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Growing focus on 'Marinaconomics' as Brazil poll nears

After the tragic death of Eduardo Campos in an airplane crash in early August, Marina Silva, who stepped up from the number two spot to replace him as the Partido Socialista Brasileiro (PSB)'s presidential candidate, has blazed her way up the opinion polls and is a real contender to win the October race. Most analysts believe that the 2014 election has become a two-way affair between Silva and the incumbent, Dilma Rousseff, who is seeking a second term at the head of a sprawling coalition led by the leftist ruling Partido dos Trabalhadores (PT). Brazil's business community is not hiding its support for Silva. In fact, when Rousseff has done poorly in the opinion polls, the stock exchange has rallied, raising an interesting paradox of an anti-establishment politician who has become the darling of Brazilian business.

To get elected, almost all politicians have to appeal to different and sometimes antagonistic interest groups. The original PSB ticket sought to do just that. As presidential candidate, Eduardo Campos promised to deliver a more orthodox economic policy, toning down the high taxes and persistent interventionism of the Dilma Rousseff government.

If his job was to reassure business, Marina Silva, as his running mate, had a different task: attracting the protest vote. With her winning personal story (a successful battle against poverty, won through hard work and dedication), her background as an environmental activist; and her reputation for austerity and honesty, she was well placed to do that. Now that she is number one on the ticket, Silva seems to be doing both jobs quite effectively, if the pollsters are right. But just to make sure the appeal is as wide as possible she now has the PSB's former lower house bench leader Beto Albuquerque as her number two. His task is to rebuild bridges to the country's important agri-business sector, which has been somewhat alienated by Silva's history of opposition to genetically modified food crops.

Nonetheless, there is a big question as to what Silva will do if she wins. The candidate and her advisors have made clear that she will deliver on Campos' broad economic policy promises. These are being summarised by the campaign team as: greater fiscal discipline, greater autonomy for the central bank, tougher inflation-targeting (aiming at a core target rate of 3%, rather than the current 4.5%), and a freely floating currency.

According to María Alice Setubal (known as Neca), whose family controls Itaú Unibanco, Latin America's largest bank and who also serves as an advisor to the PSB candidate, "those who know Marina know she will follow

through on what she is saying. Marina will commit to all pledges made by Eduardo Campos in relation to inflation targeting, tax reform and central bank autonomy". Heading off criticism that Silva has no economic management experience, Neca Setubal says the candidate is "surrounding herself with people who understand the markets; she is committed to gaining the trust of the financial establishment". Some journalists speculate that Setubal could become Silva's chief of staff, a move that would further build that trust.

Another adviser, Eduardo Giannetti da Fonseca, has accused the Rousseff administration of being "reckless" in the way it has allowed inflation to stay at 6.5%, the ceiling of the existing target range (4.5% +/-2.0%). "The ceiling became the centre of the target" he says. Gianetti also says that the currency, the Real, must be allowed to float freely, and not be deliberately overvalued as at present, where it is being used an anti-inflationary tool. "That is an action that generates distortions and is a worrying framework for the country" he notes.

Also on the cards is an unwinding of the present government's policy of subsidising petrol and electricity prices. This, it is acknowledged, would have a short-term negative effect on demand. According to Gianetti, a victory by Silva and the PSB "would allow the economy to function with less clumsy intervention. Brazil would go through a couple of quarters of adjustment, but it would have growth by the end of 2015".

"Those who know Marina know she will follow through on what she is saying. Marina will commit to all pledges made by Eduardo Campos in relation to inflation targeting, tax reform and central bank autonomy"

- María Alice Setubal

One perceived weakness is that Santos may be seen as anti-agribusiness, a sector that contributes around 23% of GDP. As environment minister (2003-2008), she insisted on tough anti-deforestation regulations in the Amazon and opposed the introduction of transgenic crops. However, the official version from the campaign team is that legislation in the last few years struck a balance on these issues (transgenic crops are allowed under certain conditions) that Silva accepts: she is not against GM foods in all cases, but does want an appropriate mix of crops.

Whether she can win over the agri-business sector remains to be seen. One agri-business "billionaire", who wished to remain anonymous, told *Forbes* magazine that he liked Silva and that "we shouldn't have any problems once the law is respected… I think we will have a few surprises in this election, and they will be good". But soya farmer Henrique Ceolin went on the record to the *Wall Street Journal* to say, "I only know that she was always against agribusiness. I don't trust her". Her proposal to reduce petrol price subsidies, however, has gained the support of sugar cane and ethanol producers – as ethanol would end up more competitively-priced, and sales at petrol stations thus would increase.

Latest polls too close to call

The latest (mid-September) opinion poll by Ibope put Rousseff on 36% of voting intentions ahead of the first round vote on 5 October, with Silva on 30% and Aécio Neves, of the main opposition Partido da Social Democracia Brasileiro (PSDB), on 19%. Ibope predicted a technical tie between Silva and Rousseff in a second round run-off scenario. A second round, required if no candidate wins 50% + 1 in the first round, would be held on 26 October.

Likewise, Datafolha in mid-September put Rousseff on 36% of voting intentions and Silva 33% in the first round. Aécio Neves, on just 15%, would lose out in the first round. In a run-off, Silva was on 47%, versus 43% for Rousseff.

MEXICO

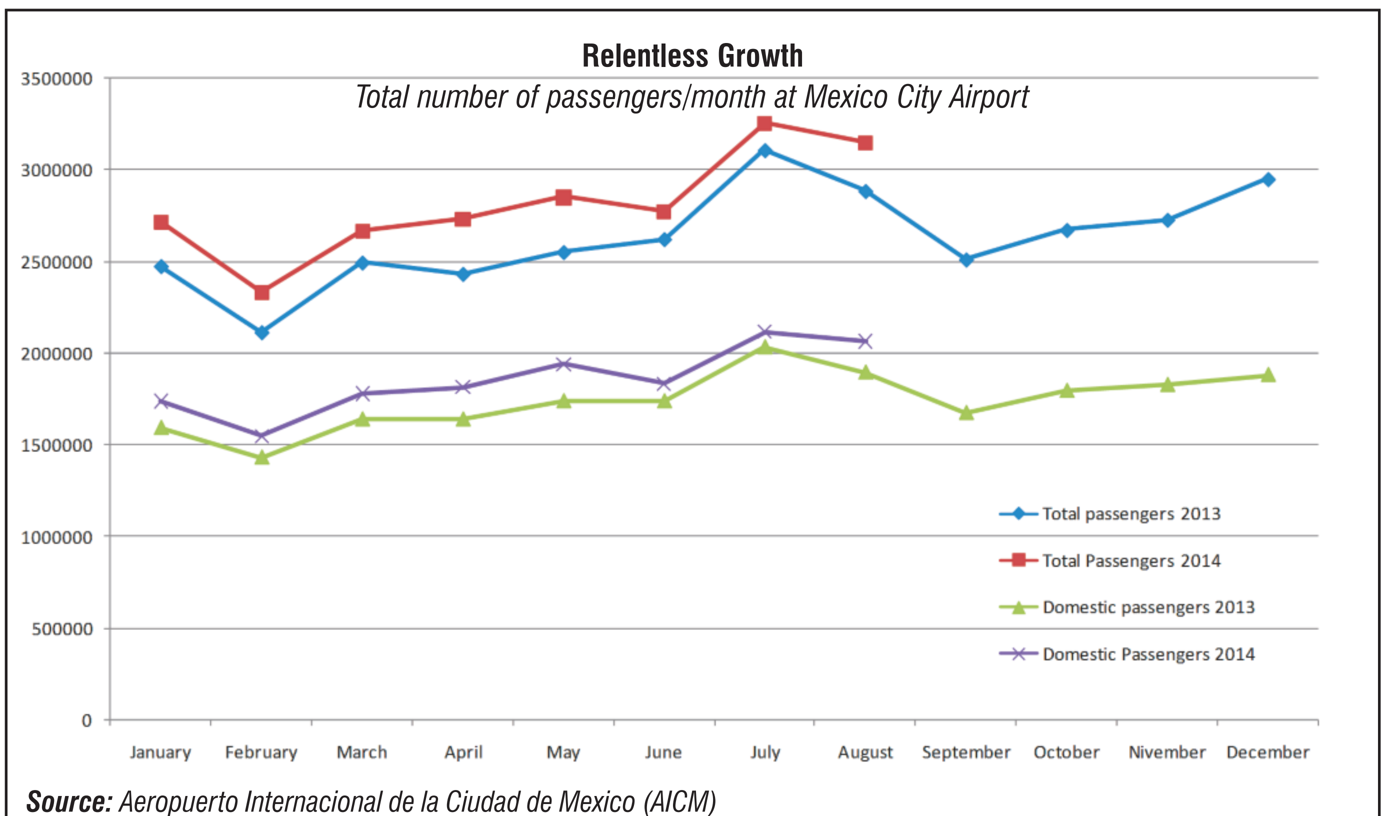
An airport to define a presidency?

> "One interesting reading of these moves is that the president is making a deliberate play to boost the standing of the ruling Partido Revolucionario Institucional (PRI) in Mexico City, long an opposition stronghold."

Assume you are the president of Mexico. In your first 21 months of a six-year term in office you have won congressional approval for far-reaching reforms covering banking, the tax system, education, telecommunications, and most importantly, the energy sector. Because of this, your international reputation is extremely good; you've had your picture on the cover of *Time* magazine. But there is a problem. It will take years before these reforms boost economic growth, which at the moment remains weak. And at home your popularity ratings are falling. Mid-term elections are due in 2015. Perhaps now might be a good time to launch one of the world's largest infrastructure projects?

