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Temer's message: privatise and grow

On 21 September Brazil's new president, Michel Temer, addressed US business leaders and investors at the Council of the Americas in New York with a simple message. Brazil, he said, is offering privatisations and concessions to attract the international private sector back into the country and to stimulate economic growth.

Temer made a strong pitch to potential new investors in Brazil. He could almost be accused of a degree of over-selling. The president invited private business to take part in a new phase of Brazilian growth. The country was enjoying "extraordinary political stability between the executive and legislative branches", he declared, and was beginning "crucial" reforms to the pension system, to the structure of government spending, and to labour legislation.

To this end, Temer invited business leaders to take part in the new investment partnership programme (Programa de Parcerias de Investimento – PPI) which would "do something established in our constitution, namely to have private enterprise participate in the development and growth of the country alongside the government." Critics may say that these are still somewhat early days to talk of stability and growth (the country remains in recession and politics are still volatile in the wake of the impeachment process that brought Temer to office). But the new president might be excused for wanting to make an upbeat presentation on his international debut.

His pitch to investors had two component parts. The over-arching initiative is known as the 'Crescer' ('Grow') programme, and was first announced on 13 September. This is a package of 34 privatisations and concessions in a range of areas, including transport, energy and water supply and drainage. Projects are being offered to the private sector including for the building and operating of airports, ports, highways, and railways, as well as oil and gas exploration and production (E&P) contracts. First in line are likely to be the airports of Porto Alegre, Salvador, Florianópolis and Fortaleza, which are expected to go out to tender in the first quarter of 2017. Also in the pipeline are a port terminal for fuels in Santarém, along with a terminal for wheat in Rio de Janeiro, and five highways.

Of particular interest to investors are a series of oil and gas licence auctions. Mines and Energy Minister Fernando Bezerra Coelho has said that the government will be auctioning old onshore petroleum fields in February 2017, followed by an offshore pre-salt auction in June 2017. The pre-salt auction will involve blocks adjacent to existing concessions in the Campos and Santos Basins. "We are talking of billions and billions of reais in job creation, income, construction, equipment and services", the minister said.

To back up the Crescer programme, the government will offer BRL30bn (US$9.3bn) worth of concessionary finance. Of this total, BRL12bn (US$3.6bn) will come from FI-FGTS, an infrastructure fund, and BRL18bn (US$5.4bn) from the state-owned National Economic and Social Development Bank (BNDES). Officials stress that Bndes, however, will play a smaller and more enabling role than under the previous left-wing government, aiming to fund no more than 20% of the value of individual projects, and avoiding any "crowding out" of private sector participation and funding streams.

PPI

The second element of the Temer pitch was the PPI itself (as per Law 13,334/2016). Its basic purpose is to modify and streamline the early stages of the selection and tendering process, in that way that corrects some of the many obstacles that in recent years have held back the design and implementation of infrastructure projects in the country.

The law creates an IPP Council and Secretariat, and charges them to work together efficiently to secure all licences, approvals and permits, including environmental approvals, *before* a project goes out to tender. It is hoped that this will minimise the number of delays and cancellations occurring after the tender stage. To give it greater power to get things moving, the IPP Council reports directly to the president. Moreira Franco, a close advisor to Temer with prior ministerial experience, has been appointed to the helm. A small and significant change, also designed to accelerate the process, is that tender documents will now be published in English as well as Portuguese. The law also creates a fund, the Fundo de Apoio a Estructuração de Parcerias, or FAEP, which will be operated by BNDES to provide project-specific funding.

Analysts have welcomed this attempt to put the process on a more business-like footing. They warn, however, that the way the PPI Council and Secretariat and the FAEP work together on a daily basis has yet to be defined and depends on the passage of secondary enabling legislation. Nevertheless, Enio Verri, an economist and member of the federal chamber of deputies, says that the IPP law is "a lot more" than a mere streamlining operation. He stresses its wide scope in authorising divestments, its power to overrule local restrictions, and the absence of clauses favouring the participation local over international companies. The government is trying to signal that it is "open for business" much more effectively than at any time in recent years.

Outlook improves

Brazil will post real annual GDP growth of 1.3% in 2017, according to the 30 October weekly consensus forecast of local economists compiled by the central bank (BCB). This is the most optimistic outlook in a year, and signals reviving confidence under the Temer government.

In the meantime, the domestic economy remains weak. Second quarter GDP was -0.6% quarter-on-quarter and -3.8% year-on-year, the sixth consecutive quarterly contraction. The result was weighed down by a weaker agricultural sector, due to this year's 'El Niño' phenomenon. Activity in the large services sector (roughly 70% of GDP) also remained weak, contracting by 0.8%. While the industrial sector also contracted by 0.2%, manufacturing activity turned positive for the first time in five quarters, with a small increase of 0.3% over the previous quarter. But high interest rates, high unemployment and high consumer debt mean that Brazilian household demand is likely to be slower to recover than investment. Unemployment hit 11.6% in the May-July period, a four-year high, with 12m people out of work.

ARGENTINA

Waiting for an investment boom

Simply put, it could be said that the Argentine government led by President Mauricio Macri is following a three-step economic policy plan. Step one: correct major economic imbalances. Step two: invite foreign investors into the country. Step three: wait for positive results. Here, we assess its progress.

Reality, of course, is always more complex than simple three-step plans. Since taking office last December, President Macri has sought to correct some major economic imbalances, liberalising the exchange rate, reducing export taxes, resolving long-standing foreign debt disputes, restoring access to international capital markets, and beginning to tackle a large inherited fiscal deficit. But this is unfinished business: while beginning to ease, inflation remains a big problem. Unemployment is high, the economy is contracting this year, and the much-heralded recovery has yet to make itself felt. Still, the government was confident enough to launch Step 2, an investment forum held in Buenos Aires on 12-15 September and heralded as a "mini-Davos".

Macri, his ministers and provincial governors told over 1,000 business participants that up to US$200bn worth of investment opportunities were on offer in oil and gas, renewable energy, mining, industry, agriculture, road and rail transport and telecoms. In his speech to open the forum, Macri declared, "We inherited a country in recession, with very high inflation. But now we are getting it under control." Officials are also taking steps to make Argentina more foreign investment-friendly. Most of the country's major arbitration disputes with foreign investors have been settled. A new public-private partnership (PPP) law working its way through congress also extends the jurisdiction of international arbitration courts.

There have been some early and positive responses. The US industrial group General Electric has said it will invest US$10bn in Argentina over the next decade – it has already committed US$1.2bn, much of that to build thermal power plants. Siemens of Germany plans to invest US$5.6bn in infrastructure projects, including gas-fired power plants. Pan American Silver of Canada and Dow Chemical of the US have announced other investment pledges. UK-based BP says it will invest in Argentina's large Vaca Muerta shale oil deposits, which chief executive Robert Dudley has described as having "vast potential". The Export-Import Bank of the US says it will resume lending to Argentina after a 15-year interruption. By improving the quality of its economic data, Argentina is rebuilding bridges with the IMF, after ten years of icy relations.

There are signs that sentiment in the local business community is improving. Daniel Fernández, local CEO of the French supermarket chain Carrefour, acknowledges that sales fell by around 5% in the first months of the year but says that he expects activity to pick up in 2017. Miguel Bein, an economist who advised Macri's Peronist rival in the 2015 elections, says that the economic outlook is now good, with signs of strength in cement sales, the construction sector, and in consumption. According to Diego Coatz, chief economist for the Unión Industrial Argentina (UIA), the main industrial lobby, "there is not going to be a boom, but little by little, things are getting better".

One key issue is whether new investment will come in at sufficient volume and speed to help give the necessary boost to business confidence and economic recovery. At the World Economic Forum in Davos in January this year, Macri said he was targeting foreign direct investment inflows of US$20bn in 2016. In September, the economy ministry said that total private sector investment pledges had reached US$32.6bn, of which US$12.2bn corresponded to domestic Argentine companies.

This implies that the remaining FDI total stands at US$20.4bn, ahead of the target announced in January. While this is impressive, this is the amount pledged, rather than materialised. Materialised investment in the first half of this year was actually only US$1.3bn. So the time lag before ground is broken and new jobs are created could still be substantial. President Macri himself has emphasised that investment will increase in a steady flow rather than in a single large step-change. While there are also political risks to compute (opposition to the government could step up a notch if the hoped-for recovery does not materialise next year), it is clear that the new administration has made a good start towards its 'step two', pursuit of investment-led growth.

