gross national savings (percent of GDP) | 15.8 | 13.4 | 16 | 19.3 | 19.4 | 21.8 | 21.4 |
| **External sector** | | | | | | | | |
| | Gross international reserves (millions of dollars) | 2,778 | 3,255 | 3,698 | 3,992 | 4,172 | 4,559 | 4,823 |
| | Gross international reserves (in months of imports) 3/ | 3.3 | 3.8 | 4.3 | 4.8 | 4.5 | 4.7 | 4.8 |
| | Change in net international reserves (increase -) | 367 | -546 | -264 | -307 | 128 | -311 | -251 |
| | Current account balance (percent of GDP) | -8.6 | -9.6 | -7 | -5.5 | -3.8 | -4.1 | -4.3 |
| | Exports f.o.b. | 4.8 | -6.6 | 4 | 0.9 | -4.2 | 10.3 | 3.6 |
| | Imports f.o.b. | 2.2 | -3.7 | 1.2 | 0.1 | -4.8 | 10.5 | 3.1 |
| ***Sources:*** *Central Bank of Honduras, Ministry of Finance, and IMF staff estimates and projections.* | | | | | | | | |
| *1/ 2017 data as of October 24, 2017.* | | | | | | | | |
| *2/ 2017 data as of June.* | | | | | | | | |
| *3/ Refers to the following year's imports of non-maquila and nonfactor services.* | | | | | | | | |

## REGION

### It's slow: but it is still a recovery

**September and October are the months in which international bodies such as the IMF and the Economic Commission for Latin America and the Caribbean (ECLAC) set out their new economic forecasts. This time, the message seems to be consistent: there is a recovery, but it is painfully slow.**

The IMF says that after disappointing growth in the last few years, economic activity in Latin America and the Caribbean (LAC) remains on track to recover gradually in 2017-2018, as recessions in some of the larger countries like Brazil and Argentina come to an end.

It expects LAC as a whole, which suffered a GDP contraction of 0.9% in 2016, to expand by 1.2% in 2017 and by 1.9% in 2018. Domestic demand is recovering gradually, while the contribution to growth from net exports is falling, as higher demand pulls in increased imports. Inflation is moderating, allowing some scope for monetary stimulation. Fiscal imbalances continue. For next year, the IMF expects GDP growth of 1.5% in Brazil, 1.9% in Mexico, 2.5% in Argentina, and 2.8% in Colombia.

The exception to the recovery story will continue to be Venezuela, which the IMF says "remains in a full-blown economic, humanitarian, and political crisis, with no end in sight". Venezuela's GDP is projected to fall by 6% next year; in 2014-17 the IMF estimates the country suffered an accumulated 35% fall in its GDP.

The Fund stresses that for most economies this is the moment to pursue structural economic reforms. Priorities should include closing infrastructure gaps, investing in human capital, encouraging female labour force participation, reducing labour market informality, enhancing good governance, fighting corruption, and seeking trade and financial integration.

The ECLAC forecast for the region is for 1.2% GDP growth this year, the same as the IMF projection, but it sees a slightly stronger rebound next year, pencilling in overall regional growth of 2.2% in 2018. ECLAC notes that South America, which was particularly hard-hit by the commodities slump, is now picking up speed. Central American countries will grow by 3.5% on average next year, it estimates.

A separate survey of economists by *Reuters* suggests that for the first time in years, Brazil will grow more rapidly than Mexico in 2018. Economists said that single-digit interest rates in Brazil would help lift growth to 2.3% next year, finally bringing the 2014-2016 recession to an end. But with uncertainty over Nafta and the 2018 presidential elections, Mexican growth would be marginally slower at 2.2%.

## REGIONAL BUSINESS REVIEW

### REGION

### Labour markets still weak

**A combination of low economic growth rates or outright recession in some countries in recent years has created weakness in employment markets in the Latin America and the Caribbean region (LAC), but a joint report published in October by two United Nations bodies, the Economic Commission for Latin America and the Caribbean (ECLAC) and the International Labour Organisation (ILO), suggests that there may be light at the end of the tunnel.**