Of course, no-one what President Enrique Peña Nieto is thinking, or exactly what political and economic calculations he is making, but there is much to suggest that the announcement of a new Mexico City airport, made on 2 September as part of his annual state of the nation address, may be a defining moment for his single term presidency (2012-2018). At an overall cost of around US$9.2bn, this is clearly not just another project. The president described it as "the biggest infrastructure project in our country in recent years, and one of the largest of its type in the world".

There is little doubt that Mexico City, one of the ten largest metropolitan areas in the world, needs a new airport. When the current airport — Aeropuerto Internacional de la Ciudad de México (AICM), also known as Aeropuerto Internacional Benito Juárez, was built in 1952, the Mexican capital had a population of 3.0m; today it has over 21.0m. A second runway was built in 2007, but as it is located very close to the first runway, fully simultaneous use of both is not possible. The existing facility has a maximum handling capacity of about 32m passengers a year. In 2013, it handled 31.5m



Source: *Aeropuerto Internacional de la Ciudad de Mexico (AICM)*

“Spending on transport infrastructure projects...will include 24 railway lines (including a Mexico City – Querétaro high speed train link) and four new metro rail lines in Mexico City itself. Investment in rail projects in 2014 alone will reach US$1.8bn, the president said.”

passengers. With planes landing or taking off every minute, every available slot is already full at peak times in the mornings and evenings. A recent study by a local think-tank, Instituto Mexicano para la Competividad (Imco) concluded: “We face an undeniable reality: AICM has reached the upper limit of its capacity, and because of the dense urban sprawl surrounding it, it cannot be enlarged”. Passenger numbers have been growing at 9% per annum, squeezing out airfreight and raising logistics costs (Mexico City is the second largest Latin American airport by passenger traffic, but the third largest by air cargo tonnage). Imco cites a World Trade Organisation (WTO) study suggesting that a 10% increase in transport costs can reduce foreign trade by as much as 20%.

President Peña Nieto has come up with a bold response to the problem. He announced that the government had made a decision to build a brand new airport in the Texcoco Valley, about 10kms from the current site. At an estimated cost of US$9.2bn, this new airport eventually will have six runways and the capacity to handle 120m passengers a year. In a first phase, lasting about five years, the airport will have three runways and capacity to handle 60m travellers. Better still, on 3 September, the day after the speech, the government announced that the design contract had been awarded to a partnership between the British ‘starchitect’ Norman Foster (responsible among other things for Terminal 3 at Beijing Airport, Hong Kong Airport and Berlin’s Reichstag building) and the Mexican architect Fernando Romero (responsible for the silver-curved Soumaya Museum commissioned by Mexican billionaire Carlos Slim). The two men unveiled their proposal: a gigantic X-shaped membrane-roofed terminal with references to the coat of arms in the Mexican flag, the eagle devouring a snake on top of a cactus. Foster described it as “a soaring, sculptural, trailblazing structure”, while Romero stressed its “monumental scale”, echoing the old Aztec capital of Tenochtitlán, which would make it into a bold and contemporary “gateway into Mexico”. Peña Nieto described it as “the emblem of a modern Mexico”.

The project can also be seen as emblematic of a wider political change in the Peña Nieto presidency. In his first 18 months in office, the president has focused on long-term structural reforms. While they make sense to investors and economists, the domestic political benefits are distant. Opinion polls suggest a majority of the population opposes the energy reforms and remains stubbornly gloomy about the economy. The government itself admits things will take time. Officials calculate that opening up the energy sector will attract new investment and boost Mexico’s GDP growth rate by between one and two percentage points – but only from 2018 onwards (which happens to be Peña Nieto’s last year in office). Government officials have also said that the energy reforms, coupled with a shift to gas-burning power generators, could lead to lower electricity prices – but only from around 2016 onwards. Meanwhile, GDP growth has been sluggish. It

The top airports in Latin America – Year to September 2012

Rank	Name	Passengers/year, m	Rank	Name	Cargo (tonnes)
1	Sao Paulo – GRU	32.385	1	Bogotá - BOG	628,423
2	Mexico City – MEX	28.732	2	Sao Paulo - GRU	481,681
3	Bogotá – BOG	21.965	3	Mexico City - MEX	403,885
4	Rio de Janeiro – GIG	17.387	3	Santiago de Chile - SCL	298,150
5	Sao Paulo – CGH	16.597	4	Lima - LIM	288,823
6	Brasilia – BSB	16.175	5	Campinas - VCP	273,027
7	Cancún – CUN	14.129	6	Buenos Aires - EZE	208,682
8	Santiago de Chile – SCL	13.731	7	Quito – UIO	186,915

Sources: *AICM, Airports Council International, World Wide Airport Traffic Statistics.*

slumped to only 1.1% in annual terms last year, and according to a World Bank forecast will edge up to a still-disappointing 2.3% in 2014.

So there is now a suggestion that with the structural reforms done and next year's mid-term elections approaching, the president is switching to some old-fashioned and electorally-focused pump-priming of the economy. While the airport is also a long-term project – it won't begin operating until after 2018 – it will generate significant employment from as early as next year. Federico Patiño, the financial director of the project, says that in the construction phase it will employ 150,000 workers. According to transport and communications minister Gerardo Ruiz, once in operation, for every 1.0m passengers travelling through the airport 4,000 jobs will be created (1,000 directly, 3,000 indirectly). Tourism will also receive a boost (Mexico is among the top 15 most-visited countries in the world). More widely, the president has signalled a generalised increase in public spending on big infrastructure projects. In his 'Informe' (the annual state of the nation address), he promised a big boost in spending on transport infrastructure projects. These will include 24 railway lines (including a Mexico City – Querétaro high speed train link) and four new metro rail lines in Mexico City itself. Investment in rail projects in 2014 alone will reach US$1.8bn, the president said. Peña Nieto also promised to boost poverty alleviation programmes such as Oportunidades, now renamed Prospera.

"Enrique Peña Nieto is talking of a country that does not yet exist... and we citizens, hearing his description, would like to live in the country that he's living in."

One interesting reading of these moves is that the president is making a deliberate play to boost the standing of the ruling Partido Revolucionario Institucional (PRI) in Mexico City, long an opposition stronghold. Those who take this view say that both the right-wing Partido Acción Nacional (PAN) and the left-wing Partido de la Revolución Democrática (PRD) have made a hash of transport projects in the sprawling capital in recent years. It was during the PAN federal government led by Vicente Fox (2000-2006) that an attempt to expropriate farmers' land to build a new airport ran into determined and violent opposition in the Texcoco Valley town of San Salvador Atenco, leading to the embarrassing collapse of the entire project. Following on from that failure, the country's next PAN president, Felipe Calderón (2006-2012), opted for the second-best solution, building another runway at the over-congested existing airport. Meanwhile, a succession of left-wing Mexico City mayors failed to significantly improve urban transport. Mauricio Ebrard (2006-2012) did commission the so-called 'golden line' - Mexico City metro's 12th line - but it has been bedevilled by allegations of irregularities and technical problems, and services have been indefinitely suspended on half the line because of unstable tracks and the danger of derailment. By promising to deliver no less than four new lines, Peña Nieto seems committed to convincing voters that the PRI can deliver where its rivals have failed. Some say the airport project is designed to win over Mexico City's middle class; the promised new Metro lines are designed to win over Mexico City's urban working class.

The president does seem to be articulating a coherent and modern vision for the future of the Mexican economy. It includes deep, market-friendly structural reforms and greater competitiveness on the back of lower energy costs and a more efficient transport system, of which the new airport is just one example. But like all bold visions, it carries some serious risks. One is that the execution will fall below expectations. Because of its very ambition and complexity, the airport project could face technical problems, delays and cost overruns (the Texcoco Valley is a former lake-bed and some technicians say laying solid foundations for the airport structures could be a more expensive business than envisaged). While the project will use federal land – meaning expropriation is not necessary - some local farmers have already signalled that they intend to fight the new project just as intensely as they fought its predecessor in 2002.

A second risk is that Peña Nieto's public commitment to creating a more open and transparent economy, less subject to monopolistic practices, is seen to be more rhetorical than real. The telecoms reform was designed to reduce the power of dominant groups in the industry such as Carlos Slim's América Móvil. But the fact that the airport design contract has been won by a partnership including Fernando Romero (who is Slim's son-in-law) ,with Grupo Carso (owned by Slim) already one of the front-runners to win the civil engineering tender due early next year, may lead Mexican voters to conclude that "everything changes, but nothing changes" and that the dominant groups are getting more, rather than less powerful.

A critical view was expressed by the Mexican journalist, Jorge Zepeda, who in a recent article published by Spain's *El País* said: "Enrique Peña Nieto is talking of a country that does not yet exist… and we citizens, hearing his description, would like to live in the country that he's living in". His main point was to claim a disconnect between the president's view of a modern Mexico and the reality of unequal income distribution, drug-related violence and corruption. Zepeda conceded that the country's annual GDP growth rate will probably rise to 4%-5% in the second half of Peña Nieto's *sexenio*, but he argued that "the benefits will be felt almost exclusively by the one-third of the population that can describe itself as in the middle or upper classes".

BRAZIL

Embraer lands big Japanese order

The Brazilian aircraft manufacturer Embraer had a good month in August, announcing a US$677m order from Japan Airlines (JAL) for 15 of its regional E-Jets. While JAL also ordered planes from rival Mitsubishi Aircraft, which is entering the regional jet market in Latin America, Embraer's ability to clinch deals in geographically distant markets reaffirms its position as a highly competitive global player.