MEXICO

Trouble on the fiscal front

For the third year in succession, Mexico will experience a fiscal squeeze in 2017. The proposed budget for next year, submitted to congress on 8 September, cuts back spending aggressively but also targets a primary budget surplus, the first since 2009. It is not clear that the new finance minister, José Antonio Meade, will be able to square the circle.

The fourth budget to be prepared under the presidency of Enrique Peña Nieto arrived in much less auspicious circumstances than the preceding three. Forty-eight hours before submission, there was a change at the top of the finance ministry, with Meade replacing Luis Videgaray, after the latter paid the price for inviting Donald Trump to visit Mexico, a visit widely seen at home as a public relations disaster. More importantly, international oil prices remain depressed, heralding yet another year of low government revenue. Uncertainty over the impact of the US elections (or 'the Trump factor') continues to weaken the Mexican peso. And to complicate matters, Mexican domestic politics are moving up the agenda. The Peña Nieto administration has slumped in the opinion polls. Its long-standing plans to boost average GDP growth from 2-3% to 4-5% ahead of the 2018 presidential race appear to be coming to nothing.

The 2017 budget once more proposes spending cuts – a total of M$239.7bn (US$12.83bn), representing a fall of 1.7% in real terms. These cuts are equivalent to 1.2% of GDP. Of the total savings required, the largest contribution, of around M$100bn (US$5.3bn), falls on Pemex, the state oil company. Pemex has already suffered deep cuts these past 18 months, and is struggling under a heavy debt burden as it tries to cope with the transition to a more competitive domestic energy market. The budget's assumption is that Pemex, through private sector partnerships and production sharing deals, will become less dependent on government funding. But the transition, amid an international oil slump, is problematic. The budget projects Mexican oil production to fall from the current level of 2.16m barrels per day (bpd) to just 1.93m bpd next year, the lowest level since 1980.

There are also deep cuts to education, health, communications and transport, agriculture and environment, all of which are politically unpopular. The M$37.28bn (US$1.95bn) cut in education spending, for instance, comes as the government has been battling teachers' unions over its reforms to the sector, which are supposed to improve the quality of education and equip the country to be more economically competitive. The squeeze has also been bad for public sector investment, which is reduced to 2.8% of GDP, the lowest level in 50 years.

On the plus side, the Peña Nieto government insists that it has been doing better than expected in its attempt to raise non-oil revenues. It is therefore projecting a 0.4% increase in real terms in total budget income, to M$4.3tn (US$230bn), reflecting a 16% fall in oil revenues and a 10% increase in non-oil revenues. Albeit under circumstances not of their choosing, officials note that the federal government budget is transitioning, to become less dependent on oil revenues. As a share of total spending, oil revenues are set to fall from 18.7% in 2016 to an expected 16% in 2017.

The 2017 budget ambitiously targets a primary budget surplus equivalent to 0.4% of GDP which, if achieved, would be the first such positive balance since 2008 and a turn-around from an expected primary deficit of 0.4% of GDP this year. After interest payments, the overall public sector borrowing requirement will be 2.9% of GDP. The Peña Nieto government is committed to reducing it to 2.5% of GDP by 2018.

The budget is based on the assumption that GDP will grow at a subdued rate of 2-3% next year, and that inflation will be close to the central bank target rate of 3%. It also assumes an average oil price of US$42 per barrel, with an exchange rate of MXN18.20/US$.

Some of these assumptions may not prove correct. US election-related uncertainty could trigger slower growth and domestic financial volatility. The Mexican peso has already weakened more than expected, depreciating by 14% against the dollar in 2015, and by a further 10.5% in the first nine months of this year. In September, it briefly fell to MXN20/US$. Mexico is largely protected against any further oil price falls in 2017, however, as it has again taken out a sizeable oil hedge.

One of the key worries is that the fiscal deficit will increase borrowing requirements, push up public debt as a proportion of GDP and trigger downgrades from the international ratings agencies. This explains the government's emphasis on containing spending. The main public debt measure, the Saldo Histórico de los Requerimientos Financieros del Sector Público, or SHRFSP, is now expected to reach 50.5% of GDP in 2016, above the previously expected 46.3%. Questioned in congress on the increase, Meade insisted that it was sustainable and stressed that improved tax revenues are helping to strengthen public finances.

Ratings agencies Moody's Investors Service and Standard & Poor's (S&P) both expect Mexico's debt leveraging to increase in coming years. Jaime Reusche of Moody's noted: "The budget continues to signal consolidation and that may indeed be favourable for maintaining the rating where it is, but the proof is in the pudding". Víctor Herrera of S&P said that aiming for a primary surplus was "a nice sign", but added that "to benefit, it has to be large enough for Mexico to be able to amortise debt".

VENEZUELA

Debt restructuring aims to avert default

With the government facing large scheduled debt repayments before the end of 2017 and the economy mired in deep recession, there has been rising speculation, once again, about a possible external debt default.

Reflecting the severe liquidity concerns, the government is trying to restructure several of the bonds held by the state oil company Petróleos de Venezuela (Pdvsa), asking investors to exchange instruments set to mature in 2017 for a new bond that will mature in 2020. Essentially an effort to buy time, the left-wing government led by President Nicolás Maduro is gambling that oil prices will have recovered by then, putting the company in a better economic position to make the repayments. Yet bondholders are likely to remain sceptical and take-up may well be low, sustaining concerns about creditworthiness in the medium term.

With US$1.1bn in interest and capital debt repayments falling due in October and a further US$2.9bn in November this year, there has been rising concern about the Venezuelan government's ability to make these scheduled payments. The repayment schedule is also heavy in 2017, with a total of US$10bn falling due, including large repayments in April (US$3.6bn) and November (US$2.9bn).

The government announced early in 2016 that it was seeking to restructure these liabilities, but a prolonged silence on the issue since then prompted many to assume that concerns about sovereign creditworthiness had precluded a possible deal with bondholders. Attention switched to the authorities' much-diminished international reserves, and whether they actually had enough cash to make the payments.

Against this backdrop, the last-minute announcement that the government plans to restructure the public sector's short-term debt liabilities is positive, in that it provides hope that the sovereign will avoid a costly default on its external debt. The government unveiled terms of the initial offer on 16 September, which in essence proposed exchanging Pdvsa bonds falling due in 2016 and 2017 with a new 2020 bond. The offer involved swapping the instruments at parity, so not increasing the net present value, aside from a slight increase in interest repayments. To incentivise bondholders to accept the exchange offer, the Venezuelan authorities offered shares in Citgo – the US-based refining arm of Pdvsa – as collateral.

Markets responded negatively, with Pdvsa bond prices dropping following the government's announcement. Many questioned the true value of Citgo's holdings and the likelihood of securing a pay-out in the event of an eventual default. The lack of incentive for bondholders to accept the offer prompted speculation about a low take-up from investors.

In response, on 26 September the government sweetened the terms of the offer. Instead of offering a straight swap, the government offered an extra US$170 for each US$1,000 of bonds maturing in April 2017 and an additional US$220 for each US$1,000 maturing in November 2017, provided that investors accept the offer before 6 October. If bondholders accept the swap after that date, but before the 14 October cut-off, the incentive will fall to an additional US$120 and US$170, respectively. The fact that no extra incentive

was offered for 2016 bonds implies that the government does not expect bondholders to accept an exchange deal given the proximity of the maturity date, but that it is instead trying to alleviate liquidity problems next year.

This, in turn, reflects the reality that the authorities are believed to have the funds to make the payments falling due in October and November. International reserves held at the Banco Central de Venezuela (BCV, the Central Bank) stood at US$11.8bn on 23 September, down sharply from US$16.3bn at the start of the year. In theory, this provides ample funds to meet short-term repayments, but Venezuela has in recent years held a fairly large proportion of this (around two-thirds) in gold. The BCV has been selling gold over the course of the year to boost liquid reserves, which is likely to cover near-term repayments.

The key question is what proportion of bondholders will accept the exchange offer and if, by choosing not to participate, they might lose their initial investment if the country subsequently defaults next year. The government has indicated that they are hoping for over half of investors to swap their debt instruments for the new 2020 bond, but private financial analysts estimate an acceptance rate of only around 20-30%.

Given that the government has so far shown a steely determination to continue servicing debt, cutting back sharply on imports of essential basic items like medicines and food in order to conserve foreign currency, bondholders might hold out on the assumption that they will be paid regardless. In addition, the critical economic problems facing the country and a deep-seated pessimism that conditions will be any better in 2020 has led many to question whether the government's repayment capacity will be any stronger in four years' time.