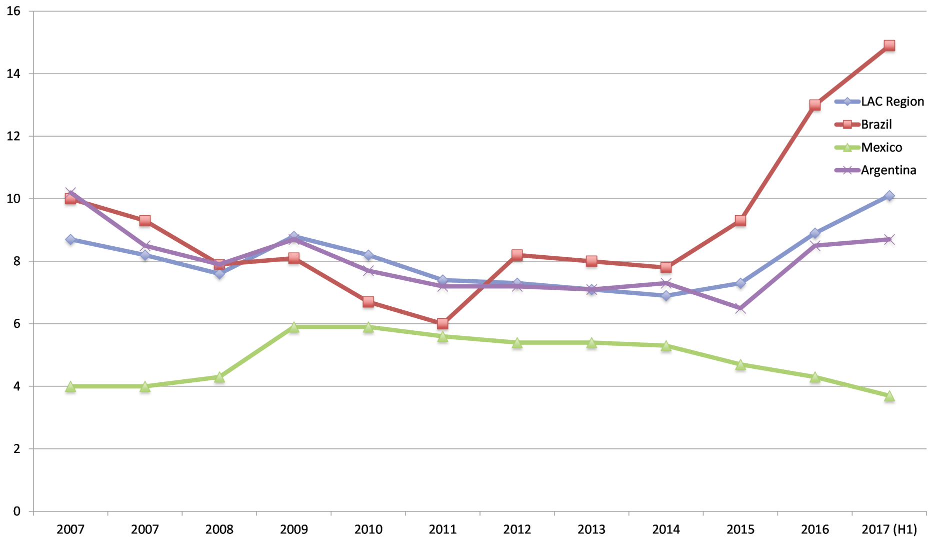
The report analyses labour market trends in the first half of 2017, relative to the same period of 2016. Available statistics on employment are far from comprehensive, so the focus is on one key indicator that is comparable across most of the larger economies – urban unemployment. The conclusion is that urban unemployment continues to increase across the region, but at a lower rate.

The average urban unemployment rate for the LAC region in 2017 as a whole is projected at 9.4%, an increase of 0.5 percentage points on the 8.9% level registered in 2016. In the first half of 2017, the total size of the urban labour force in the region contracted by 0.3 percentage points. This trend was particularly affected by the weak performance of the Brazilian labour market. Brazil experienced a sharp economic contraction in both 2015 and 2016, but a very modest recovery has begun to make itself felt in 2017. As a result, its labour indicators are beginning to stabilise. In contrast, labour market indicators have been more favourable in other countries, particularly so in Central America.

While there is reason to believe that unemployment will begin to fall over the next 1-2 years, as local economies pick up pace, the LAC recession seems to have eroded the quality of the new jobs that are being created. In six out of eight countries that produce the necessary data, in the first half of this year the growth of formal, salaried jobs, has lagged behind the expansion of self-employment. Stagnation in formal employment creation was reported in Argentina, Chile, Peru and Uruguay, while there was growth in Mexico and Central America. The real wages earned by those with formal jobs rose in six countries (Brazil, Chile, Colombia, Costa Rica, Nicaragua and Uruguay), but fell in two others (Mexico and Peru).

**Urban unemployment rates in Latin America and the Caribbean**

*% of economcially active population in urban areas*




***Source:*** *ILO-ECLAC*

The report also highlights evidence that for young people, the journey between leaving full-time education and starting a salaried job is becoming longer. Alicia Bárcena, ECLAC's executive secretary, and José Manuel Salazar, the ILO's regional director, note in the foreword that "the paths for young people into the labour market in the region are found generally to be much longer than in the developed countries, something that is heavily shaped by the role of women, often still centred on care giving and household activities." A significant proportion of adolescent students aged 15-19 also have to work to contribute to the household budget.

On the other hand, those in full employment in the 20-29 year-old age group also take up post-secondary study as a tool for upward labour mobility. The report suggests that Latin American governments should focus on improving the transition from education to work and increasing the employability of young people. The latter requires a combination of measures on the supply side (training and career guidance, help with transport costs) and on the demand side (possible job creation subsidies and incentives).

## The position in other selected labour markets

The newly installed government in Ecuador led by President Lenín Moreno has talked up latest GDP results as evidence of an economic recovery in the country, yet labour market data from the national statistics institute (INEC) suggests otherwise.

The central bank reported real annual GDP growth of 3.3% in the second quarter, which was celebrated by the Moreno government. While the result in large part owed to a rebound from a low base in the year-earlier period, central bank manager Verónica Ártola claimed the local economy was showing "permanent signs of recovery, and for the third straight quarter". She cited "an increase in consumer spending, financial services, and greater availability of credit", as well as growth in the non-oil sector, which expanded by 3.4%.

Meanwhile, the national unemployment rate was 4.1% in September, down from 5.2% a year earlier, the INEC reported, a figure again loudly celebrated by the government.