JAL has ordered a combination of 15 E170 and E190 Embraer jets; if it exercises an option to take a further 12, the total value of the order will exceed US$1bn. The Japanese airline had already incorporated 15 regional jets from Embraer back in 2007. "This repeat order by JAL is an affirmation of the added value that the E-Jets have brought to its operations over the years. It has enabled the airline to grow its domestic network in a sustainable way" said Paulo Cesar Silva, CEO of Embraer's commercial aviation unit. Success in Japan came on the back of a bigger deal in China last July, when it was announced that Embraer would sell 60 of its Series 2 E-190s, 40 directly to Tianjin Airlines and 20 for leasing purposes to the Industrial and Commercial Bank of China. That deal, estimated to be worth US$3.2bn, was announced during Chinese president Xi Jinping's visit to Brazil. Meanwhile on the home market, the budget airline Azul Linhas Aéreas Brasileiras in July placed an order for 30 of the Series 2 E-195s, worth US$1.87bn.

The orders suggest that Embraer's assembly line at Sao José dos Campos in São Paulo state will be kept busy for the next few years. In its commercial aviation division, the initial signs are that the Brazilian company has positioned itself better than its archrival, Bombardier of Canada. Embraer has seized a big chunk of the global market for regional jets (100 to 130 seats) and is determined not to let go of that niche. In 2013, according to *Bloomberg*, Embraer received a total of 272 regional jet orders, against only 27 for Bombardier. Both companies are investing heavily in the next generation of regional jets: Series 2 for Embraer and the CSeries for Bombardier.

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But the two have approached their next-generation aircraft differently. Bombardier's CSeries project was launched in 2008 with the ambitious aim

of designing a new single-aisle regional jet from scratch. It would be 20% more fuel-efficient, reduce noise and CO2 emissions, and have a more flexible seating range accommodating between 108 and 160 passengers, therefore allowing it to compete with the smaller aircraft produced by the likes of Boeing and Airbus. With a US$3.5bn development budget, CSeries planes were expected to enter service in 2013. However, as often happens with complex aviation projects, there have been engine troubles, delays and cost overruns. Total costs to date have exceeded US$4.4bn and the first CSeries jets are not expected to enter service until 2016. To compensate for the financial drain, Bombardier has announced a series of cost-cutting programmes across its operations.

In contrast, Embraer was comparatively less ambitious. It launched the Series 2 programme later (in 2011), with a smaller budget (US$1.7bn), and with the more limited objective of re-engineering and updating the existing E-Jets. Despite these more modest aims, the new jets are said to offer "double percentage digits" reductions in fuel costs, noise, CO2 emissions and maintenance costs. Embraer Series 2 jets are expected in service by 2018 – two years later than the CSeries – but this has not dampened airline interest or advance orders.

Curado describes Embraer's vision as to "evolve from a Brazilian exporter to a global business headquartered in Brazil".

Embraer's chief executive, Frederico Curado, recently estimated that in 2014 the company will make 55% of its revenues from the commercial aviation sector, 25% from executive jets, and 20% from defence contracts. He described the commercial aviation sector, which accounted for 90% of revenue in 2000, as "cyclical and extremely cash-intensive". There had been a deliberate aim, therefore, to develop the other two divisions to smooth out some of the peaks and troughs of the main business and end up with "a more stable portfolio of products and revenues". The company is particularly enthusiastic about recovering demand for executive jets in the US.

Curado describes Embraer's vision as to "evolve from a Brazilian exporter to a global business headquartered in Brazil". In his assessment, the company is well on its way to achieving that. As he put it: "We have established manufacturing, customer support, engineering, and R&D operations abroad (US, Europe, and China); have gained access to great talent; and have brought our organisations closer to our customers around the world (exports represent some 85% of revenues). All of this has strengthened our position as a global player."

CHILE

Scissorhands takes over at Codelco

Nelson Pizarro, nicknamed 'scissorhands' for his cost-conscious management of mining projects, took over as the new CEO of Codelco, Chile's state-owned copper company, on 1 September. Appointed by the board, Pizarro did not conceal that staff and cost reductions may be on the way, although he said he would take two to three months to audit the company's various mining projects.

"It has been calculated that Codelco has handed over around US$100bn in profits since 1970, and got US$4bn of that amount back.""It has been calculated that Codelco has handed over around US$100bn in profits since 1970, and got US$4bn of that amount back."

Pizarro is an industry veteran, with a track record in both Codelco and in the private sector mining, where he has worked for Antofagasta Minerals. He replaces Thomas Keller, who was dismissed by the Codelco board in June. Oscar Landerretche, the new chair of the board, himself appointed earlier this year by President Michelle Bachelet (after she took office in March), said that Pizarro's role will be "to create new leadership in Codelco to move forward and push through the biggest investment programme in the history of the company". He will have to do this at a time of falling ore grades and weaker international copper prices, while attempting to maintain good relations with Codelco's powerful trade unions. "In these difficult conditions, Nelson Pizarro is probably the right man for the job" said Juan Carlos

Guajardo, head of the copper studies institute, Centro de Estudios del Cobre y la Minería (CESCO).

At least there has been some progress on the thorny issue of Codelco's relationship with government. The company's curse has been its ability to generate large revenues, which has persuaded a succession of governments to treat it as a cash cow. Copper accounts for 60% of Chile's exports and 15% of its GDP. Under existing regulations, Codelco must hand over all its profits every year to the ministry of finance, and submit a request to get some of them back for its investment programme. Since this system was put in place on Codelco's creation in 1971, governments have been very eager to take and much less eager to give back. It has been calculated that Codelco has handed over around US$100bn in profits since 1970, and got US$4bn of that amount back. In an attempt to give Codelco a better deal and a longer planning horizon, the Bachelet government in August said that it would commit to giving the company US$4bn between now and 2018, of which US$1bn would be in the form of returned profits, and the remaining US$3bn in treasury-issued debt. This will at least give Pizarro a predictable core funding base: Codelco will also borrow on international capital markets to boost its investment programme. The company says it needs to spend over US$20bn to revamp its older mines and develop new ones.

Former president Ricardo Lagos (2000-2006), while admitting that his own administration took its pound of flesh, has said that Codelco should be given greater autonomy, perhaps with a charter similar to that enjoyed by the central bank. "If you compare Codelco's current corporate structure to that of the central bank, the degrees of autonomy are clearly different, which is based on the importance the company plays in the country's public finances", he recently said.

Pizarro will no doubt be going through Codelco's first half results with a fine toothcomb. Output was up by 4% to 788,000 tonnes of copper, but pre-tax profits were down 27% to US$1.3bn, largely because of weak international prices, which dropped 8% to US$3.14/lb. The Chief Financial Officer, Ivan Arriagada, said he was not too worried about prices in the long run. "We don't see fundamental changes in copper market fundamentals and we expect it to remain relatively favourable," he noted. But despite an 8% reduction in cash costs, management is expected to keep up the pressure for efficiency to counteract the effect of falling ore grades. For example, Pizarro has said he favours a plan to convert the gigantic Chuquicamata mine from open cast to underground, so as to get better yields, a project that is opposed by the mining unions because it will lead to job losses.

MEXICO

Pemex restructures

> "Whether Pemex grows as a Mexican oil major, or evolves like Norway's Statoil into an international oil major in future years, is uncertain, but much will depend on how truly free it is to invest in expertise and productive assets, while maximising government value."
>
> *- The Atlantic Council*

On the surface at least, it looks as if Pemex, Mexico's state-owned oil giant, is on the front foot and adapting quickly to changing times. On 11 August, President Enrique Peña Nieto signed into law a package of by-laws ushering in wide-ranging changes to the country's energy markets. Nine days later, on 20 August, the chief executive of Pemex, Emilio Lozoya, announced a restructuring of the company. The question is whether Pemex is ready for a smooth transition from seven decades of monopoly power to a new, more competitive future.

The official view is that Pemex, a vast and sprawling company (it has 150,000 employees), is rising to the challenge to become more agile, flexible and efficient. To do this it will simplify its structure. Its existing six subsidiaries will initially be reduced to two. One of the six, Instituto Mexicano del Petróleo

(IMP), a research institute, will be hived off to work across the industry as a whole. Exploration and Production (E&P) will remain a key subsidiary, while the other four (refining, gas and basic petrochemicals, petrochemicals, and PMI Comercio Internacional, the holding company for all overseas operations) are to be merged into a single unit to be called Industrial Transformation. Separately, three new subsidiaries are to be set up to focus on emerging opportunities in the deregulated energy sector: these are a drilling subsidiary, a logistics and transport unit and a unit to co-generate electricity as a by-product of industrial operations. It is envisaged that each of these units will sell services not just to other parts of Pemex, but also to the new private sector players entering the industry, such as the International Oil Companies (IOCs) that are expected to invest in Mexico.

While the changes are seen as sensible in themselves – for example a range of overlapping procurement departments will be rationalised – they leave many questions unanswered. One concerns timing. Changes are coming at the top of Pemex, with the much-criticised oil workers' union (often seen as an exponent of Teamster-style corruption) losing its board level representation, and five new independent directors due to be appointed. The new board will continue to have government representatives on it (the CEO, for example, is a direct presidential appointment; and the energy minister is also a member), but is intended that it should sit more at arms' length from the executive, be more commercially independent in its outlook, and have greater budget autonomy. However, its new members will not be confirmed until October, so the new board could conceivably revisit the whole restructuring or require further changes.

In second place, there is no sign, as yet, that a company that has been active in all areas of the oil and energy business is thinking of specialising in a few key areas, where it might best compete. Admittedly, Lozoya has made some comments in this regard, noting that Pemex is unlikely to be at the forefront of shale exploration, as it lacks the necessary expertise. The question was recently posed in a report by The Atlantic Council, a Washington based think-tank which, while enthusiastic about a possible "energy renaissance", noted that "whether Pemex grows as a Mexican oil major, or evolves like Norway's Statoil into an international oil major in future years, is uncertain, but much will depend on how truly free it is to invest in expertise and productive assets, while maximising government value".