A related question is which government will be in office at that time. At the moment, President Maduro is clinging on to power, attempting to fend off opposition efforts to oust him by means of a recall referendum. Even if the government averts these efforts, by pushing back a referendum date past 10 January (meaning that even if the public voted to recall him, Maduro would simply be replaced by his vice president), it appears highly unlikely that the ruling Partido Socalista Unido de Venezuela (PSUV) would win the 2018 election. If the opposition wins power, there is a significant risk that they would not recognise debt incurred by the PSUV government, on the principle that it represents "odious" or illegitimate debt that was incurred for purposes that did not serve the country's best interests (and is therefore not enforceable). So, by agreeing to exchange 2017 bonds for 2020 instruments, investors might risk not being paid at all.

This is a particular concern, because the current government has racked up large amounts of debt, taken on by Pdvsa, which would significantly hamper the next government's ability to recover from the deep economic recession. If the opposition does take power before 2020, either as a result of a recall referendum, a period of social unrest or the 2018 presidential election, the new government would require significant external assistance to address the economy's deep-seated structural problems that have caused hyper-inflation, a prolonged recession and a liquidity crisis.

Such assistance would be likely to take the form of an IMF loan package and would require several domestic reforms. At the same time, the new government would be likely to seek a restructuring deal, either pushing back the maturity on the 2020 bond and/or securing a haircut on its liabilities.

Like many of the PSUV government's decisions, this latest announcement is driven by a desire to delay having to confront the economy's severe problems, proposing a stop-gap measure that pushes an immediate problem into the future, albeit worsening the likely impact. At no point has the Maduro administration demonstrated that it is willing to tighten fiscal policy to reduce the need to take on additional debt. It is completely unwilling to address the budget deficit, which is so large that the authorities have simply stopped publishing fiscal data, in fact expanding spending in an attempt to bolster its plummeting approval ratings. Meanwhile, it has continued to print money to help plug the deficit which, combined with reduced imports, has fuelled eye-watering levels of inflation. So with little sign that the government is even considering altering its policy stance, bondholders will have little confidence that they would be paid in full in 2020, even if the PSUV remains in power.

This leaves investors with a somewhat depressing conclusion: even if current holders of 2017 bonds agree to the terms of the government's exchange offer, eventual payment in 2020 is highly uncertain, regardless of who is in office at that point. However, if the vast majority reject the offer currently on the table, the government might default next year. The only certainty is that the government's economic difficulties remain pressing, with no perceptible way of avoiding a further downward spiral.

CUBA

Cuba signs over 20 agreements with China

Given that Cuba is grappling with a sharp economic deceleration and a liquidity crunch – related to cutbacks in assistance from Venezuela – Cuban authorities welcomed the signing of a raft of trade and investment treaties during a three-day visit by the Chinese premier. However, the agreements will provide no quick-fix for the Cuban economy. Even if the investment materialises in full, projects will proceed extremely slowly, under the ever-watchful eye of the Cuban authorities.

The three-day visit to Cuba on 24-27 September by the Chinese premier of the state council, Li Keqiang, was symbolically important, marking the first official visit to Cuba by a Chinese premier since 1960. Li's visit came directly after another first for the Chinese premier, having previously addressed the UN's General Assembly in New York. The overseas trip reflected the fact that China is seeking a greater international role, particularly in the context of its expanded economic interests.

Over the course of Li's visit to Cuba, the two countries signed over 20 co-operation agreements, covering diverse areas of the economy, including agricultural manufacturing, renewable energy, public transport, construction, biotech, pharmaceuticals and telecommunications. The two countries also signed memorandums of understanding (MOUs) covering technology transfer and joint collaboration on research and development (R&D) in the biotech sector.

The bilateral agreements will deepen the diplomatic and commercial ties that have already been growing in recent years. China has emerged as an increasingly important strategic ally for Cuba, with extensive economic and military co-operation, including credit guarantees that have reduced the cost and facilitated the availability of external financing.

Loans have also been forthcoming, with two credit lines agreed in February that funded Cuba's purchase of Chinese tractors to boost the rice harvest, together with 240 passenger train wagons. Chinese loans are also helping to fund the expansion of the cargo port in the city of Santiago de Cuba.

China is also showing a growing interest in constructing manufacturing assembly facilities in Cuba, including for home appliances and agricultural machinery. The authorities hope that this will boost bilateral trade: China is already one of Cuba's more important trading partners, but its share of export sales (6%) and import purchases (10%) remains comparatively low, and has not changed significantly since the early 2000s.

The trade and investment agreements come at an opportune time for Cuba, which is witnessing a sharp economic slowdown as commodity prices for Cuba's two main export goods – nickel and sugar – remain low. Assistance from Venezuela, which has provided crucial support in recent years under the auspices of the 'oil-for-doctors swap', is also drying up, reflecting the worsening economic crisis in that country.

And even though the Cuban tourism sector continues to thrive, very low levels of investment and difficulties in accessing financing mean that the economy has few sources of foreign exchange. Piecemeal progress in unpicking US sanctions imposed under the half century-old economic embargo has stalled as the US presidential elections approach, with no sign of any moves towards removing the embargo outright until 2017, at the very earliest (the embargo is codified into US law and its removal requires an act of congress).

This combination of factors has forced the Cuban government to adopt austerity measures, including energy rationing and import cuts. In turn, this has contributed to a sharp deceleration in economic growth, from 4% in 2015 to 1% in the first half of 2016.

Given that the Communist government led by President Raúl Castro has put nearly one-fifth of its own investment plans on hold in an effort to rein in the fiscal deficit, the Cuban authorities will welcome the prospect of greater Chinese investment, provided that it materialises as expected. (There has been speculation that the domestic slowdown in China might prompt the Chinese authorities to reassess their extensive overseas investment plans, with the IMF warning in January that decelerating growth could have spillover effects to other economies.)

Yet even if planned bilateral trade and investment does materialise, these latest agreements with China are unlikely to provide a quick fix for the Cuban economy, since investment projects tend to progress extremely slowly on the island, partly reflecting the desire of the Cuban authorities to proceed cautiously and with extensive oversight. In the meantime, the local economy will continue to perform weakly, with a potential lifting of US sanctions the only tangible factor that could lift growth back to 4-5% in the medium term.

REGION

IMF downgrades regional growth, but warmer on Brazil

The International Monetary Fund (IMF) released its latest half-year update to its World Economic Outlook (WEO) on 3 October with a continuing bearish tone, downgrading its overall forecast for global growth this year and warning of continuing uncertainty in 2017.

The Fund expressed concern about the fact that "anti-integration policy platforms appear to be gaining more traction" in advanced economies, while emerging markets continue facing headwinds from still-weak commodity prices and uncertainty over China, among other things. Warning of "a generally subdued baseline for growth and substantial uncertainty about future economic prospects", the Fund identified five main risks to its latest outlook: political discord and inward-looking policies (above all in the UK/Europe and the US); stagnation in advanced economies; the progress of China's ongoing adjustment (from a reliance on investment, industry and exports towards greater dependence on consumption and services), plus associated spill over effects; still-uncertain financial conditions in emerging markets; and a range of additional noneconomic factors affecting various regions, from the migration crisis in the Middle East and Europe to the Zika virus in Latin America.

With regards to Latin America, the Fund was more positive towards Brazil, noting that its outlook has strengthened relative to April. It suggested that while the economy remains in recession, "activity appears to be close to bottoming out as the effects of past shocks – the decline in commodity prices, the administered-price adjustments of 2015, and political uncertainty – wear off".

Overall however, economic activity in Latin America and the Caribbean continues to slow, and it now forecasts a contraction of 0.6% in 2016 (down by 0.1 percentage points on April). A recovery should take hold in 2017, with growth reaching 1.6% (0.1 percentage points up on April). However, the fund emphasised, as always, that aggregate regional aggregate growth "masks substantial heterogeneity", and so while several countries remain mired in recession, "most countries in the region are continuing to expand" this year.

By country, the Fund now forecasts real annual GDP growth of -3.3% in Brazil this year, rebounding to 0.5% in 2017. This is up by about 0.5 percentage points on its forecasts for both years in April. Noting that confidence appears to have bottomed out, the Fund bases its forecast on the assumption of "declining political and policy uncertainty and the waning effects of past economic shocks".