Yet behind this lies a problematic picture of stagnant formal employment, along with record informality and rising sub-employment, evidencing the steady deterioration of Ecuador's labour market since late 2014. While the Moreno government is talking up an economic recovery, the reality is that Ecuador is not creating decent employment, and continues to place workers in informal, transient and underpaid jobs.

By way of illustration, the fall in headline unemployment is not being matched by growth in formal jobs. In fact, just four of every ten Ecuadorean workers (40%) are currently in 'adequate employment', meaning full-time permanent work paying at least the minimum wage. That amounts to just 3.3m people, out of a total economically active population (EAP) of 8.2m.

Moreover, 46.4% of those with jobs (whether permanent or temporary) are working in the informal sector, a record. This explains the fact that barely 30% of workers were registered for social security purposes in September, a drop of five points in the space of 12 months.

According to INEC data, over half of the EAP (55.3%) is now categorised as being in 'inadequate employment'. Within this, 20.5% (or 1.7m) are officially underemployed. Five years ago, in December 2012, just under 604,000 people were ranked as underemployed.

On top of that, another 24% fall into the vaguely-defined category of 'other sub-employment', with a further 10.1% in unpaid employment. Together, these three categories sum 3.0m people, almost as many as in proper employment.

Underemployment is particularly problematic in urban areas, with the INEC reporting a sharp rise in underemployment in Guayaquil (to a high 24.1% in September, from 19.9% a year previously) and Machala (to 22.2%, from 16.5% previously). Guayaquil, the country's main port and business hub, has been badly affected by the economic slump in the country since 2014. By contrast, in the capital Quito, home to the government and the sizeable public sector, underemployment was distinctly lower, at 7.5% in September.

Moreno has pledged to create 200,000 new jobs for young people in the period to 2021 under his ‘Youth Impulse’ program, announced in July. The scheme will be implemented by a technical secretariat for youth, the first ever government institution with ministerial status focused specifically on young people. The scheme aims to use technology to create a youth labour ‘stockmarket’ to better match demand with supply. Financial incentives will also be offered to entrepreneurial young people with ideas for start-ups and productive employment, with US$300m available to 2021.

“Who better to stimulate national development than the new blood of this Revolution”, Moreno declared, praising the “marvellous force of youth”.

## BRAZIL

### The return of deepwater oil

**The auction of a number of pre-salt oil and gas blocks in Brazil’s Atlantic offshore on 27 October was hailed as a qualified success. Importantly, Royal Dutch Shell, already a big investor in the country, took nearly half the blocks on offer. The oil giant appears to be convinced that it can make a profit in the Brazilian deepwater, even with oil prices as low as US$40 a barrel. That in turn suggests that oil and gas development could play a big role in the country’s economic recovery.**

It is clear that Brazil is looming large in Shell’s international strategy. Upstream director Andy Brown commented, “These winning bids were submitted after our thorough evaluation, and add strategic acreage to our global deep-water growth options”. The company seems to have been attracted by the geological quality of the blocks, but also by the government’s recent moves to relax local content rules and roll back the requirement that state-owned Petrobras should have a minimum 30% stake in all pre-salt projects.

According to Brian Youngberg, a hydrocarbons analyst at Edward Jones, “Brazil’s offshore is one of the last major plays out there that is in its infancy. Companies that are still interested in the big elephants out there, like Exxon and Shell, are aggressively pursuing them”.

In the latest auction, eight major pre-salt exploration and production blocks were offered. The reserves in question are billions of barrels compacted under a thick layer of seabed salt. Shell won three blocks in partnership with other companies, including Petrobras of Brazil, Total of France, and CNOOC of China.

BP of the UK won a further two blocks. Exxon Mobil of the US, which had won ten blocks outside the pre-salt area in an earlier auction on 27 September, won one further block. Two blocks were not allocated.

ANP, the Brazilian regulator, said signing bonuses totalled BRL6.15bn (US$1.88bn), around 79% of the government target. President Michel Temer said the contracts signed represented investment of BRL100bn (US$30.8bn) over the next 35 years and the creation of half a million jobs. Although the revenue from signing bonuses was lower than hoped, officials still described the auction as a resounding success. They emphasized that the development of these blocks could more than double the country’s oil production over the next decade to reach 5m barrels per day (bpd). The pre-salt fields are already responsible for round half of Brazil’s total production. ANP said that in September the country’s total hydrocarbons production was 2.653m bpd, of which 49.8% came from pre-salt fields.

