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LATIN AMERICA ADVISOR

Featured Q&A *With Our Board of Advisors*

Q According to the minutes of its January monthly meeting—released last week—the Brazilian Central Bank's monetary policy committee (Copom) noted that consumer and wholesale price movements in December could signal a "persistent acceleration of inflation." How do you read Brazil's inflation data? Should investors expect to see more interest rate cuts by the Central Bank in the near future? Is the Bank's 2004 inflation target of 5.5 percent still a realistic goal?

A **Board Comment: Michael Gavin:** "We've had a couple of months of problematic core inflation numbers, nothing terrifying, but outside the government's inflation target and going the wrong direction. We've also seen a somewhat disturbing rise in wage pressures. Wage data are pretty spotty in Brazil, but the year-on-year growth of the CNI index of manufacturing wages accelerated to 14.5 percent in November. It's natural to expect wages to recover some of the purchasing power lost during last year's inflationary spike, but the Central Bank wants to be sure that the process happens gradually so that it does not trigger a revival of inflationary expectations. A weak labor market and generally stable currency set the stage for some deceleration of underlying inflationary pressures in the months to come, and we think that by March or April the Central Bank should be cutting interest rates again. We continue to believe that the inflation target will be met."

A **Guest Comment: Graciana del Castillo:** "It would not be surprising that in an election year Lula's agenda would focus more on growth reactivation rather than on the difficult structural reforms that are desperately needed. Unpopular tax and labor reforms are likely to be postponed as are

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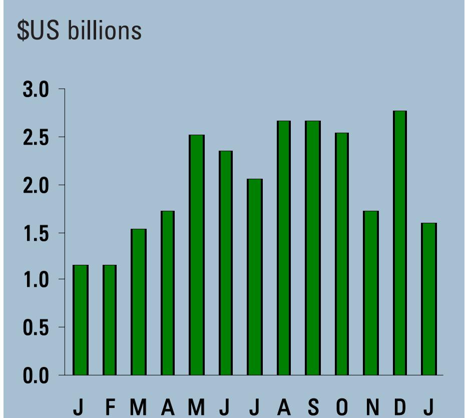
CHART OF THE DAY

Brazil's Trade Balance
Jan 2003–Jan 2004



Source: Ministry of Development, Industry, and Trade.

Inside This Issue

NEWS BRIEFS

Brazil Posts Record January Trade Surplus

Brazil on Monday reported a record trade surplus for the month of January of $1.59 billion on growing farm exports. Exports grew 26.5 percent from January 2003 to $5.8 billion, while imports rose 21 percent to $4.21 billion. The country posted a record trade surplus of $24.83 billion in 2003.

Mexico's 29-Day Cetes Rises to 4.88 Percent

Mexico's benchmark 29-day Cetes interest rate rose 19 basis points to 4.88 percent at the Central Bank's weekly auction on Monday. The increase follows five consecutive weekly declines, and comes ahead of the release of January inflation data expected to show a small increase in prices.

FirstEnergy Sheds Two LatAm Assets

US power company **FirstEnergy Corp**. said Monday it has completed the sale of two assets in Latin America. The company said it sold its wholly owned Bolivian power generation unit, **Guaracachi America** to **Bolivia Integrated Energy Limited**, and its 28.67 percent stake in Colombian power plant operator **Termobarranquilla** to **Darby Delaware Mezzanine Holdings**.

Banco Bradesco Q4 Profit Rises 2.4 Percent YoY

Banco Bradesco, Brazil's largest private bank reported a fourth-quarter 2003 net profit of 715 million reais ($US 244 million), up 2.4 percent from the same quarter of 2002. The bank posted a record profit of 2.3 billion reais for all of 2003.

Source: Reuters.

Company News

BBVA Bids for Full Control of Mexico's Bancomer

Spain's **BBVA** on Monday announced a surprise 3.3 billion euro ($US 4.1 billion) cash bid to buy out the 40.6 percent stake in Mexico's **Bancomer** it does not already own, Reuters reported. If accepted, the acquisition would give BBVA full control of Mexico's largest bank and add 0.6 percent to BBVA's projected earnings per share from this, 1.0 percent from 2005, and 2.5 percent from 2006. "Mexico is by far the most important economy in Latin America—its GDP per capita is twice that of Brazil ... and it's an emerged, not an emerging, economy, BBVA Chairman Francisco Gonzalez told reporters. BBVA said it would issue new shares to pay for the acquisition, adding that it has already raised 85 million euros through the sales of industrial stakes during the fourth quarter of 2003. BBVA's offer of 12 Mexican pesos per share is equal to a premium of about 13 percent over Bancomer's closing share price on Friday of 10.59 pesos. Bancomer's shares rose 11.47 percent on Monday to end at 11.75 pesos per share. In a research note, released this morning, **JP Morgan** analyst Victoria Miles said the bid is part of BBVA's strategy to concentrate its Latin America investments in Mexico. "Bancomer already accounted for the majority of BBVA's Latin American investments, following the sale of its Brazilian subsidiary in 2002 and a reduction of its market share in Argentina since the crisis.