Meanwhile Argentina is praised for having begun "an important and much needed transition to a more consistent and sustainable economic policy framework" which has, however, " proven costlier than envisaged" this year, with real GDP growth now projected at -1.8% in 2016 (down from -1% in April). Optimistically, the Fund says that growth can strengthen to 2.7% in 2017, on the back of moderating inflation and "more supportive monetary and fiscal policy stances".

On Venezuela, the Fund is more pessimistic than in April, estimating that the country's recession will deepen in 2016 and 2017 "as the decline in oil prices since mid-2014 has exacerbated domestic macroeconomic imbalances and balance of payments pressures", it notes dryly, foregoing any reference to the political and social crisis in the country. It now projects a real GDP contraction of 10% annually this year and -4.5% next year, with an average annual inflation rate of 475% and 1,660%, respectively. These dire forecasts will inevitably provoke a strong reaction from the left-wing Caracas government, which accuses the IMF in being in cahoots with the (alleged) US-led economic war against the Socialist 'Bolivarian Revolution'.

Western Hemisphere: Real GDP, Consumer Prices, Current Account Balance, and Unemployment

North America	**2.5**	**1.6**	**2.2**	**0.4**	**1.4**	**2.4**	**–2.6**	**–2.6**	**–2.7**	**. . .**	**. . .**	**. . .**
United States	2.6	1.6	2.2	0.1	1.2	2.3	–2.6	–2.5	–2.7	5.3	4.9	4.8
Canada	1.1	1.2	1.9	1.1	1.6	2.1	–3.2	–3.7	–3.1	6.9	7.0	7.1
Mexico	2.5	2.1	2.3	2.7	2.8	3.3	–2.9	–2.7	–2.8	4.4	4.1	3.9
Puerto Rico[4]	0.0	–1.8	–1.4	–0.8	–0.2	1.1	. . .	. . .	. . .	12.0	11.9	11.9
South America[5]	**–1.3**	**–2.0**	**1.1**	**. . .**	**. . .**	**. . .**	**–3.7**	**–2.0**	**–2.0**	**. . .**	**. . .**	**. . .**
Brazil	–3.8	–3.3	0.5	9.0	9.0	5.4	–3.3	–0.8	–1.3	8.5	11.2	11.5
Argentina[6]	2.5	–1.8	2.7	. . .	. . .	23.2	–2.5	–2.3	–3.2	. . .	9.2	8.5
Colombia	3.1	2.2	2.7	5.0	7.6	4.1	–6.4	–5.2	–4.2	8.9	9.7	9.6
Venezuela	–6.2	–10.0	–4.5	121.7	475.8	1,660.1	–7.8	–3.4	–0.9	7.4	18.1	21.4
Chile	2.3	1.7	2.0	4.3	4.0	3.0	–2.0	–1.9	–2.4	6.2	7.0	7.6
Peru	3.3	3.7	4.1	3.5	3.6	2.5	–4.4	–3.8	–3.1	6.0	6.0	6.0
Ecuador	0.3	–2.3	–2.7	4.0	2.4	1.1	–2.2	–1.5	–0.9	4.8	6.1	6.9
Bolivia	4.8	3.7	3.9	4.1	3.9	5.1	–5.8	–6.6	–4.9	4.0	4.0	4.0
Uruguay	1.0	0.1	1.2	8.7	10.2	8.7	–3.5	–2.9	–3.1	7.5	7.9	8.5
Paraguay	3.1	3.5	3.6	3.1	4.1	4.1	–1.7	0.6	–0.5	6.1	5.9	5.5
Central America[7]	**4.2**	**3.9**	**4.1**	**1.4**	**2.5**	**3.0**	**–4.0**	**–3.7**	**–3.7**	**. . .**	**. . .**	**. . .**
Caribbean[8]	**3.9**	**3.4**	**3.6**	**2.2**	**3.5**	**4.5**	**–4.3**	**–4.5**	**–4.6**	**. . .**	**. . .**	**. . .**
Memorandum												
Latin America and the Caribbean[9]	0.0	–0.6	1.6	5.5	5.8	4.2	–3.6	–2.3	–2.3	. . .	. . .	. . .
East Caribbean Currency Union[10]	2.3	2.2	2.6	–0.9	0.3	2.2	–12.1	–12.6	–13.8	. . .	. . .	. . .

Note: Data for some countries are based on fiscal years. Please refer to Table F in the Statistical Appendix for a list of countries with exceptional reporting periods.
[1]Movements in consumer prices are shown as annual averages. Year-end to year-end changes can be found in Tables A6 and A7 in the Statistical Appendix.
[2]Percent of GDP.
[3]Percent. National definitions of unemployment may differ.
[4]The Commonwealth of Puerto Rico is classified as an advanced economy. It is a territory of the United States, but its statistical data are maintained on a separate and independent basis.
[5]Includes Guyana and Suriname. Data for Argentina and Venezuela's consumer prices are excluded. See country-specific notes for Argentina in the "Country Notes" section of the Statistical Appendix.
[6]See country-specific notes for Argentina in the "Country Notes" section of the Statistical Appendix.
[7]Central America comprises Belize, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.
[8]The Caribbean comprises Antigua and Barbuda, The Bahamas, Barbados, Dominica, Dominican Republic, Grenada, Haiti, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago.
[9]Latin America and the Caribbean comprises Mexico and economies of the Caribbean, Central America, and South America. Data for Argentina and Venezuela's consumer prices are excluded. See country-specific notes for Argentina in the "Country Notes" section of the Statistical Appendix.
[10]Eastern Caribbean Currency Union comprises Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines, as well as Anguilla and Montserrat, which are not IMF members.

Source: *IMF World Economic Outlook, October 2016*

The also-left-leaning government of Ecuador, the Fund notes, "continues to face a challenging outlook given the reduced value of its oil exports and its dollarized economy". However, citing the partial recovery in global oil prices and a more favourable external financing outlook, the Fund adjusted its projected contraction in activity for 2016 and 2017 to be less severe than it projected in April, at -2.3% and -2.7%, respectively; an fairly sizeable adjustment that President Rafael Correa took great delight in criticising in mid September, slamming the Fund's forecasts as "astrology".

According to the Fund, most of the remaining commodity exporters in the region will experience some deceleration in activity in 2016. In Colombia, growth is expected to ease to 2.2% (from 3.1% in 2015), reflecting tighter macroeconomic policies. Similarly, the protracted decline in the price of copper and policy uncertainties are weighing on Chile's outlook, with growth declining to 1.7% in 2016, from 2.3% in 2015. In both countries, nonetheless, the Fund expects that growth will strengthen in 2017, "and gradually rise to potential thereafter".

Unlike most of its peers, Peru is expected to grow faster this year and next, with growth rising to 3.7% and 4.1% in 2016 and 2017, respectively, "on the back of expanding activity in the mining sector and higher public investment". Those forecasts remain a bit more moderate than Peru's new government led by President Pedro Pablo Kuczynski, which in its draft budget for 2017 projected real annual GDP of 4% this year and 4.8% in 2017. Nonetheless Peru remains the 'darling' of the IMF and international investors, who remain upbeat about its near term prospects.

Finally, growth in Mexico is projected to decline to 2.1% in 2016 "due to a weak export performance in the first half". The IMF expects a moderate acceleration to 2.3% in 2017 "as external demand recovers", rising to 2.9% over the medium term, as the structural reforms implemented by the current government from 2013 take hold. The Fund does not allude to the 'Trump Factor', the concern in Mexico about the negative economic impact of a victory by the US Republican Party's presidential candidate Donald Trump in the upcoming 8 November general election.

REGIONAL BUSINESS REVIEW

REGION

Climate change will impact agriculture

The region of Latin America and the Caribbean (LAC) has a good record for developing agriculture, reducing hunger and improving food security. Yet over the next few decades some of these gains will be challenged by climate change. That is the conclusion of a major report written jointly by the UN Food and Agriculture Organisation (FAO), the Economic Commission for Latin America (ECLAC) and the Latin American Integration Association (ALADI)[1].

The report notes that LAC is the only region in the world that has halved both the proportion of people that suffer from hunger and their absolute number, targets set respectively by the UN's Millennium Development Goals (MDGs) and by the World Food Summit of 1996. It says that the proportion of people suffering from hunger fell from 14.7% in the three years to 1992 to 5.5% in the three years to 2012. The LAC figure for 2012 was just under half the world average, which stood at 10.9% of the global population. Within LAC, the reduction in hunger was greatest in South America. Progress was slower in both Central America and the Caribbean. In absolute numbers, there are now some 34m people suffering undernourishment in the region – half the number in that situation at the time of the 1996 World Food Summit, but still a significant number.