Perhaps the biggest question mark hangs over two very politically sensitive issues which sit like elephants in the room: overstaffing and corruption. A more competitive Pemex will need to tackle both, and the fact that neither has been specifically mentioned in the company's strategic plans worries some analysts. David Shields, an industry specialist and editor of *Energía a debate*, says: "Greater efforts against corruption are needed, but the worse problem is political intervention by President Peña Nieto himself, who has made questionable business decisions for Pemex with Spanish and Chinese authorities (buying a Spanish shipyard and promising major pipeline business to China)". Some analysts argue that Mexico should have emulated what was done in Brazil, where Petrobras remains state-owned but has minority private sector shareholders and is listed on the stock market. Petrobras is not without its own corruption problems at the moment, but the argument is that its stock market listing exposes it to a greater level of scrutiny and accountability. Mexico's Energy Minister, Pedro Joaquín Coldwell, was recently asked why the government had not sought a listing for Pemex. He said that "political conditions" did not favour a listing: "I think that will have to be a subject for the future. At the end of the day, reforms aren't all done in one go and they don't last forever. There has been a great step forward, and this Mexican model will continue to evolve and be enriched", he said.

"Some analysts argue that Mexico should have emulated what was done in Brazil, where Petrobras remains state-owned but has minority private sector shareholders and is listed on the stock market. Petrobras is not without its own corruption problems at the moment, but the argument is that its stock market listing exposes it to a greater level of scrutiny and accountability."

REGION

What the big two could do differently

Brazil and Mexico are the two economic giants of Latin America. They are suffering from slow growth (Brazil more so than Mexico). And they traditionally don't pay too much attention to each other. This should change, says the Development Bank of Latin America (CAF), which suggests that greater integration between these two giants could help them both, and the rest of the region, to move more strongly on the path to recovery.

According to the CAF's president, Enrique García, Brazil and Mexico should develop a joint agenda for economic integration, which would help boost the entire Latin American region at a time when growth has been slowing. Speaking at the CAF's annual conference in Washington at the beginning of September, García said the top priority should be to create "a competitive regional market" that would allow Latin America to evolve from "a comparative advantage model, based on the raw materials production cycle", to "a comparative advantage model based on value added".

Brazil – Mexico trade figs

Mexican exports to Brazil in 2012 were worth US$5.66bn, or 1.6% of its total exports of US$349.6bn that year. Brazil exported US$4.5bn to Mexico in 2012, a mere 1.8% of its total exports of US$242.6bn.

Colombia's former finance minister José Antonio Ocampo took up the theme. He said the political distance between the two countries was harmful. "We have a situation where Brazil does not support what Mexico proposes, and Mexico won't support an idea coming from the Brazilians". The differences had a long history he said, and had evolved into a situation where each country leads a separate trade block: the Pacific Alliance in Mexico's case (comprising Chile, Peru, Colombia and Mexico), and the Southern Common Market (Mercosur, comprising Argentina, Brazil, Paraguay, Uruguay and Venezuela) in Brazil's case.

Ocampo insisted it was not really a question of ideological differences. "In Europe, governments of the Right and Left collaborate, even though they've fought wars. So why can't we do it here? It is good business and it generates prosperity. We Latin Americans don't have a history of big wars but an infinity of small slights and acts of contempt". He went on to say that Mexicans "think things are going well if Brazil is doing badly, and the Brazilians think the same about Mexico. In fact, we'd all be better off if both Mexico and Brazil do well at the same time".

While he did not specifically address the relationship between Brazil and Mexico, Enrique Iglesias, the former president of the Inter American Development Bank (IDB) and a veteran of regional trade negotiations, spelled out the case for greater integration. With global tail winds decreasing for the Latin American economies, "we have to look with much greater interest at the question of economic modernisation, so that we do not just base our growth on high raw material prices or capital inflows" he said. "We need to find the dynamics of our own internal markets. Let's not forget that Latin America and the Caribbean has a total regional GDP of US$7.0trn. That is a lot of money, and a very powerful market."

To take full advantage of it, Iglesias said it was necessary to pursue deeper integration, focused on re-industrialisation and shared value chains. "What does a small country like Uruguay do to become involved in industrialisation? Well it needs to link up to bigger markets, to Brazil, Argentina, Chile.

We should look to China, where 40% of its exports by value are actually produced in Taiwan, Vietnam, and other Asian countries. Actually, if you look back historically, it was post-war Japan which pioneered this first, incorporating complementary components from neighbouring countries into its export effort." From this perspective, Iglesias said he was encouraged by the work of around 500 'multilatinas', Latin American multinational companies that are seeking to operate across the continent. He also argued that there would be greater value in seeking to merge the Pacific Alliance and Mercosur trade blocks into one big alliance. As he put it, in current economic conditions it is better for the Latin American economies to travel as a convoy, rather than to try and find their own way as individual ships.

URUGUAY

Conservative Left vs. Innovative Right?

Uruguay's left-wing ruling Frente Amplio coalition looked as if it was coasting home to an easy return in this year's presidential and congressional elections (due on 26 October, with a possible second round on 30 November). But in the last few months, support has been building for the traditional centre-right Partido Nacional (PN, Blancos). While the Frente is still ahead, it has become a much more open race. And in a reversal of the traditional roles, the Left has found itself defending the economic status quo, while it is the PN that is promising to shake things up a little.

Some take it as a sign of the times: the Frente Amplio, backing election for a second time of former president Tabaré Vázquez (2005-2010), has just changed its campaign slogan. Out goes 'vamos bien' ('we're doing well') and in comes 'Uruguay no se detiene' ('Uruguay doesn't stop'). Although Uruguay is, in fact, doing well after 10 years of centre left government – certainly by comparison with its immediate neighbours – the growing challenge from the youthful Luis Lacalle Pou, the PN's presidential candidate, had made that slogan sound just a little too complacent. The Frente Amplio has a fight on its hands.

Traditional roles have been reversed. When the Frente fought the 2004 elections with Vázquez as its candidate, the main criticism it had to face from the traditional parties (the PN and the Partido Colorado [PC, Colorados]), was its lack of government and economic management experience. Voting for the Frente was a leap into the economic unknown. But now, a decade later, it is the Frente that represents the status quo, and the Frente's 2014 campaign team is highlighting Lacalle's lack of experience.

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Economy Minister Mario Bergara recently announced that the economy had grown by 3.7% in the second quarter, in sharp contrast to both Argentina and Brazil, which are in recession. He said that the country had de-coupled itself from its immediate neighbours. Growth would continue, although at a slower rate (Bergara is predicting 3% for 2014 as a whole). In response to Argentina's protectionism Uruguay has re-directed its foreign trade. Less than 5% of Uruguay's exports now go to Argentina, down from 25% in 2001. China is now Uruguay's main trade partner. Uruguay is also less exposed to an Argentine financial crisis. Only 9% of the deposits in the Uruguayan banking system are owned by Argentines, compared to 40% in 2001, according to the economy minister. More generally, the Frente can point to strong economic growth, controlled inflation (although at 9% it is still on the high side), investment grade status, poverty reduction and sustained support for social spending – in its view, all good arguments to elect Vázquez.

But Lacalle's team believe they know where the government's weak spots are. Although crime rates are lower than in many other Latin American countries, they have been rising, and consistently emerge as an issue of voter concern. So is the perceived poor quality of the education system. Despite increased resources, Uruguay scores poorly on the PISA index of educational quality. Schools have also suffered from strikes by the teachers' unions (most of which are affiliated to the Frente Amplio). The government's mis-management of the closure of the state airline PLUNA is also seen as an example of poor custodianship of public money.

Lacalle, who takes care to tone down the more ideological free market commitments of his father Luis Alberto, also a former president (1990-1995), is promising to do better in these areas. One of his economic advisers, Juan Dubra, also questions the Frente's economic achievements. "They have the idea that Uruguay didn't exist before 2004 and that's not correct" he recently said. "The Uruguayan economy didn't grow because of what the Frente did. The flow of gigantic investments became possible because of things that were done before that date".

Lacalle has named Azucena Arbeleche, an economist and foreign debt specialist, as the head of his economic team (and prospective economy minister). She has said greater emphasis will be placed on the quality of public spending. As she put it, "we do need more and better paid teachers, but we can have less advisers, consultants, and political appointees". She has also stressed the importance of boosting the competitiveness of the Uruguayan economy. Arbeleche has promised to maintain social spending to protect the socially vulnerable, but she says that a Lacalle administration will do more to help people "emerge from situations of vulnerability".

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VENEZUELA

About to default, or not?

The ratings agency Standard & Poor's (S&P) estimates that there is a 50% chance that Venezuela's government will default on its sovereign debt over the next two years. We think that the likelihood is lower, but still significant, at around 25%. Below we examine signs that a default might be imminent.

On 16 September, S&P cut its long-term sovereign rating for Venezuela by one level from B- to CCC+ (seven levels below investment grade) and placed the sovereign on negative watch. S&P expects the local economy to contract by 3.5% this year and puts the likelihood of a default over the next two years at one in two - or 50%.

The possibility of a default by the radical left-wing government led by President Nicolás Maduro has received widespread coverage. For a start, the general financial environment is unfavourable. Two months ago, in our July 2014 edition, we identified evidence in the 2013 set of accounts released by the state-owned oil giant, Petróleos de Venezuela (Pdvsa), that both Pdvsa and the government have been short of cash for some time (since the end of last year, if not longer). Our assessment was that Pdvsa for a long time had had sufficient financial strength and cash flow to protect the government (through payments of royalties, taxes, contributions to social programs and dividends) from the generally downwards move in energy prices: however, the most recent data and news flow indicates that this is no longer the case.