> "Mexico is by far the most important economy in Latin America ..."
>
> — *BBVA Chairman Francisco Gonzalez*

Economic News

Mercosur Countries Receptive to US-Backed FTAA Draft Proposal

The members of South America's Mercosur trade bloc are reportedly receptive to a draft proposal by the United States and four other Western Hemisphere countries that seeks to remove barriers to successful conclusion of talks to create a Free Trade Area of the Americas (FTAA), Reuters reported, citing an unnamed source close to the negotiations. According to the source, the US, Canada, Chile, Costa Rica, and Mexico gave the Mercosur countries a proposal which calls for "eliminating export subsidies in the region as defined in the World Trade Organization Agreement on Agriculture, while dissuading the use of export subsidies by non-member countries in the FTAA." Mercosur's two largest members—Brazil and Argentina—have insisted that any comprehensive FTAA agreement would have to include US concessions on agriculture subsidies. Mercosur also includes Uruguay and Paraguay. News of the US-backed proposal came on the eve of a meeting of hemispheric trade officials this week in Puebla, Mexico to work toward a compromise in FTAA talks.

Honduras Signs Agreement with IMF

The government of Honduras on Monday signed an agreement with the International Monetary Fund that will make available $350 million in loans to the impoverished nation and forgive close to $1 billion in foreign debt, Reuters reported. "This is a good accord for Honduras, and it comes at a time when we have the right internal and external conditions to fuel strong economic growth," said Honduran President Ricardo Maduro upon signing the agreement. In a statement, Anoop Singh, the director of the IMF's Western Hemisphere department, said the agreement was made within the framework of the IMF's Poverty Reduction Growth Facility program and "carefully balances a strengthening of macroeconomic policies and institutions with much greater attention to poverty and equity issues." Under the program, Honduras is expected to improve tax collection, devote more spending to antipoverty programs, reform the country's Central Bank to bring it in line with "best practice international standards," and implement a series of institutional reforms "to improve governance, transparency, and social equity," Singh stated. The IMF official said successful implementation of the program could increase the rate of growth in Honduras from its recent average of about 2.5 percent to 4.5 percent by 2006. Last year, IMF-proposed austerity measures sparked violent protests in Honduras. With 80 percent of the Central American nation's population of 6.6 million living in poverty, Honduras is the third-poorest country in the Hemisphere after Haiti and Nicaragua.

S&P Downgrades Credit Ratings on the Dominican Republic

Ratings firm **Standard & Poor's** said Monday it had lowered its debt ratings on the Dominican Republic due to the "heightened probability" of a default on debt due the private sector. In a statement, S&P said it had downgraded the Caribbean nation's long-term sovereign credit and senior unsecured ratings to 'CC" from 'CCC,' with a negative outlook. S&P credit analyst Richard Francis noted that current negotiations with the country's Paris Club creditors could have an impact on the Dominican Republic's ability to meet its other debt obligations. "Given the general provisions of the Paris Club's Evian Approach, this could imply that the government may be asked to seek comparability of treatment from its private creditors, under which the government would have to reschedule all of its external debt," Francis said. "The government is already in arrears to its bilateral creditors and to many of its suppliers." The action by S&P follows similar downgrades last week by **Fitch Ratings** and **Moody's Investors Service**. The Dominican Republic is struggling to recover from a severe economic crisis sparked by the collapse of a major bank last year amid fraud allegations and by a plummeting peso currency.

Uruguayan President Predicts Growth Will Beat 5 Percent Forecast

Uruguayan President Jorge Batlle said Monday he was sure his country's economic growth would beat the official 5 percent forecast for 2004, Reuters reported. When asked about the economic recovery in neighboring Argentina during a press conference in Spain, Batlle replied "I am absolutely convinced the Uruguayan economy will exceed that 5 percent, not because of the strong Argentine recovery, but because of the strong Uruguayan recovery." Uruguay's economy plummeted 10.8 percent in 2002 due to the economic collapse in Argentina, and shrank an additional 2.3 percent during the first nine months of 2003. Uruguay's economy bounced back in the fourth quarter, however, showing at least 11 percent growth year-on-year, which Batlle partly attributed to the country's loan agreement with the International Monetary Fund. Batlle said he trusted experts who predict his country's economy would expand more than 5 percent this year, and he forecast Uruguay's inflation would be about 7 percent. "This year it will be in a single digit, in the order of 7 percent annual inflation," he said. "If the government was to blame that everything was going wrong, it's also to blame that everything's going well," Batlle added.