Part of the improvement is because Latin American food production has increased at a vigorous rate. In line with the global trend, food production has expanded faster than population growth. In the 2016-2017 agricultural season, the report predicts that LAC will produce 224m tonnes of grains: although this will be 2.3% down on the year before, the harvest will still be above the five-year moving average.

LAC accounts for nearly 7% of global agricultural value added, and has a large share of global markets for certain foods, such as coffee (58%), soybeans (52%), sugar (29%), beef (26%) poultry (22%) and maize (13%). Also helpful to the reduction of hunger has been the combined effects of rising living standards and redistribution of income, over the last decade or so. However, the last two years of slower or negative growth and the fact that LAC continues to be among the most unequal in the world in terms of income distribution, are limiting factors. In 2015, there were signs that earlier gains were slipping back, with an estimated 5m people falling into extreme poverty and 2m falling back into poverty.

The report has a chapter dedicated to the expected impact of climate change in the region on the agricultural sector. The sector accounts for 5% of regional

[1] *Food and nutrition security and the eradication of hunger*, ECLAC, FAO, ALADI, July 2016

GDP, 23% of regional exports and employs 16% of the economically active population. One of the general points the report makes is that governments should protect the bio-diversity of their countries' flora and fauna, simply because more diverse eco-systems are likely to demonstrate greater resilience in the face of climate change.

At a global level, some 7,000-plant species have been cultivated for food over the last 12,000 years, but currently only 15 plant species and eight animal species provide 90% of human food. Certain parts of the world are particularly prolific as centres of origin for cultivated plants. Research by Nikolai Vavilov in the 1930s identified 11 of these centres. Of those 11, four were in LAC: Southern Mexico and Central America; an area in the Andes spreading across Ecuador, Peru, and Bolivia; Chiloé in southern Chile; and an area straddling Brazil and Paraguay.

Climate change will be complex, but the bottom line is that it will have a particularly negative effect in the northeast of Brazil, in parts of the Andean region, and in Central America. Shifting weather patterns will affect crop yields, local economies, and food security. By countries, those likely to be hardest hit are Ecuador, El Salvador, Paraguay, Honduras, Nicaragua and Bolivia.

The report bases its findings on various studies and models of climate change effects. These suggest that by 2050 climate change effects will include higher average temperatures, more extreme weather (particularly in Central America and the Caribbean), a combination of floods and droughts, threats to biodiversity, threats to coral reefs and mangroves, rising sea levels, ozone depletion, and negative effects on fishing. The strength of these effects is hard to predict. Nevertheless, the report says that in Central America – where subsistence farmers account for 60% of the region's agricultural producers – a pessimistic global warming scenario predicts declining yields for maize and beans, two key local crops.

Source: *ECLAC*

Overall, the report says that because of climate change, yields per hectare in Latin America could fall by anywhere between 11.8% and 23.2%. The predicted fall in yields will be most acute in Paraguay, Bolivia (both in a range of 34.4%-43%) and Peru (20.2%-30.6%). Using this data, the report says that rainfall and temperature shifts could reduce rural incomes by as much as 20% in Bolivia, with the department of Potosí and traditional agriculture and agribusiness activities most harmed.

In Peru, the projections show that "the impact of climate change is likely to generate decreased production of several basic crops under all scenarios". There will also be a negative effect on live-

stock farming in the Puna eco-region in Peru, with a reduction in available grazing lands impacting *campesino* families, who depend on this activity.

Extreme weather

Statistics cited in the report confirm the often-anecdotal evidence that weather is becoming more extreme. The number of storms recorded in LAC in 2000-2009 was actually 12 times the number in 1970-79. Floods quadrupled in the same period. The number of people affected by extreme temperatures, forest fires, droughts, storms and flooding rose from 5m in the late 1970s to over 40m in the decade from 2000, reflecting the increased frequency of these events; but also the growth in city sizes, the spread of shanty towns, and the greater vulnerability of coastal zones. Calculations suggest that for each one degree Celsius rise in average temperatures, heavy rainfall in the region increases by around 7%. The report notes that Central America and the Caribbean will experience more intense hurricanes and longer droughts.

One significant prediction is that rainfall patterns will change in Central America. Between 1950 and 2000, in Pacific coast areas of the sub region there has tended to be two peaks in rainfall: one in June, followed by a drier 'Indian summer' in July and August, and then a second rainy season in September and October. Over the next few decades, this is expected to shift, with the intensity of the rains in the first wet period gradually falling, to leave a single more intense annual rainfall peak between October and November. This shift could endanger the *milpa* system, the simultaneous cultivation of maize, bean and squash crops that lies at the centre of Central American subsistence farming.

The three agencies that authored the report say that governments should seek to anticipate and prepare for climate change effects. "The challenge for the region is considerable: how to continue the positive process of eradicating hunger as the effects of climate change on production systems become deeper and more notorious" said Raúl Benítez, FAO regional representative. One suggested answer is a paradigm shift towards a "fully sustainable" agricultural model that protects natural resources, generates equitable socio-economic development and allows adaptation and mitigation of climate change effects.

The coffee problem

According to a new report published by The Climate Institute, climate change could cut the global area dedicated to coffee cultivation by as much as 50% by 2050. The report says that global coffee production is concentrated in a "coffee bean belt" situated between the tropics of Cancer and Capricorn.

Arabica beans (which account for around 70% of global coffee supply) require average temperatures of 18-21 degrees Celsius. If temperatures warm to 23 degrees or higher, the coffee bushes tend to grow too fast, affecting yields and the aroma and flavour of the beans. Rising temperatures and a combination of both heavier rains and more intense droughts is already affecting some key Latin American coffee producers.

In Mexico, Guatemala and Honduras, which between them produced 10m 60kg-bags of coffee in 2016, average temperatures have already increased by one degree Celsius. Central America has been hit by the spread of the coffee rust disease since 2012. In 2012, Guatemala lost about half its harvest because of the impact of coffee rust.

Brazil is the world's largest coffee producer (output of 43mn bags in 2015) but its four key production states – Bahia, Minas Gerais, São Paul and Paraná – have been affected by heats spells and cold snaps. A drought cut coffee production by one third in 2014.

De-industrialisation: The China question

In December, a sub-paragraph of Article 15 within China's World Trade Organisation (WTO) accession protocol will expire. It sounds obscure, but it could be crucial. As a result, countries in Latin America (as well as elsewhere) will need to decide, on a country-by-country basis, whether to grant China market economy status. Whether they do so or not could have far-reaching implications for their industrial sectors.

At present, Article 15 of China's WTO accession protocol means that its trading partners do not have to use Chinese costs and prices as the basis for calculating whether it is dumping products in their markets in an unfair or anti-competitive way. Instead, they can use costs and prices in a third country as a proxy, to work out whether anti-dumping tariffs should be applied. This situation recognises that because of the history of large state subsidies in the Chinese economy, its official costs and prices may not give an accurate picture.

From December onwards, this will change: each Latin American government will need to choose whether or not to recognise China as a market economy. Doing so means accepting its costs and prices as the basis for evaluating fair trade, just as for any other full WTO member. Recognising China as a market economy will have benefits – it will boost bilateral relations and could encourage trade and investment flows – but it will also have costs: it will limit the effectiveness of future anti-dumping measures as a defence against a flood of cheap Chinese products. It will be a difficult decision and different Latin American countries may choose to go different ways.

A new report[2] written by Jorge Guajardo, Manuel Molano and Dante Sica for The Adrienne Arsht Latin American Centre at the US-based Atlantic Council seeks to give the background analysis needed to help make this decision. Its basic argument is that China has played a key role in the long commodities boom that until recently allowed the region's economies to grow at an accelerated rate, but that the process has had a negative impact on Latin American manufacturing industry. The authors comment that "Industrial and high value-added sectors in Latin America now represent a smaller proportion of GDP than at the turn of the century, suggesting a process of de-industrialisation".

The authors note that China has demonstrated extraordinary growth in recent decades and played a part in the shift to global value chains, expanding its manufacturing operations while commercial and design components have remained largely in developed markets such as the US and EU. In 2004-2015, the share of manufacturing in total Chinese GDP stayed fairly constant at around 30%. In Brazil, by contrast, the share of manufacturing fell by a third (from 15% to 10% of GDP), while in Argentina it halved (from 20% to 11%). Mexico, with closer links with the US economy, saw its share of manufacturing hold fairly constant at 17% of GDP over the same period.