## A timely boost for Pemex

**President Enrique Peña Nieto has announced that Mexico's struggling state-owned oil company, Pemex, has made its biggest onshore oil discovery in 15 years.**

The find is Pemex made the discovery in the 'Ixachi-1' well, located in the municipality of Cosamaloapan, in the state of Veracruz (located about 45 miles south of the key oil port of Veracruz). Peña Nieto boasted that the overall deposit is believed to hold some 1.5m of oil in place, or about 350m in proven, probable and possible (3P) reserves.

According to Pemex's CEO, José Antonio Gonzalez Anaya, because the reserve is in an already-developed area, with existing infrastructure in place (including a gas pipeline), development should be swift, with production of light oil and wet gas potentially starting within a year, in late 2018 or early 2019. The well is quite deep, at 8km below ground, nevertheless extraction costs about 50% of offshore needs. Juan Javier Hinojosa, director-general of exploration and production at Pemex, told the UK's financial times that the light sweet crude in the Ixachi well was 'the Chanel of crude' (in reference to the prestigious French perfume), for its refining value (as a light variety it yields more crude when refined).

For Pemex, the find comes at a critical time, amid declining output and continuous budget cuts. Pemex output has declined persistently since a peak of of 3.4m b/d in 2004. In late October, the firm reported that crude production had fallen by 18% year on year in September, to 1.73m b/d, from 1.93m b/d in August, and marking three consecutive months of oil output below the 2m b/d mark.

For the first nine months, average crude production was 1.97m b/d. Crude exports mimicked this trend, falling by almost 19% in September to 1.16m b/d. (Likewise, the company's natural gas out in September – 4.302bn cubic feet per day – was down by over 23% year on year.) The company reported a loss of MXN101.8bn (US$5.3bn) in the third quarter to end of September, affected by two earthquakes in September that forced a halt in production.

In a bid to reverse the fortunes of the country's oil sector, the Peña Nieto government's flagship energy reform, approved in 2013, ended Pemex's decades-long monopoly and allowed private producers to operate their own fields for the first time. Pemex, meanwhile, is restructuring in order to become smaller and more efficient, but the oil price collapse in 2014 has severely complicated its adjustment and reform process.

This latest find comes just three months after Mexico reported the first major find by private companies. In July, Premier Oil Plc, Sierra Oil & Gas and Talos Energy LLC announced discovery of a shallow water reservoir some 60km off the coast of the south-eastern state of Tabasco, comprising an estimated 1.4bn to 2bn barrels, the fifth biggest discovery in the world in the past half-decade.

Pemex has yet to determine how much investment needed to develop the latest discovery or whether the company will seek partners, according to González Anaya. He stressed that he hoped the new find would make Pemex more attractive for joint ventures. The firm hopes to expand its program of JVs in coming months, with a view to helping Pemex reach deep-water areas in the Gulf of Mexico that require heavy investment and state-of-the-art technology and know-how.

## Doing Business in Latin America

**According to the 2018 edition of the World Bank Group's annual *Doing Business* report, released on 31 October, Latin America and the Caribbean governments continue to make incremental improvements to the business operating environments for climate for small and medium sized companies**

In a press release summarising the regional performance, the WB said that half of the region's 32 economies had implemented reforms in the past year, for an accumulated total of 398 reforms enacted in the past 15 years.

The release singled out El Salvador for earning "a notable spot in this year's global top improvers", with four reforms adopted during the past year. These included improving the reliability of electricity, by introducing a better outage management and maintenance planning system, as well as making it easier for businesses to pay taxes, by implementing an online platform for filing and payment of taxes. Other reforms covered the 'Doing Business' areas of Dealing with Construction Permits and Trading Across Borders.

Joining El Salvador in implementing multiple reforms were Jamaica and the Dominican Republic, with three reforms each. Both economies reduced the time to start a business and improved the reliability of electricity supply, the WB noted.

Brazil managed to implemented just one reform in the past year, perhaps indicative of its continuing political crisis, and the difficulties in executive-congress relations. Its sole reform was to facilitate cross border trade by reducing the time for documentary compliance for both exporting and importing. In the past 15 years, the WB noted, Brazil has implemented a total of 18 reforms, above the regional average of 12 reforms.

Mexico also implemented just one reform in the past year. This reform, in the Doing Business area of Getting Electricity, is aimed at improving the reliability of electricity supply. Mexico has implemented a total of 26 reforms in the past 15 years.