For instance, in early August, Pdvsa announced that it was looking to sell its North American refinery business, Citgo Petroleum. Rafael Ramírez, now Venezuela's foreign minister but at that time the president of Pdvsa (as well as oil minister and vice-president for economic affairs), was reported as saying that Citgo was worth more than the US$10-US$15bn widely cited in mainstream media. This is in the context of a company that generated US$114bn in revenues from sales of oil and oil products in 2013.

The heightened chatter about a default reflects the deterioration in Pdvsa's financial situation. Relative to Hugo Chávez's day, overall circumstances are direr, inflation is higher and the price of oil is moving in the wrong direction. The potential rewards from a major change in policy are greater than they were previously. However, so are the risks: bringing about a fall in inflation and explaining it so that the government looks like a winner will be very difficult. Rafael Ramírez must understand this extremely well: it is not impossible that he has actively sought a senior, but non-economic, portfolio.

Our assessment was that the sale of Citgo was akin to 'selling the family silver', given that the subsidiary has a strategic value to Pdvsa that it would not necessarily have for another buyer. Citgo's refining capacity is equivalent to about a quarter of Pdvsa's annual production. Even allowing for the fact that not all of its capacity is suited to heavy Venezuelan crudes, the refining company represents a reliable client that is geographically close to Venezuela.

In the middle of August, Dagong Global Credit, a major ratings agency in China, reduced its sovereign rating for Venezuela from (a sub-investment grade) BB+ to BB-. Like S&P, Dagong expressed concern about the likely contraction in GDP this year. Dagong also pointed out that Venezuela's international reserves had contracted to around 5.7% of GDP at the end of 2013, covering just about a fifth of the country's (growing) external debt. Ironically, Dagong downgraded its rating soon after President Maduro had signed 38 new cooperation accords with his Chinese counterpart Xi Jinping. According to President Maduro, the accords included US$4bn in direct lending to the Venezuelan government, and US$14bn in financing for development projects across a range of Venezuelan economic sectors.

Various developments in September have confirmed that Venezuela's structural problems have not been addressed. The national statistics institute (INE) reported that total imports in the first five months of this year were valued at US$15bn, or 20% less than in the previous corresponding period. However, oil exports (and the more general balance of payments figures) have not been published since Q3 2013. Meanwhile, the central bank (BCV) reported (after a lag of two months in reporting) that the national index of consumer prices (INPC) had risen by 3.9% in the month of August, having increased by 4.1%, 4.4% and 5.7% in July, June and May respectively. The bank stressed that the monthly trend has been falling consistently since a peak in April, which it has attributed to the impact of the disruptive social protests in Caracas and other key cities in the first quarter.

Over the 12 months to the end of August however, the index rose by 63.4%. By this metric, inflation has continued increasing steadily over the past year. In August 2013, for instance, the corresponding figure was 45.4%. Food price inflation in the 12 months to August 2014 was an eye-watering 91.0%, hardly suggestive of much improvement in supplies. Notably, the BCV has not published in several months its scarcity index, which measures the availability on supermarket shelves of a basket of basic consumer goods. However in the first quarter the index was reported at about 28%-30%, meaning that 3 in every 10 goods were hard to find or unavailable.

A pressing problem is the maturity profile of government and Pdvsa debt. Total debt obligations falling due prior to the end of the year amount to some US$7.0bn, a third of the (official) foreign reserves held at the central bank (US$21bn). This includes US$1.5bn in government bonds maturing in early October and US$3.0bn in Pdvsa bonds falling due at the end of the month. Venezuela's overall public debt/GDP ratio is quite low, at around 51%.

As Francisco Rodríguez suggests, the Maduro government could break the cycle by combining orthodox policies (e.g. a reduction in fuel subsidies) with another devaluation, wrapped up in a political sell. This would be no mean feat. However, a fall in inflation to 25% would be a decisive break and change Venezuelans' expectations dramatically. This win could overshadow the impact of higher fuel prices and, because of the devaluation, the cost of imported goods. A government going into the 2015 midterms as the administration that 'broke' inflation would have a huge advantage. This could be why the BCV has started to publish inflation data again. Crucially, the government would also be able to obscure the fact that it had deviated from Bolivarian principles. The timing and the messaging would be everything.

In early September, Ricardo Hausmann, a former planning minister in Venezuela (1992-1993), a former chief economist at the Inter-American Development Bank (IDB) and now a Harvard University professor, argued that the Maduro government should default on its borrowings for 'moral' reasons, given the shortages of essential consumer goods (including food and medicines). In essence, the government has been using the various official ways in which foreign currency is auctioned to importers and other parties within Venezuela to husband foreign currency reserves. One consequence of this is that the black market exchange rate has soared to BF92/US$1 or so, well above the main official rate BF6.3/US$.

However, Francisco Rodríguez, the chief Andean economist at Bank of America Merrill Lynch, argues that Hausmann and Santos are missing the point. Analysis by Bank of America notes that the net external debt of Venezuela's public sector (i.e. gross external debt less gross external assets) amounts to around 3.5% of GDP and is stable. As indicated above, the government and Pdvsa need to divert a lot of foreign exchange towards repayment of maturing debt (and around US$28bn through 2015-2018): however, Rodríguez argues, neither is insolvent.

Writing in the UK's *Financial Times*, Rodríguez suggests that the real reason for the scarcity of goods and the genuine hardship suffered by many Venezuelans is the result of government-imposed distortions. "Venezuela does not need to default. It needs to start charging a realistic price for foreign exchange. It also needs to do the same thing for the other goods and services - such as gasoline and electricity - that it sells for near zero prices".

Rodríguez notes that the budget deficit amounted to 17.2% of GDP in 2013. If the authorities were to set the exchange rate at a single level that was reasonable in terms of demand and supply, it could reduce the deficit by 10 percentage points of GDP. Abandoning fuel subsidies would cut the deficit by another seven percentage points of GDP. "Defaulting, in contrast, would free up resources for at most 1.5 percentage points of GDP."

On 10 September, Brigadier General Rodolfo Marcos Torres, the finance minister and successor to Ramírez as vice president of the economic area, denied that the country faced a balance of payments crisis and insisted that Venezuela's public sector had "full capacity" to make the external debt payments that are required. This view was echoed some days later by President Maduro himself.

Our immediate reaction is that Torres and Maduro are correct. The surge in the black market value of the US dollar indicates that the authorities have been able to maintain a tight control over the foreign exchange market, perhaps because of the bewildering complexity of the various systems by which foreign exchange is allocated within Venezuela. The amounts needed in the coming seven weeks or so (i.e. through to mid November) look manageable given the size of foreign reserves (albeit most of these are tied up in gold, with only about a third liquid) and, importantly, the government's access to Pdvsa revenues. In a truly extreme situation, Venezuela could probably call on assistance from Chinese parties, or other unorthodox sources of finance.

Certainly, there has not appeared to be any urgency on the part of the government. The sacudón (big shake up) of the government promised mid-year turned out, on 4 September, to involve the creation of some new

ministries and six new 'sectoral' vice-presidencies. The reshuffle of personalities (which led, among other things, to Ramírez being replaced in all three of his roles) looked to be an effort to preserve the balance of power between the various competing factions of the Bolivarian Revolution). It also entrenched the role of the military. There was no indication of any official desire in the presidency to undertake the reforms discussed by Rodríguez.

Nevertheless, we agree with the assessment of the various ratings agencies that a default by the government (or, less probably, Pdvsa) within the next two years is a real possibility. Recognising that Venezuela's public sector is not insolvent, has not defaulted on its debts since the late president Hugo Chávez came to power (1999-2013) and has access to unorthodox sources of funds, we would assign this outcome a probability of 25%, rather than the 50% which is the assessment of S&P.

There are three signs to watch out for that would indicate an imminent default. One is monetary in nature. Venezuela has - fairly - been described as a country on the threshold of hyperinflation. However, there has not been evidence of an increase in the velocity of money in the country that would indicate that households and businesses see a collapse as being inevitable. In a classic hyperinflationary situation, velocity soars because actors rush to change their money into something else that will not lose value hour by hour. Expectations are distorted, the government has to monetise its spending to a greater extent and a vicious spiral develops. In fact, we would suggest that the latest inflation statistics published by the central bank are significant mainly because they indicate that such a hyperinflationary spiral is not happening.

> “[W]e agree with the assessment of the various ratings agencies that a default by the government (or, less probably, Pdvsa) within the next two years is a real possibility.”

The second sign is economic. Last year, Pdvsa earned revenues of around US$114bn from sale of oil and oil products. Leaving aside imports of crude oil and other products that it could not supply itself, the oil giant's cash expenses amounted to about US$56m. In 2012, the corresponding figures had been US$125bn and US$55m. The expenses do not include contributions to the off-budget National Development Fund (FONDEN) or other social development programs.

In theory, Pdvsa would make a cash profit (but not enough to contribute to the FONDEN and the other programmes) even if the global price of oil fell to around US$60/barrel (/b), versus about US$92/b for the reference West Texas Intermediate and US$98/b for Brent crude in currently (mid September). In practice, the price of oil would not have to fall anywhere near this level to produce dire expectations for Pdvsa’s profitability and cash flow. We suggest that a 10% fall in the global price of oil over six weeks, for example, would be sufficient to change sentiment about the company’s - and therefore the government’s – prospects decisively for the worse.

The third sign is political. Widespread unrest would suggest that resentment about the shortages of basic goods - and rampant inflation - exceeds general support for the government and its Bolivarian agenda. This, too, would be a catalyst for change: however, there is as yet little evidence that this is happening.

Of course, it is possible that two of these developments could happen simultaneously. It is easy to imagine that a lurch by Venezuela into true hyperinflation would produce widespread unrest. Similarly, it would not take long for the public to work out that a 10% fall in the global price of oil would have serious implications for the government’s social programs: this too could also produce unrest.