The authors measure de-industrialisation in various ways. The rate of growth of industrial value added in Latin America has underperformed. Manufactured products have decreased as a proportion of total Latin American exports, but increased as a proportion of imports. In Brazil, imported goods represented 13% of domestic consumption in 2001, but that increased to 23% in 2014.

Typically, Argentina and Brazil have been exporting a few primary products to China and importing a wide range of manufactured ones from China. In

[2]*Industrial development in Latin America: what is China's role?* Jorge Guajardo, Manuel Molano, Dante Sica, Adrienne Arsht Latin America Centre, Artlantic Council, August 2016

Argentina's case, for example, in 2015 exports to China were concentrated in two primary products soybeans (68% of total exports to China) and soy oil (7%), while 99% of imports from China were a diversified range of manufactures.

Brazil, similarly, exported three key products – soybeans (44% of the total), iron minerals (15%) and crude oil (12%) and imported a diversified range of high value -added industrial products. Mexico's case is slightly different, as it competes with China for a share of the US manufacturing market, and applied anti-dumping tariffs to various Chinese imports in the 1990s. The authors note, however, that "China's entrance into the WTO marked a deceleration of Mexican exports to the United States".

De-industrialisation could be the result of general economic trends or government policies, rather than being specifically caused by patterns of Chinese trade with Latin America. However, using a general equilibrium model, the authors conclude that "supply levels in heavy industry and light manufacturing would be higher in many Latin American economies if Chinese subsidies to export products were not present." Interestingly, however, they suggest that as China's economy transitions and its production costs increase, Latin America may have the opportunity to rebuild its own native supply for many production and consumption inputs.

The report concludes that Latin American countries will need to consider their position on granting China market status with some care. Options might include offering recognition in exchange for side agreements to protect key sectors from excessive Chinese imports. Brazil's national industry confederation (CNI) has suggested a hybrid approach, whereby China is given market status but its costs and prices are accepted for anti-dumping purposes only if they do not diverge too far from international averages. More generally, the report suggests that Latin American governments should adopt more proactive policies to develop their own manufacturing sectors, increase "systemic competitiveness" and improve infrastructure.

REGION

TPP trade deal hangs in the balance

The fate of the world's largest free trade agreement, the Trans Pacific Partnership (TPP), hangs in the balance. Three of the 12 signatories to the agreement are from Latin America – Chile, Peru and Mexico. There is a danger that the TPP, finalised in October last year, will fail to get legislative approval, particularly in the US, where the two main presidential candidates for the November elections say that they don't support it. If the TPP fails, it may signal a more protectionist trend in global trade, which could have negative effects for the Latin America as a whole.

The TPP matters for several reasons. The 12-country agreement – negotiated over nearly ten years – includes among others the US, Japan, Canada, Australia, Malaysia and Vietnam – countries representing around 40% of world GDP. (It does not include China). For the three Latin American participants, it represents the opportunity to widen their tariff-free access to world markets in general and to the Pacific Rim in particular. On some calculations, it could add 1.1 percentage points to their GDP growth rates.

Notably, the proposed agreement goes beyond merchandise trade to include services. For Mexico, it is an opportunity to deepen and intensify the trade advantages it began to acquire over two decades ago through the North American Free Trade Agreement (Nafta) with the US and Canada. Wider

strategic issues are also at play – for the US it is a chance to exercise a leadership role in the Pacific, to some extent countering Chinese influence.

But the TPP is in trouble. With protectionist sentiment on the rise and both Donald Trump, the US Republican presidential candidate, and Hillary Clinton, his Democratic Party rival, now opposing ratification of the treaty, analysts say that its only chance of US Congressional approval will come in the 'lame duck' period between the 8 November election and the end of President Barrack Obama's term in early January 2017. And that chance looks slim.

Many Mexican analysts feel that a failure to ratify the TPP might be an early sign of a US attempt to turn away from Nafta, particularly if Trump wins the elections. With the Mexican economy very closely integrated with its northern neighbour, an attempt to restrict bilateral trade flows could have negative effects for both economies.

It is hard to square talk of building a wall, deporting migrants and raising tariffs between the two countries with the fact that the components in the average automobile now on sale in the US may have crossed the border up to eight times as part of an essentially bi-national assembly process. Gary Clyde Hufbauer, of the Peterson Institute for International Economics, says that 70% of a Honda CR0-V built in Jalisco, Mexico consists of inputs originally made in the US and Canada. He thinks a Trump administration would threaten to leave Nafta so as "to create some story line where jobs are created in the United States" by pressuring US companies to shift operations back north of the border. But this would risk reprisals from Mexico and set off what could develop into a mutually very costly trade war.

PANAMA

Is the wider canal paying its way?

On 26 June, after US$5.4bn worth of investment on a nine-year mega-construction project, the enlarged Panama Canal was opened to shipping. It can now accommodate the passage of larger container ships, with capacity for 13,000 twenty-foot equivalent units (TEUs), up from 5,000 before. Large tankers can also use it for the first time, including those shipping liquid natural gas (LNG).

After three months, first indications are that canal traffic has increased, but the shipping industry remains volatile, so it may be too early to confirm clear trends. The sudden bankruptcy of South Korea's Hanjin Shipping at the end of August underlines the problem. One of the more dramatic assessments of what this means came from Gerry Wang, chief executive of Hong Kong-based Seaspan Corp, who said that "the fallout of Hanjin Shipping is like Lehman Brothers to the financial markets. It is a huge, huge, nuclear bomb. It shakes up the supply chain, the cornerstone of globalisation". Officially however, the Panama Canal Authority (Autoridad del Canal del Panamá, ACP) was keeping calm. It noted that Hanjin accounted for only 1.2% of total canal traffic and was ranked as the ACP's 17th most important client. It also suggested that some of Hanjin's routes might be taken over by other shipping lines.

On 21 September, *Pacific Treasure*, a Royal Dutch Shell oil tanker, became the 200th vessel to use the enlarged Canal since it opened at the end of June. ACP head Jorge Luis Quijano commented that he was "very optimistic" about toll revenues. The ACP is expecting a US$263.6m increase in toll revenue in fiscal 2017, and says its total contribution to the Panamanian treasury will rise in that year to US$1.6bn, up from US$1bn in fiscal 2016. But it is difficult to

isolate the economic impact of enlargement from other factors, such as competition between routes and cyclical movements in world trade. Olmedo Estrada of the Panamanian College of Economists, for example, calculates that the canal's share of global trade freight will hold steady at 6%, but that the economy will slow and that increased competition from the Suez Canal will also have an impact.

A domestic economic downturn was clearly under way earlier this year, before the enlarged canal came into operation. According to the national statistics institute (INEC), Q2 16 ACP toll revenues were down 8.7% on the same year-earlier period, while revenues from related services to shipping was off by 13.1%, reflecting a slower expansion of global trade. Containers handled in the second quarter were down by 11.8%. It will be interesting to see, when Q3 16 data is published, whether the 'enlargement effect' can offset this cyclical downturn.

There are at least two battles in progress for market share. One is the stong competition between West and East coast ports in the US. Shipping Asian exports to the US via the enlarged canal to East Coast ports is now cheaper, but takes longer than the alternative of using the often-congested West Coast ports and onwards rail and road freight to get to the final destination. For fresh produce, the faster West Coast route is probably still best, although the new generation of Panamax ships using the canal have cooling capacity. According to a specialist from Beacon Economics, cited by the *Los Angeles Times*, "People have been scratching their heads and sharpening their pencils ever since the Panamanians announced they would construct a new canal. After all this time, we still don't have a definitive sense of what will happen."

The second battle is between the Panama and Suez Canals for certain global long-haul shipping routes. The Suez Canal can accommodate even large container vessels, the mega-box ships with capacity of up to 22,500 TEUS. On the return leg from the US East Coast to Asia, some shippers are preferring to use the Suez rather than the Panama Canal. In part, this may be because the Suez Canal has been aggressively cutting its toll rates. "When we were about to launch our expansion, Suez began with a 35% discount", says Quijano. "Later, they raised the discount to 50% and the latest is that they've lowered prices by as much as 65%". He insists that the Panama Canal will hold its current rates and not enter a price war.

While some shippers shifted their routes from Suez to Panama when Panama enlarged, others have moved the other way. Quijano says that for each box ship that shifts to Suez from Panama, the ACP loses around US$600,000. According to industry sources, at present there are 14 regularly weekly services representing 94,250 TEUs of capacity using the Panama Canal, versus 12 weekly services using the Suez Canal and representing 105,892 TEUs.