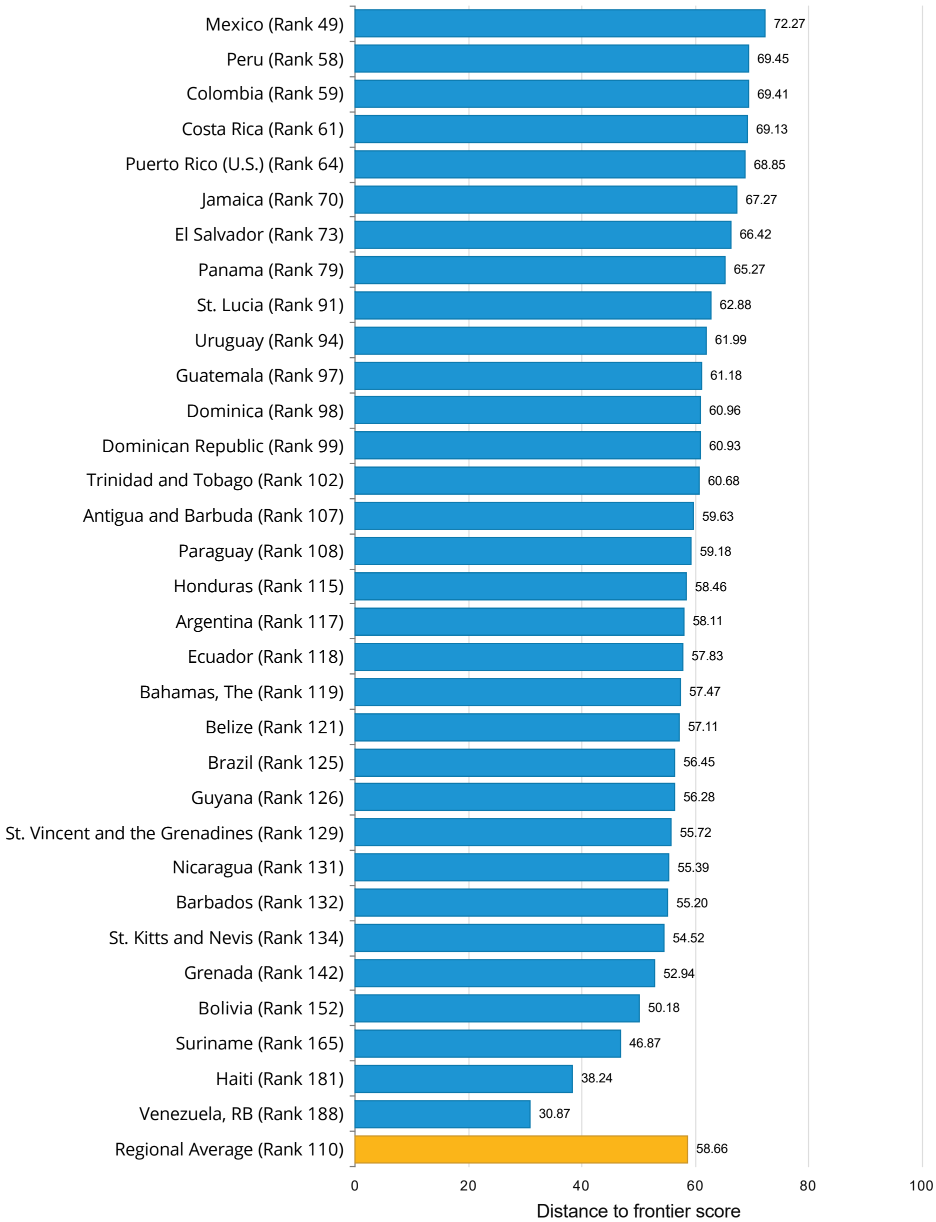
Santiago Croci Downes, Program Manager of the Doing Business Unit, noted that "reforms implemented by economies in Latin America and the Caribbean continue to improve the business environment for entrepreneurs. As the impact of these reforms spreads, we are likely to see a more dynamic private sector, which will boost economic growth in the region".

Latin American economies perform best in the areas of Getting Electricity and Getting Credit. For example, nine of the region's 32 economies are among the top 20 in the area Getting Credit, thanks to well-developed public registries and credit bureaus, the WB noted. In addition, obtaining an electricity connection in the region takes 66 days on average, which is faster in than in the OECD high-income area, where the average is 79 days. However, the cost to connect to the electricity grid in the region remains significant, with an average of 927.4% of the income per capita, compared to 63% in OECD high-income economies.