A change in the captain, not the course

The mid-September resignation of Luis Miguel Castilla as Peru's economy & finance minister, and his replacement by Alonso Segura Vasi, is unlikely to result in major changes to the country's longstanding orthodox economic policy stance. Segura's main challenge is to counter the economic slowdown and make sure that the gains to date – including a sharp reduction in poverty rates – are not eroded before the next scheduled general election in 2016.

Luis Miguel Castilla who formally stepped down for 'personal reasons', had overseen the successful management of Peru's economy since 2011 and had been the longest serving cabinet minister (and was seen by many as being the most influential.

Castilla was replaced by Alonso Segura Vasi, the top economic adviser at the economy & finance ministry (MEF), and a former official of the International Monetary Fund (IMF). Segura had collaborated closely with Castilla since his arrival at the MEF in 2013. Segura is unlikely to make major changes to economic policy in the short- or medium-term. Whether or not Castilla – who publicly applauded Segura's appointment – exerts an influence from outside cabinet remains to be seen. Either way, orthodox economic policies appear likely to prevail.

"In short, with Segura as economy minister, official policies will remain orthodox and expansionary. And fortunately for the Humala government, there is room for an expansionary stance."

Segura is now tasked with implementation of the latest economic stimulus package seeking to boost investment and private sector economic activity. As **chart 1** shows, overall growth has slowed markedly in recent months, with the year-on-year increase in real GDP slipping from 5.1% in Q1 14 to 1.7% in Q2. Partly, this has been the result of a deceleration in government consumption growth, which went from a pacey 9.8% to 4.9% year-on-year. Because of a slippage in the prices of major export commodities (particularly copper), exports were 5.1% lower than they were in Q2 13. This has weighed both on government spending and also on corporate investment, which was down 2.6% in Q2 14 over the corresponding year-earlier period.

Most other metrics are reasonably favourable. Overall output has still been rising, led by the services sector. Inflation has come down. The main index of consumer prices (CPI) slipped from 3.3% in Q1 14 to 2.7% in Q2. For the

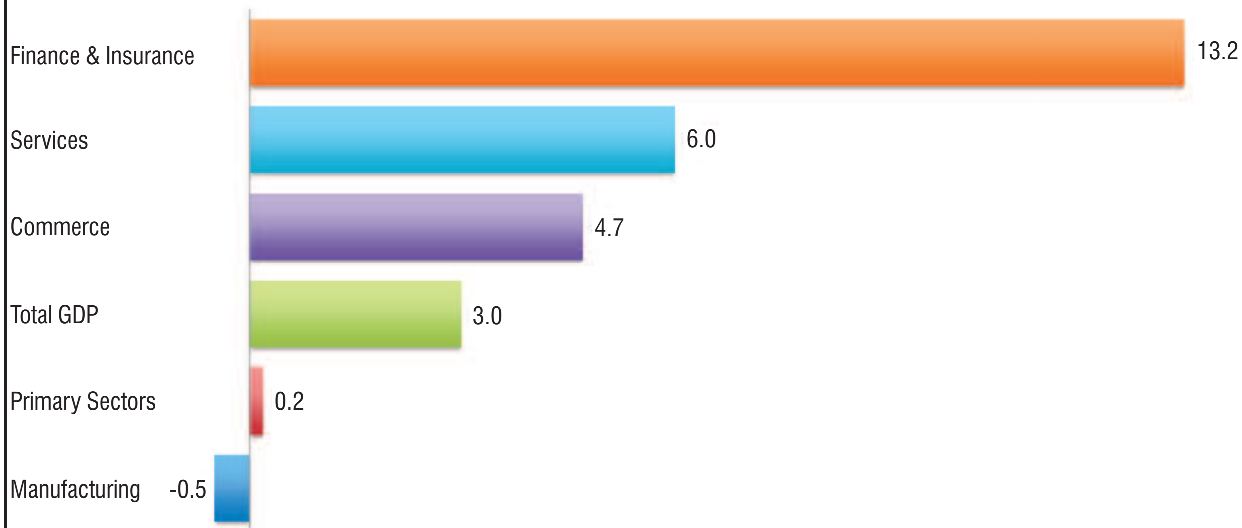
Chart 1: Peru's economy: key metrics

Year-on-year growth (%) in real terms	1Q14	2Q14
GDP	5.1	1.7
Private consumption	5.1	4.2
Public consumption	9.8	4.9
Gross domestic investment	-0.5	-2.6
Exports	3.0	-5.1
Imports	-0.7	-2.1
Production	0.3	1.2
Rate (%)		
Unemployment	5.6	6.1
Growth in nominal salaries (urban)	0.0	1.8
Growth in nominal wages (urban)	-2.1	4.0
CPI inflation	3.3	2.7
PPI inflation	1.2	0.6

Source: *BCRP*

producer price index (PPI), the corresponding figures were 1.2% and 0.6%. However, the unemployment rate has risen slightly, and urban salary earners have suffered a fall in real incomes. This, along with general antipathy towards the political class over another spate of corruption scandals, has contributed to a renewed decline in the popularity of President Ollanta Humala. In the latest (September) poll commissioned by the national daily El Comercio, the president's approval rating had dropped four percentage points to 25%, reversing an upwards trend evident through July and August. Castilla's approval rating, moreover, had dropped five percentage points to 20%, the lowest of any cabinet minister.

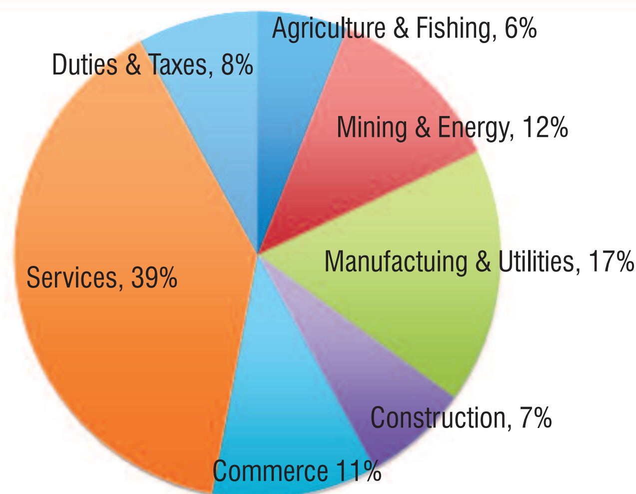
Chart 2: Real growth year-on-year (%), January-July 2014



Source: *BCRP*

The latest figures published by the Banco Central de Reserva del Perú (BCRP, central bank) indicate that the economy would have been a lot weaker but for the growth in the services sector and, in particular, in financial services and insurance. As **chart 2** shows, the economy posted overall real annual growth of 3.0% in the first seven months of this year. Primary sectors (including agriculture & fisheries and minerals & energy) have been stagnant, as has the manufacturing sector. However output in the services and commerce sectors (wholesale and retail trade) rose by 4.7% and 6.0% year-on-year respectively. This matters, because the two combined account for about half of the entire economy. Manufacturing (including utilities) is the next largest sector, generating about 17% of output. **Chart 3** provides the details.

Chart 3: Components of Peru's GDP (%), 2013



Source: *BCRP*

Consumption is being boosted by the growth in financial services – from a fairly low level of development. As **chart 4** (*overleaf*) shows, total lending to

Chart 4: Year-on-year growth in credit to private sector (%), August 2014	
Loans to companies	12.9
Corporates and large companies	15.4
Medium-sized enterprises	19.7
Small businesses	1.7
Loans to individuals	12.4
Consumer loans	11.8
Car loans	*7.6*
Credit cards	*11.5*
Mortgage	13.2
TOTAL	**12.7**
Source: *BCRP*	

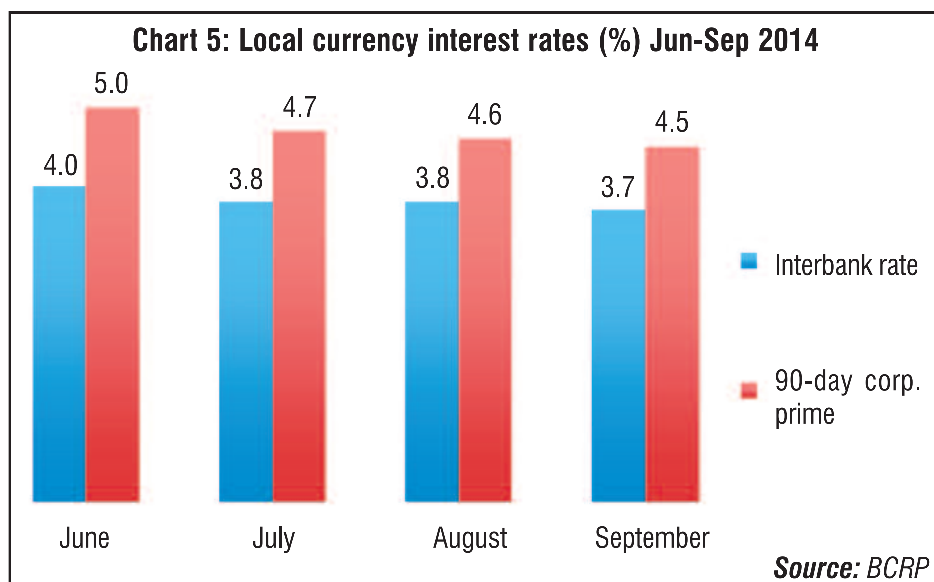
Peru's private sector grew by 12.7% over the year to August 2014. Lending to companies and to individuals rose by similar amounts. Within corporate lending, credits to large and medium-sized entities have grown by 15.4% and 19.75 respectively. The main area of weakness has been in lending to small and micro-businesses. The low availability of credit for the smallest (i.e. one-person or family) enterprises almost certainly has contributed to the adverse assessment by many Peruvians of the economy's current performance.