ECUADOR

The quest for funds

In late September, Ecuador reopened its March 2022 US dollar bond for US$1bn, after it issued another tranche of 2022 bonds for US$1bn in July.

The radical left-wing government again offered a hefty 10.75% yield on the six-year bonds, indicative of the high risk attached to the sovereign, which along with the also oil-export dependent Venezuela remains among the worst-rated globally.

The sovereign has now issued US$5.5bn in bonds (in five tranches) since it returned to the market in 2014, following a selective default on US$3.2bn of debt declared 'illegitimate' by President Rafael Correa in December 2008. Upon its return in 2014, it successfully sold US$2bn in an oversubscribed issue, with a yield of 7.95% and a ten-year maturity. It then issued two US$750m five-year bonds in each of March and May 2015, with yields of 10.5% and 8.5% respectively, followed by the two tranches of US$1bn (each yielding a higher 10.75%) to date this year. Given that these issues have been short term and at fairly high interest rates, they will immediately increase payment obligations for the next government due to take office after the mid-February 2017 general election. Interest payments alone look set to rise to over 2% on GDP from next year. At a time when oil prices remain relatively weak, this will limit the net government's room for manoeuvre when drawing up its budgets.

According to the finance ministry data, total consolidated public debt as of 30 September was USS$37.81bn, or 39.2% of GDP and close to the 40% limit set under the 2008 constitution. This is up from US$20.9bn (22% of GDP) just three years ago and reflects the extreme difficulties faced by the Correa administration upon the collapse in global oil prices, starting in mid-2014. The latest issue will go towards the 2016 budget, the finance ministry said in a statement, as the government struggles to cope with a US$3bn reconstruction bill after the strongest earthquake in 40 years hit in mid April, devastating parts of Pacific coastal region, with over 600 deaths. Reconstruction work is underway, which the government hopes will help the stagnant domestic economy.

Aside from rapidly accumulating new external debt since 2014, the Correa government has also taken to relying rather heavily on short-term (180-day) treasury notes, financed by the central bank. The bank's total purchases of these are now estimated at over US$3bn, from just US$61m two years ago. For a dollarised economy like Ecuador, this will raise some alarm bells, amid its already stretched dollar liquidity position.

Another concern for some private economists is the Correa's government's accumulating debt to strategic partner China. Within the total public debt figure reported in June, the finance ministry put bilateral debt to China at US$7.9bn, over one-third of the total reported public debt and the same as the country's multilateral funding (also reported at US$7.9bn in June). However, by contrast with multilateral lending, Ecuador's debt with China tends to be costlier and contracted at shorter maturities. Typically, it is also 'tied-lending', destined for specific projects. These mostly are infrastructure schemes, like the recent string of new hydroelectric plants built in the country; these were financed by China and constructed by Chinese firms using Chinese labour.

Other credits from China are tied to future oil sales, and so the treasury does not classify them on its books as 'debt', but instead registers them as 'oil pre-sales'. As such, the total does not appear in the officially reported total public debt figure. Economists argue that this 'creative accounting', also sometimes used by Venezuela in its strategic relations with China, could very easily come back to bite future administrations, while oil sector analysts also point out these cash-for-oil-deals (the terms of which are unknown) tie Ecuador into long term oil supply deals with China that may not necessarily be feasible (or profitable) for the country in decades to come. Venezuela, for instance, which is struggling to maintain oil production levels, is suspected of having to divert exports meant for top dollar-paying customers like the US to China, potentially earning less in the process.

IESS accumulates government securities

According to late September comments by Ricardo Espinosa, president of Ecuador's social security institute (IESS), the institute now has total investments worth US$17.4bn, up from US$2.8bn previously, of which US$7.4bn is in finance ministry bonds. Espinosa insisted that the government securities were a good investment, with a favourable interest rate of about 7.5%. He insisted that the cash-strapped finance ministry "pays us interest, they are totally up to date".

Overall, Espinosa added, IESS investments generate an average return of 8%, with US$7bn invested in mortgage credits over terms of 20-25 years, another US$2bn in unsecured credits to IESS affiliates and retirees, and US$1.5bn in the private productive sector.

The IESS has a total accumulated debt of US$80bn, Espinosa said, mostly destined for the construction and equipping of hospitals in the country.

Exporters fret about EU association agreement

Time is running out for the European Union (EU) to ratify Ecuador's adhesion to its existing association agreement with the Andean (Colombia and Peru), which was agreed two years ago in 2014 but which has still not been ratified.

While the talks were ongoing, the EU twice rolled over existing preferential tariff access for Ecuador under its Generalised System of Preferences (GPS). However, Ecuador's inclusion in the GPS is set to expire for good on 31 December next, so unless it is part of the association agreement by then, local exporters will face a hefty increase in tariffs to European countries as of 1 January 2017.

Part of the reason for the delay on the European side has been the Correa government's imposition of import tariffs in a bid to defend the country's balance of payments/liquidity position in response to the oil price shock. Following the temporary imposition (and then removal) of tariffs and quotas on imports from Colombia and Peru in early 2015, in March 2015 the Correa government instead moved to impose blanket global tariffs ranging from 5% to 45% on a basket of 2,961 designated non-essential imports (one-third of the total import basket). These so-called 'balance-of-payments safeguards' were added on top of some existing tariffs, much to the chagrin of some local manufacturers.

These safeguards were due to expire in June this year, but they were extended for 12 months after the April earthquake, with the explicit permission of the World Trade Organisation (WTO). As part of the deal with the WTO, the external trade committee (Comex) agreed to draw up a schedule for the removal of the tariffs in April-June 2017, and immediately reduced by 5% the levy on around 700 items.

The safeguards have worked from the point of view of the balance of payments, with imports falling faster than exports over the past 18 months, and this is despite the huge shock to exports from the collapse in oil prices. Indeed, according to the central bank, the country registered a small trade surplus of US$696m in the first half, compared with a deficit of US$1.2bn in the year-earlier period. While export revenues fell by 19% year on year (led by a 38% contraction in the value of oil sales and an 8% drop in the value of non-oil sales), imports fell by 35% in the same period. As a result the first quarter current-account deficit was the lowest in three years, at US$376m, or 1.5% of GDP, down from 3.3% of GDP in Q4 2015, providing important financial relief.

But with strong demands both by Ecuadorean exporters for closure on the agreement, as well as pressure from European exporters for the removal of costly restrictions on European-made cars, Parma ham and other luxury foods still a major sticking point with Brussels, the Correa government has been obliged to move earlier. Thus in mid September the government announced that as of 26 October the highest import tariff would be reduced to 35% from 40%, with the mid-level 25% tariff eliminated and items in that tier henceforth subject to the 15% duty. Clearly, the aim of this is to accelerate towards ratification. However, even though the country's foreign trade minister, Juan Carlos Cassinelli, and the vice-president, Jorge Glas, have lobbied hard in Europe in recent weeks, there is a real concern that Ecuador's accession might not now occur until March 2017. Local export groups put the potential revenue loss to exporters at US$100m. President Correa has publically pledged state drawbacks to compensate. Exporters, however, argue that costs would go well beyond lost revenue to the permanent cancellation of their contracts in Europe, for example, and they also point out that the Quito government has already been quite tardy in providing compensation to local exporters under existing drawback schemes.

And in Brussels, trade lawyers continue to say that while there may be political will to help out Ecuador amidst its current economic difficulties, particularly on the part of countries like Spain and Italy, two heavyweights within the EU, the deal technically cannot be ratified without the suppression of the safeguards.

PERU

Kuczynski get his decree powers

On 29 September Peru's opposition-controlled congress agreed to give temporary legislative powers to President Pedro Pablo Kuczynski for a reduced period of 90 days (he had requested 120 days). The successful vote was received with obvious relief by the centrist new government, after some fears that it might be rejected

All Peruvian governments since the return to democracy in 1990 have been granted temporary decree powers at the outset of their terms in order to kick-start their government plans into action. The unicameral assembly, controlled with 72 of 130 seats by the right-wing Fuerza Popular (FP, the party associated with the disgraced former authoritarian leader Alberto Fujimori [1990-2000] and now led by his daughter and narrowly defeated 2016 presidential candidate Keiko Fujimori) voted roundly to grant the legislative powers after a six-hour debate.