Russia, Venezuela Considering Construction of Alumina Plant

Russia is in talks with Venezuela to invest $1 billion in an alumina plant in the South American country, Reuters reported Monday. "We have agreed ... to create a working group which will conduct the first phase of negotiations," said Russian Deputy Prime Minister Vladimir Yakovlev during a visit to Venezuela. Firms interested in the proposed construction project include **Russian Aluminum**, the country's largest aluminum producer, and Venezuelan state-run mining firm **Corporacion Venezolana de Guayana** (CVG), Yakovlev said. Details of the project, including a timetable for construction of the plant, are being discussed, the Russian official added. Venezuela already has two main aluminum smelters in southeastern Bolivar state. The larger of the two smelters, Venalum, has a capacity to produce 430,000 tons of aluminum per year. Before his departure on Wednesday, Yakovlev plans to meet with President Hugo Chavez and with government oil and energy officials. CVG is also in talks with Iranian companies.

Political News

US Withholding $15 Million in Military Aid to Ecuador

US Ambassador to Ecuador Kristie Kenney said the US will withhold $15 million in military aid to the Andean country due to its failure to sign an agreement protecting members of the US military from prosecution by the International Criminal Court (ICC), according to an interview published Monday in local daily *El Universo*. "We respect the position of Ecuador and we are still talking to arrive at an agreement," Kenney stated, noting that a US law—the American Service Members Protection Act—signed by President George W. Bush in 2002 conditioned continuing military aid on commitments by recipient countries to protect US soldiers from prosecution by the ICC. Last year, the US suspended military aid to almost three dozen countries—including 11 Western Hemisphere nations—for failing to sign bilateral agreements exempting US troops from prosecution by the ICC [Editor's note: see related Q&A in the July 8, 2003 issue of the *Latin America Advisor*]. "Ecuador can sign or not, and our country has the democratic right to deny aid to countries with which we do not have protection for our military," the diplomat added. Kenney said that apart from the suspended $15 million in military aid, the Bush administration has proposed a $70 million aid package for Ecuador in 2004.

US Amb. to Ecuador Kristie Kenney. *Photo: US State Department.*

Featured Q&A

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the plans to establish a *de jure* independent Central Bank—a highly ideological issue resisted by various groups in Lula's government. Despite political pressures to cut interest rates, however, the Bank has acted once again with the *de facto* independence (both of objectives and instruments) that it has exhibited for a number of years. Although the Bank attributes the recent hike in inflation mostly to seasonal and one-time factors, the Copom expressed concern about the surge in core inflation, which was generalized to most items in the consumption basket. Because of this surge and the difficulty of estimating the impact of the 1,000 basis point cut in the Selic since June 2003, the Copom decided to maintain caution in monetary management and keep interest rates unchanged. The easing cycle is likely to resume in the second quarter. It will be difficult for the Central Bank to achieve the inflation target of 5.5 percent for this year."

> "A cautious Bank sends a much better signal than a Bank that turns out to be wrong."
>
> *— Albert Fishlow*

A **Guest Comment: Desmond Lachman:** "The Bank's conservative policy actions and statements need to be seen in the context of its basic mandate to reduce inflation to 5.5 percent by year-end. In an effort to establish policy credibility, the Bank of Brazil is particularly keen to meet its inflation target this year after having missed it in each of the past three years. As a result, the Bank is more inclined to the risk of maintaining monetary policy too tight rather than too loose. Over the next few months, inflation will decline toward the Bank's inflation goal as the gaps in the labor and product markets created by the recent recession produce downward pressure on prices. At the same time, the recent strengthening of the Brazilian currency will also exert disinflationary pressure. In the months immediately ahead, one must expect the Bank to resume its past program of gradually reducing short-term interest rates as the economic upturn fails to gather momentum. In real terms, Brazilian interest rates are currently at around 10 percent, which would appear to be excessive if Brazil's recovery is to gain traction. This would appear to be particularly the case should the Brazilian currency remain strong and should the government continue to meet its primary budget surplus target."

A **Guest Comment: Albert Fishlow:** "The Brazilian Central Bank is concerned with a possible resurgence in inflation associated with increased economic activity. Some current studies identify a real interest rate of 9 percent as the limit where one sees pressures mounting. That is the reason for Central Bank caution. It wants to ensure that the real interest rate continues to decline. A month of rate stability, especially with lesser price increases in February, can provide greater certainty to the continuity of both reduction in inflation as well as the real interest rate. A cautious Bank sends a much better signal than a Bank that turns out to be wrong."

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