One of the biggest challenges identified by the WB for the region is the time it takes to pay taxes. On average, this takes 332 hours per year in Latin America and the Caribbean, compared to the average of 161 hours per year in the OECD high-income economies. The region also underperforms in the areas of Registering Property and Starting a Business. It takes on average 63 days to transfer property in the region, which is significantly more than across OECD high-income economies where it takes 22.5 days.

The region's top ranked economies in 2018 are Mexico (in 49th place out of 190 countries), Peru (58) and Colombia (59). While Mexico's overall score increased to 72.27 points, up by 0.18 higher, it fell two places in the ranking, from 47 previously, came despite the fact that the country's score. The report notes that Mexico improved its scores in areas like ease of opening firms and obtaining permits but suffered considerable setbacks in areas such as taxation and resolving insolvency.

**How economies in Latin America and Caribbean (LAC) rank on the ease of doing business**




***Source:** World Bank*

## Other report highlights

• With 34 reforms, Colombia has implemented the most reforms in Latin America and the Caribbean in the past 15 years. In Starting a Business, Colombia has reduced the number of days to register a new business to 11 days, from 44 days in 2003.

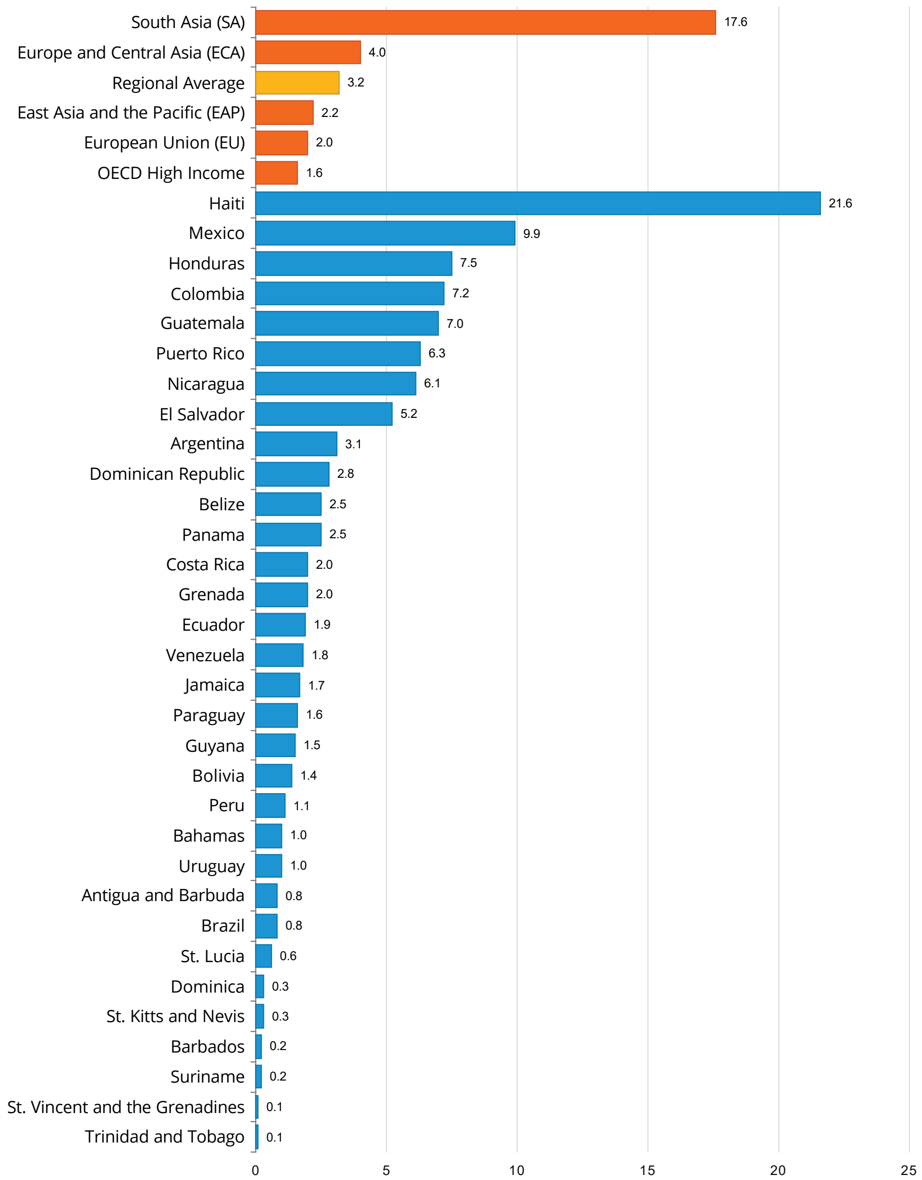
- Mexico and Jamaica come second and third in the region for the number of reforms implemented over time, with 26 and 25 reforms respectively. Fifteen years ago, it took 31.5 days to start a business in Mexico City, compared to 8.5 days today. While in Jamaica, which is in the top five ranked economies in Starting a Business, it takes just three days to register a business, compared to 31 days 15 years ago.