Given President Kuczynski's strong public approval ratings (his support hit 63% in September, up two points on August and well above the 50.1% of the vote he won in the 5 June' presidential run-off) and his favourable image among international investors, most notably in the US, the FP, which Keiko Fujimori has pledged will provide a "responsible opposition", likely knew that it would do itself no political favours by breaking with tradition to deny Kuczynski his request. Having used its congressional majority to permanently obstruct the last, nominally leftist government led by Ollanta Humala (2011-2015), between now and the next 2020 election the FP needs to prove, finally, that is mature, democratic and responsible enough to govern, rather than merely acting as a stubborn foil to the executive.

The FP-dominated congress voted to approve the powers just a day after the congressional commission partially approved the request, and a week after the budget commission had rejected it. Given that both commissions are FP-controlled (as is the also-powerful audit commission), it seems fair to assume that the FP and Kuczynski's novice prime minister, Fernando Zavala, did some serious dealing in-between. The 2017 budget, currently also before congress, likely was the subject of some of those negotiations.

Aside from the move to cut the decree power period from 120 to 90 days, which was criticised by Zavala, most of other changes were indeed economy-related, after the budget commission had rejected the Kuczynski request on the grounds that that the proposed economic and fiscal reforms in his proposal would conflict with the constitutional limits on the power of the executive and also undermine the constitutional duties of the legislature. In particular, the head of the budget commission, the high-profile *Fujimorista* Cecilia Chacón, noted that the executive's request to be allowed to establish a new "macroeconomic fiscal framework", clashed with the legislature's duty to approve and audit the budget. The audit commission, headed up by the FP's Héctor Becerril, partially approved the request, agreeing to 11 of the 21 points, notably including the proposal for an independent attorney general's office. But notably, Kuczynski's request to beef up the financial intelligence unit (Unidad de Inteligencia Financiera, UIF), in order to bring Peru into line with international anti-money laundering regulatory practices, as recommended by the Financial Action Task Force (FATF) and the Organisation for Economic Co-operation and Development (OECD), which Peru is seeking to join, was not well received by the *Fujimoristas*. This may add to the long-standing whiff of suspicion over the financial dealings of the party and its various allies (the FP's chairman, Joaquin Ramírez, was forced to step aside ahead of the June run-off ballot, after it emerged that he himself was under investigation for money laundering).

Kuczynski's request included 21 measures targeting economic reactivation and citizen security grouped under the five priority axes that form the core of his government plan. The first is reactivation of the domestic economy and consolidation of a simpler tax system aimed at supporting formalisation. In a bid to make taxation fairer, the government intends a gradual three percentage point reduction in the rate of value-added tax (VAT) from the current 18% from January 2017; an amnesty on the repatriation of undeclared earnings overseas; and changes to fiscal transparency rules. Corporate tax cuts introduced by the Humala administration would be rolled back in order to pay for the VAT cut, which is opposed by the *Fujimoristas* on the grounds that it will eat into funds for essential fiscal spending needs. Other measures would restructure PEN25bn (US$7.4bn) of debt held by the country's regional governments. Elsewhere, reforms would make it easier for foreign banks to enter the local financial system, so as to increase competition.

The executive also wants to set up a new infrastructure fund in support of its plan to lift real annual GDP growth to 5% from 2018, which Kuczynski and senior ministers touted to US investors when in New York in September for the UN General Assembly. In support of this, the national investment agency, Proinversión, is to be overhauled. The government also wants to legislate for improvements to the security system, the judiciary and domestic policing. In support of this, the president requested powers to introduce new anti-corruption policies, including protection mechanisms and incentives to prevent government corruption. Related to this, it envisages a new autonomous attorney general's office (Procuraduría General del Estado).

Elsewhere, the president wants to legislate to expand the provision of water and sanitation to vulnerable and rural sectors, one of his flagship pledges. Finally, the long-troubled state oil company, Petroperú, would also be re-structured.

Kuczynski's finance minister, Alfredo Thorne, was confident that 90 days would be sufficient to implement the plans, telling local media, "I think that [90 days] will be enough. On the economic side, we have almost everything prepared already, although we need to refine some details. But I think we will get it done in 90 days."

Zavala, meanwhile, said that the president would use the first 30 days of his decree powers to focus on crime, the top voter concern in this year's elections, along with the economy. Pollster Ipsos in September reported strong public support for Kuczynski's request to legislate in areas including corruption (backed by 87% of Peruvians) and public security (97%). Echoing Thorne, the PM noted that "economic matters, and above all security issues, are well advanced. Some security measures will be ready in 30 days".

The 2017 budget

Finance Minister Thorne's 2017 budget proposal is costed at PEN142.5bn (US$42.2bn), a nominal increase of 4.7% over the 2016 plan and 20% of GDP. It projects real annual GDP of 4% this year and 4.8% in 2017.

Having inherited a higher-than-expected fiscal deficit of 3.3% of GDP to end July, well above the 2.5% that the outgoing Humala government had pledged, Thorne, a former senior World Bank economist, was obliged to adjust his fiscal targets. He still aims to trim the deficit to 1% of GDP by 2021, but more gradually, so as not to choke off the domestic recovery or force excessive austerity on the new administration. Thus, after an expected deficit of about 3% this year, the 2017 target will be 2.5% of GDP (from 1.8% previously), falling to 2% in 2018, 1.8% in 2019, 1.5% in 2020 and 1% in 2021. This additional leeway (amounting to about US$1.5bn in 2017) should cushion the revenue impact of the government's planned tax reforms and it will also allow more room for Kuczynski's spending and investment plans, which aim to lift real GDP growth to 5% from 2018 onwards.

REGION

Corporate Radar

América Móvil eyes Oi: Mexico-based telecoms giant América Móvil is considering a takeover bid for all or parts of Oi, its struggling competitor in Brazil. Oil filed for bankruptcy in June, with debts of BRL65.4bn (US$20bn). Daniel Hajj, chief executive at América Móvil, the company controlled by Mexican entrepreneur Carlos Slim, told the Brazilian business daily *Valor*, "we are open to considering all options…I am very interested in Brazilian market consolidation, but I don't know how it will happen."

The comments come against a background of continued rumours of takeovers or realignments among Brazil's four main operators, whose margins have been squeezed by two years of recession. One of the players, TIM Participações (controlled by Telecom Italia), began negotiations on a merger with Oi earlier this year, but talks have since cooled. Neither América Móvil nor the other main player, Telefónica of Spain, has ruled out merging with Oi. Any move would need regulatory approval. In a research note, Credite Suisse recently suggested that a full takeover of Oi by one if its rivals might be ruled out, as being anti-competitive, but suggested that partial takeovers of some of its assets could go ahead.

Tough going for Latin corporates: A report by Fitch Ratings published in late August noted that times are tough for big corporates operating in Latin America due to a combination of sluggish growth, depressed commodity prices and significant political risk. According to Fitch director Jay Djemal, "Across Latin America, corporates face headwinds that are not expected to abate before year end. The only bright spots are Mexico and Peru – both countries are now expected to enjoy positive GDP growth that should support the corporate sector." The report noted that short-term prospects in Argentina remained weak, with the economy shrinking because of higher utility rates and a weaker exchange rate. In Brazil, it observed that the recession continued to bite, with companies facing high political uncertainty, low commodity prices and tight financing conditions. Chile was experiencing the third consecutive year of sluggish growth because of low copper prices.

Schlumberger back into Venezuela: Houston-based oil drilling and services company Schlumberger said it was one of three companies to win a US$3.2bn contract from Venezuelan state oil company PDVSA. The announcement was made just months after Schlumberger had closed some of its Venezuelan operations because of government payment delays. The other companies directly involved are Horizontal Well Drillers and Venezuela-based Y&V. International groups Halliburton and Baker Hughes are also to provide support. The new contract is to drill 480 Orinoco Belt wells, of which Schlumberger's share is 80. The contract, described by PDVSA as "one of the world's largest drilling projects" is designed to counter the rapid fall in Venezuelan oil output. Crude output was down 12% in the year to August, reaching 2.3mn barrels per day. The fall came against the background of the country's deepening economic crisis. Many service companies working on contract to PDVSA say they are not being paid on time. PDVSA says the contract is linked to a US$7bn plan to restructure its debt. Byron Pope, an oil industry analyst, told the *Wall Street Journal* that Schlumberger was probably taking the long view on Venezuela. "They've made it clear to PDVSA that they are not going to work indefinitely if they don't get paid" he said, adding "I think one of the ways they were effective in getting their message to PDVSA was in terms of starting to pull some resources and people out of the country."

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