There is plenty that the government can do to boost demand, even if prices of commodity exports remain soft (whether because of stagnation in China's manufacturing sector or some other reason). The IMF estimates that government revenues and spending will be broadly balanced this year, at around 21% of GDP each. It expects that general government net debt will fall to 3.2% this year, from 3.5% of GDP in 2013. The current account deficit is also falling relative to GDP. At a forecast 4.8% for 2014, it is at a level that is manageable for a country set to achieve nominal growth of 5%-6%.

Financial market participants have been relaxed about Peru's situation. In a country with overall GDP of about US$217bn, foreign reserves amount to around US$65bn and have been broadly unchanged since the beginning of 2013 (prior to which they had been growing quite steadily). The currency has weakened slightly against the US dollar through Q3 14, but only from PEN2.80/US$ to PEN2.86/US$. The BCRP has stabilised the rate by selling foreign currency. Over the last year, yield spreads on Peruvian debt have fallen by 26 basis points (bps) to 156. Across Latin America as a whole, spreads have remained basically unchanged at 393bps. As **chart 5** illustrates, local currency interest rates are low and have been falling. US dollar interest rates within Peru reflect the extremely low levels currently prevailing globally. Encouragingly, local banks and customers increasingly are looking to deal in the local currency. Whereas credit in Soles rose 19.2% in the year to August, credit in US dollars increased by just 3.9%, according to the BCRP.

In short, with Segura as economy minister, official policies will remain orthodox and expansionary. And fortunately for the unpopular Humala government, there is room for an expansionary stance. In fact Castilla had been criticised for being too slow to react to the soft external scenario despite having fiscal tools at his disposal. In coming months, we expect greater government spending and new initiatives to promote lending – especially to small and micro-enterprises. A further round of stimulus measures will be pro-business, with tax incentives and cuts to bureaucracy. In the event that the global economy is weaker through Q4 14 than most commentators are expecting, the Peruvian government is well placed to cushion the impact. In terms of its economic management, the country's captain may have changed, but the course has not.

Chart 5: Local currency interest rates (%) Jun-Sep 2014



Source: *BCRP*

Key Points

- US$/PEN has moved from about 2.80 to 2.86 through Q314 - in spite of net sales of forex by BCRP.
- Net foreign reserves have remained broadly unchanged at about US$65bn.
- EMBIG Peru spreads down 26 bps to 156bps over year to 16 September.
- EMBIG Latam spreads down 3 bps to 393bps
- Copper price slips from nearly 400c/lb to 313c/lb since January 12.

TRINIDAD & TOBAGO

Change for the better? Watch for the hard numbers

Moves by the government of Trinidad & Tobago to reform the country's public service, and other initiatives, should boost the economy's productivity and growth over the medium-term. A return to effective operation of the Central Statistics Office (CSO) will be an important indicator that this is actually happening. There are also other clearly observable signs to watch for over the next two years.

In the report published following its latest Article IV consultation with the government in early June 2014, the International Monetary Fund (IMF) noted that the economy has embarked on sustainable growth of around 2.0%-2.5% per annum. As **chart 1** shows, most of the recent metrics (and the IMF's own forecasts) are favourable. At current prices and exchange rates, GDP per capita is around US$21,000 and is rising steadily. According to official figures, inflation is about 5% and is falling: however, the IMF suggests that the figure may overstate the extent to which consumer prices are actually rising. Officially, unemployment is also about 5% of the labour force, although the IMF notes that under-employment is rife. Trinidad & Tobago's substantial exports of oil and other products underpin a current account surplus of around 10% of GDP. Savings and investment have been about 24% of GDP and 14% of GDP respectively.

Chart 1: Trinidad & Tobago: Selected economic indicators, IMF

	2012	2013	2014	2015	2016	2017	Estimates Start After
GDP, Current Prices (TTDmn)	171.92	178.27	186.57	194.03	201.36	209.02	2011
GDP, Current Prices (US$mn)	26.74	27.70	28.99	30.15	31.29	32.48	2011
GDP per capita, Current Prices (US$)	19,993	20,611	21,462	22,209	22,934	23,688	2011
Total Investment (% GDP)	13.99	13.99	13.99	13.99	13.99	13.99	2011
Gross National Savings (% GDP)	18.93	24.17	24.05	22.93	22.02	21.27	2011
Average CPI Inflation (%)	9.26	5.20	4.80	4.00	4.00	4.00	2013
Unemployment Rate (%)	4.80	5.00	5.00	5.00	5.00	5.00	2011
Population (Mn)	1.34	1.34	1.35	1.36	1.36	1.37	2012
Government Revenue (% GDP)	31.73	32.78	32.20	31.36	30.94	30.59	2013
Government Spending (% GDP)	31.98	35.09	34.68	34.41	34.47	34.51	2013
Government Net Debt (% GDP)	12.90	6.66	9.52	13.03	16.68	20.57	2013
Government Gross Debt (% GDP)	36.86	30.62	33.28	36.67	40.27	44.13	2013
Current Account Surplus (% GDP)	4.95	10.19	10.06	8.94	8.03	7.29	2011

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

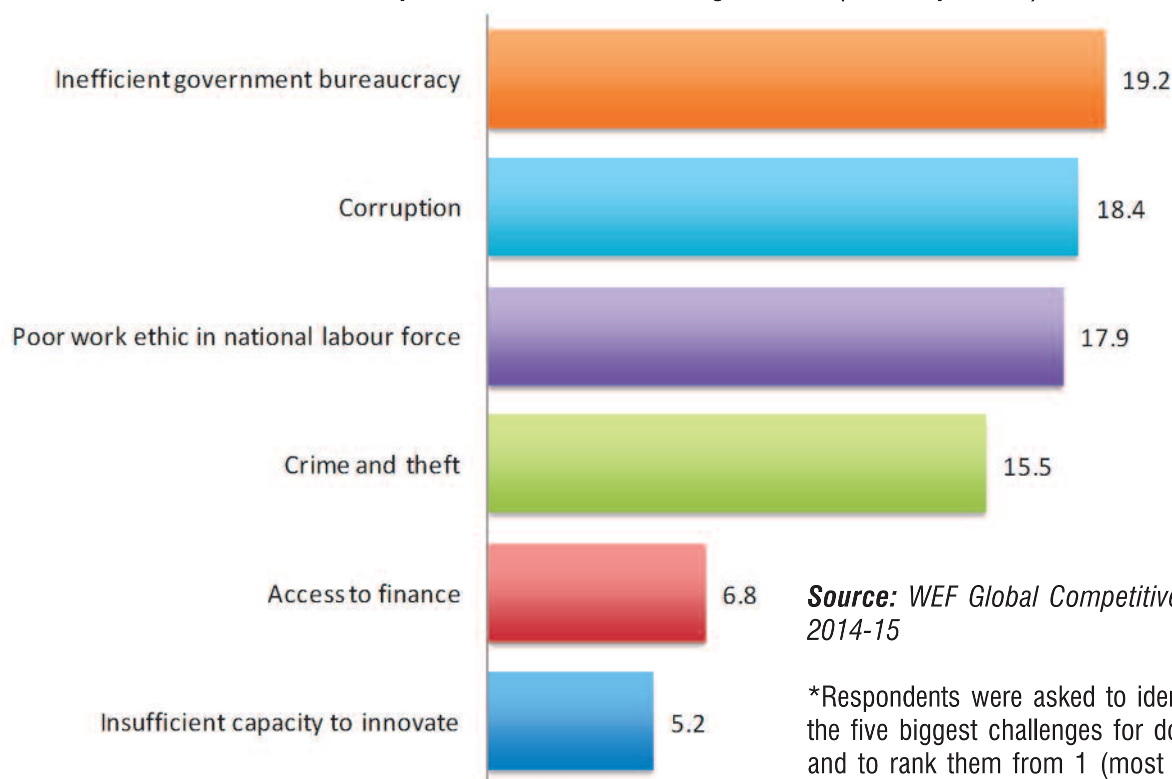
Public finances are in good shape. The budget deficit should fall from 3.7% of GDP in 2013 to about 2.5% this year. Gross government debt is not particularly high, at about 33% of GDP. The figure for net government debt drops to about 10% of GDP after allowance is made for the accumulated funds in the Heritage and Stabilization Fund (HSF). Set up in 2007, the HSF is the successor to the Interim Revenue Stabilization Fund, which dated from 2000.

Contributions to the HSF come from petroleum revenues. With assets under management (AUM) of US$5.5bn (or about 20% of GDP), the HSF provides the government with a buffer against a downturn in hydrocarbons revenues, and provides an alternative source of investment income.

The IMF report alluded to the possibility that excess liquidity in the banking system may be leaking into imports and, in particular, automobiles. Overall, though, the relevant monetary aggregates are not expanding at a worryingly rapid rate. According to the Central Bank of Trinidad & Tobago (CBTT), total local currency (M3) rose by 12% to the equivalent of US$13.18bn over the year to the end of June 2014. Including foreign currency deposits within the banking system, the equivalent figures were 9% and US$16.74bn. The CBTT noted that gross lending by the commercial banks rose by 7% to the equivalent of US$8.46bn over that period. The IMF assessed the banking system as sound.

However, Trinidad & Tobago is not a particularly easy country in which to do business. In its latest (2014-15) Global Competitiveness Report, published in early September 2014, the World Economic Forum (WEF) ranked Trinidad & Tobago as the 89th most competitive country, of 144 assessed worldwide. As usual, the WEF asked each of the firms that it surveyed to identify the five biggest challenges to doing business in a country. As **chart 2** shows, the most pressing problems include the inefficiency of government bureaucracy, corruption, the (perceived) poor work ethic of the labour force and crime/theft. Conversely, access of finance and the ability of local businesses to innovate were not widely seen as problematic.