- Economies in the region have significantly reduced the time to start a business by introducing online systems, simplifying procedures and launching one stop shops for business registration. Now, on average, starting a business in the region takes 38 days, compared to 78 days 15 years ago. Nevertheless, the current average is still significantly above the global average of 20 days.

The following charts show Latin America's performance relative to international averages in two of the Doing Business Areas – 'Dealing with Construction Permits' and 'Paying Taxes'. We chose these two against the backdrop of the Odebrecht kickbacks-for contracts scandal in the region in 2016-2017, and the related ongoing concern, in the region and elsewhere, about the use (and abuse) of fiscal havens to evade (legally or otherwise) the payment of taxes.

**Dealing with Construction Permits**

*Cost (% of warehouse value)*




***Source:*** *World Bank*

## Dealing with Construction Permits

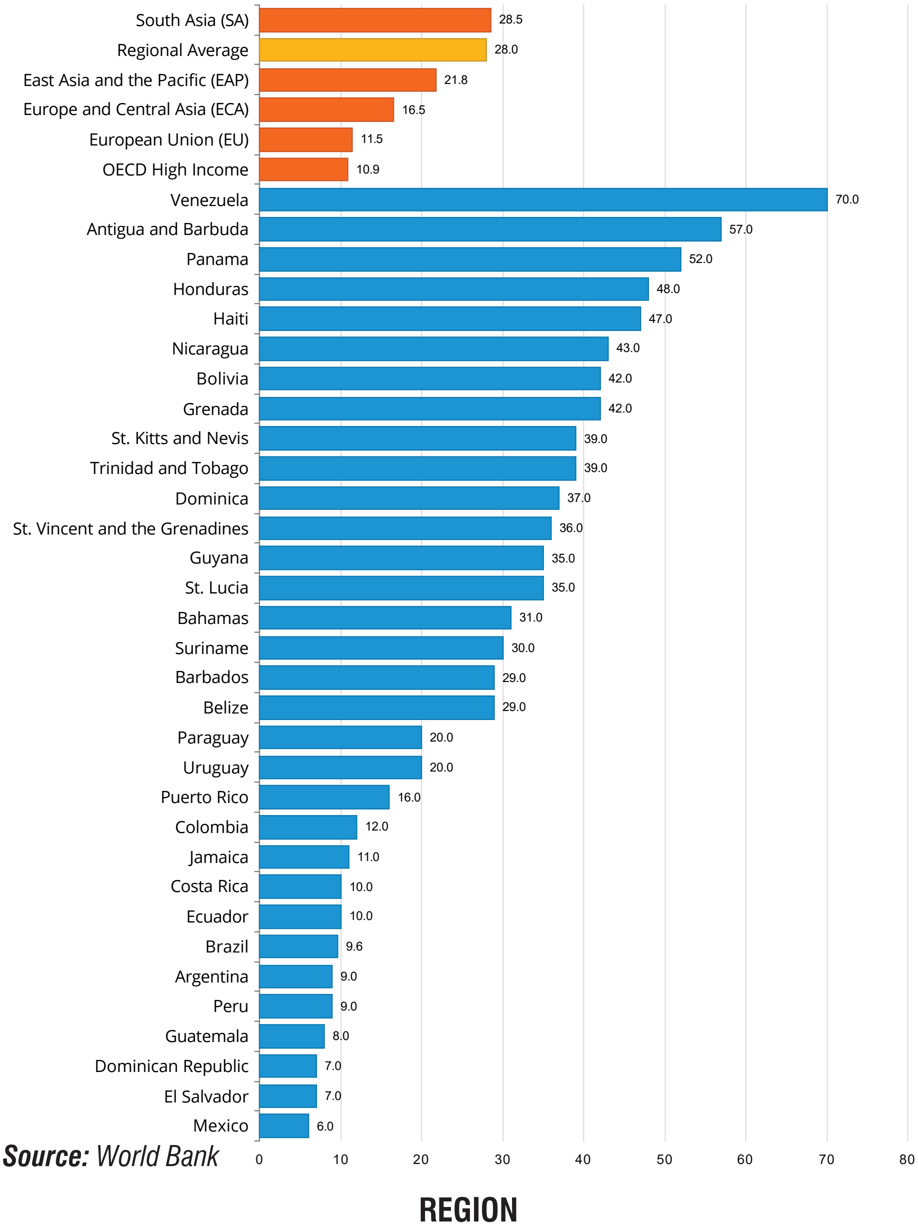
This indicator tracks the procedures, time and cost to build a warehouse—including obtaining necessary the licenses and permits, submitting all required notifcations, requesting and receiving all necessary inspections, and obtaining utility connections. In addition, the Dealing with Construction Permits indicator measures the building quality control index, evaluating the quality of building regulations, the strength of quality control and safety mechanisms, liability and insurance regimes, and professional certification requirements. The most recent round of data collection was completed in June 2017.