Chart 2: The most problematic factors for doing business (% of responses*)



Source: *WEF Global Competitiveness Report 2014-15*

*Respondents were asked to identify and rank the five biggest challenges for doing business and to rank them from 1 (most serious) to 5 (least serious). The chart shows percentages weighted according to rankings.

These findings are reinforced by the country's rankings in the various aspects considered by the WEF. As **chart 3** indicates, Trinidad & Tobago's investment environment (including tax incentives, availability of funding and access to relevant technology) is strong - and, in some respects, compa-

rable with those of developed countries. Social services, including health and education, also appear to be better that might be expected given the overall level of competitiveness. The WEF also found that physical infrastructure is of higher quality than might be expected (and was something that did not cause undue concern to the businesses surveyed by the WEF).

Chart 3: Trinidad & Tobago's competitiveness in a global context	
Selected indicators (NB the lower the figure, the better)	
	Ranking/144
Overall	89
Infrastructure	52
Macroeconomic environment	38
Health & primary education	59
Higher education & training	77
Financial market development	52
Business costs of crime and violence	141
Ethical behaviour of firms	125
Burden of customs procedures	127
Cooperation in labour-employer relations	133
Pay and productivity	124
Favoritism in decisions of government officials	137
Tax incentives to invest	20
Legal rights	11
Availability of selected technologies	52
Soundness of banks	40
Source: *WEF Global Competitiveness Report 2014-15*	

"About one quarter of the entire workforce is employed by the public sector, across 48 ministries, agencies and departments."

However, of all countries surveyed by the WEF, Trinidad & Tobago ranked in the bottom quintile (if not decile) for aspects such as: the ethical behaviour of firms; the burden of customs procedures; favouritism in decisions made by public officials; co-operation in negotiations between labour and employers; and pay and productivity. The business costs of crime and violence are higher in Trinidad & Tobago than in all but three of the 144 countries assessed.

In short, Trinidad & Tobago provides a classic example of a country where structural reforms could substantially improve perceptions of the business sector, boost the efficiency with which public sector services are delivered and - perhaps most importantly - reduce inequality in a country where the wealth of the energy sector has not automatically 'trickled down'.

Fortunately, the current government is aware of this. As the IMF noted, the average time needed to start a business in Trinidad & Tobago has been reduced from 43 days to just three. The time needed to obtain construction permits has fallen from 42 weeks to just six. The government, it notes, is "also reducing the time to clear shipments through customs and intends to establish appropriate insolvency frameworks, reform procurement legislation, expedite property registration and improve contract enforcement".

Following the financial crisis of 2008-09, which resulted in the collapse of the Hindu Credit Union and the CL Financial Group (a conglomerate which included CLICO, one of the largest life insurance companies in the Caribbean), the government is also making good progress with reform of the financial sector, which is already strong by a number of benchmarks. Five non-bank Systemically Important Financial Institutions (SIFIs) have been identified. Each regulated by their own Act, they include: the Unit Trust Corporation (UTC); the Home Mortgage Bank (HMB); the T&T Mortgage Finance Co. (TTMF); the National Insurance Board (NIB); and, the Agricultural Development Bank (ADB). The long-term objective is to bring these institutions under the supervision of the CBTT.

There is advancement on other fronts. The CBTT is working with the ministries of Finance and Planning on a National Financial Crisis Contingency Plan. New legislation in the pipeline will strengthen the regulation of insurers and insurance. The Occupational Pensions Act and the Unit Trust Corporation Act are being updated. Another new law will require that all real estate agents active in Trinidad & Tobago hold licenses: this would be a major change, because only a third of the country's 1,500 agents are licensed currently.

"Reform of the public service will be a time consuming, complex and probably contentious process. Protagonists who see themselves as actual or potential losers from the change are unlikely to accept it without loud complaint. The next general elections are due in September 2015."

It remains to be seen what progress is made with labour policies within the public sector workforce, something the IMF considers as urgently needed. About one quarter of the entire workforce is employed by the public sector, across 48 ministries, agencies and departments. However, human resource management is concentrated in a small number of centralised agencies - the Chief Personnel Officer, the Ministry of Public Administration and the Services Commissions Department (SCD - comprising the secretariat for the Public Service Commission, the Teaching Service Commission, the Judicial & Legal Service Commission and the Police Service Commission), which are not well co-ordinated.

The consequences of all this are not good. The various ministries and agencies have little ability to make necessary hiring and firing decisions. Overall accountability is very low. Processes move at glacial speed: as the IMF observed, negotiations for the 2008-10 wage round for public servants were only concluded in 2012.

Acknowledging the problem, the Public Service Commission allowed the 48 line ministries, agencies and departments to hire acting and temporary staff from 2006. The number of temporary staff rose from 1,920 in 2005 to 12,636 in 2012, according to the Commission. Meanwhile, the number of new permanent appointments in a calendar year fell from 916 to 628. Over the same period, the number of people in acting roles (i.e. where they have greater responsibilities but no formal promotion) has more than doubled to 18,012. Inevitably, morale has fallen.

An additional challenge is that the public sector (and other key actors) does not have access to the data that it needs. Writing in June 2014, the IMF observed that, because of the extreme resource constraints at the Central Statistical Office (CSO), "official trade data are available up to February 2012, and labour market data up to March 2013, while the GDP data for 2012 is still only provisional". As a temporary measure, CBTT staff has been assigned to the CSO for one year. In addition, Statistics Sweden is helping the government with an "aggressive" plan to modernise the CSO.

Reform of the public service will be a time consuming, complex and probably contentious process. Protagonists who see themselves as actual or potential losers from the change are unlikely to accept it without loud complaint. The next general elections are due in September 2015. Campaigning will likely be dominated by debates over the controversial changes to the constitution that have been proposed by the People's Partnership (PP) government led by Prime Minister Kamla Persad-Bissessar. As the IMF observed, the political cycle will likely delay fiscal reforms that could be beneficial, such as a reduction in fuel subsidies.

Nevertheless, we would take it as encouraging sign if the WEF's Global Competitiveness Report for 2015-16 observes clear improvements in several aspects of the overall business environment in Trinidad & Tobago. We would also be heartened by clear progress with the new legislation that is designed to strengthen the financial sector.

Over two years (i.e. a period that includes the general elections and beyond), we hope to see real reform to labour relations and management within the public sector. Most crucially, we would see the return to effective operation of the CSO as an encouraging sign.

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POSTSCRIPT

VENEZUELA

Pdvsa and stealth devaluation

As we went to press on 25 September, the government led by President Nicolás Maduro announced new rules governing the sale by the state oil company Petróleos de Venezuela (Pdvsa) of US dollars to buy Bolívares Fuertes (BF) for payment of its mandatory contributions to the off- budget national development fund, Fonden.

Pdvsa will benefit from the new rules governing its purchase of Bolívares Fuertes in two ways. The burden of supporting the Fonden will be dramatically reduced. Pdvsa should be able to book a one-off boost to finance income.

Previously, Pdvsa had to purchase local currency at the main official foreign exchange (FX) rate of BF6.3/US$. Henceforth, Pdvsa can use any of the country's three official rates; the official BF6.3/US$1 rate, as well as the two secondary rates - BF11/US$1 and BF50/US$1 - sold through the Sistema Complementario de Administración de Divisas (Sicad).

The immediate impact of this change is that it dramatically reduces the burden – to Pdvsa – of supporting Fonden. On Pdvsa's reported accounts, net contributions to the Fonden had fallen from the equivalent of US$14.4bn in 2011 to US$8.3bn in 2012 and to US$5.2bn in 2013, but these were still substantial in the context of a company whose annual sales of oil and other products in 2013 amounted to US$114.0bn.

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Other contributions by Pdvsa for social development purpose had fallen from US$15.6bn to US$9.0bn to US$7.8bn over the same three years. In US dollar terms, the effective cost of any level of support to Fonden has been reduced by about 87% under the latest measure.

The move constitutes a partial (or stealth) devaluation that will serve to conserve cash within Pdvsa: crucially, this cash will be available both to the government and the oil company to repay investors in maturing bonds. As such, the risks of default by either the government or Pdvsa in coming weeks have been reduced. Although politically unpalatable for the Socialist government, a default in the medium term is not impossible. (As we explained elsewhere in this edition, there are three developments that might indicate that a default is imminent: a clear pick-up in the velocity at which local currency circulates in Venezuela as the country moves into a truly hyperinflationary situation; slippage in the oil price over a short period of time; and/or widespread labour or social unrest.)

Thus far, commentators appear not to have focused on an additional benefit that will accrue to Pdvsa. The partial devaluation will give it a one-off profit. As we noted in our July 2014 edition, Pdvsa recorded a gain of US$7.8bn when the BF was devalued in February 2013. At that point in time, Pdvsa had had net liabilities in BF that were the equivalent of US$25.0bn.

> "On this occasion, Pdvsa should be able to book a gain of around 87% of the net liabilities to Fonden that can be settled through the new exchange rate regime. As the numbers above indicate, the gain could be very substantial, amounting to several billions of US dollars. It will be possible for Pdvsa to distribute the gain to the government as a dividend. This will increase the flexibility of both parties in coping with an acute shortage of cash."

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Looking forward, we would not be surprised if the government announces additional administrative changes that allow Pdvsa to buy local currency for other purposes at rates that are much closer to fair value (or downright cheap) than the official BF6.3/US$.

In the meantime, the government's tight control over the market for foreign exchange will cause the (illegal) black market rate to remain at extreme levels. On 29 September the parallel rate slipped past BF100/US$ for the first time, making one 100 'strong Bolívares' worth less than one US dollar.

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