## Paying Taxes

The Paying Taxes indicator records the taxes and mandatory contributions that a medium-size company must pay or withhold in a given year, and also measures the administrative burden in paying taxes and contributions. The most recent round of data collection was completed on 30 June 30 2017, covering calendar year 2016.

## How easy is it to pay taxes in economies in Latin America and Caribbean (LAC) - and what are the total tax rates

*Payments (number per year)*




**Source:** *World Bank*

## Corporate Radar

### Pemex announces big find

State oil company Pemex has announced what it describes as its most important onshore discovery in the last 15 years. The Ixachi-1 well, 72kms south of Veracruz, is estimated to hold total 3P reserves of around 350m barrels of light oil and gas equivalent (boe). Officials say the find is particularly valuable because it is close to existing pipeline infrastructure and can be brought into production relatively rapidly, by 2018 or 2019. The announcement came as Pemex production levels continue to fall. In September (a month affected by hurricane damage), output slipped to 1.73m bpd. Average output for 2017 is expected to be around 1.9m bpd, significantly below the 2004 peak of 3.4m bpd.

### Chinese bid for Oi?

A *Reuters* report that China Telecom Corp could bid up for BRL20bn (US$6bn) to acquire control of Oi, Brazil's troubled mobile telephony company. Oi declared bankruptcy in mid-2016 and its future remains subject to debt rescheduling negotiations with its creditors. A creditors' assembly was due for 10 November, to discuss a plan to restructure Oi's total debts of around BRL65bn (US$19.9bn)

### Ecuador taps up bond markets again

Ecuador placed US$2.5bn in sovereign bonds in late October. A finance ministry statement said the 10-year bonds offered a yield of 8.87% and were oversubscribed, with demand reaching US$8bn. Institutional investors from the US, Europe, Asia and other Latin American countries were among the purchasers. Separately, the ministry announced that it had also secured a US$500m loan from Goldman Sachs.

The funds raised by the bond issue and the loan will be used to finance priority investment projects in the 2018 budget. In a new audit report, the national planning and development secretariat (Senplades) and the transport & public works ministry (MTOP) listed 640 incomplete projects inherited from the previous administration.

Originally valued at US$2.1bn, some US$4bn has already been invested in these schemes, with another US$1bn needed to complete them. Explaining that projects have not been completed for various reasons, including termination of contracts, lack of funds and technical failures, the head of the MTOP, Paúl Granda, said that 111 projects remained active.

### Antofagasta going green

Chilean mining company Antofagasta is seeking to renegotiate its long-term energy contracts so as to shift the balance in favour of renewable resources such as wind and solar energy. Chief executive Iván Arriagada said renewable energy prices had become more competitive.

The company's Los Pelambres copper mine now relies on renewable energy for 45% of its total needs. Other Antofagasta mines in northern Chile, such as Centinela, Antucoya, and Zaldivar are still using electricity from coal-fired plants, but were looking to move towards renewables.

"Going forward, we will prefer non-conventional renewable resources, and it wouldn't surprise me if we passed 50%, though we don't have a specific goal", Arriagada said.

### Banorte merges with Interacciones

Grupo Financiero Banorte on 25 October said that it had signed an agreement to merge with Interacciones, one of its top 10 rivals in the Mexican banking sector, for an undisclosed sum. Banorte, led by Carlos Hank González, is the fourth largest bank in the country. Interacciones, led by Carlos Hank Rhon, is smaller, and specialised in funding Mexican states.

The merged bank will be the second largest in the country, with 15.46% of total assets, placing it second to BBVA Bancomer with a 23.19% share. The merger is subject to regulatory approval by the Comisión Federal de Competencia (Cofece).

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