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Featured Q&A *With Our Board of Advisors*

Q Stating that the "worst is over," Brazilian President Luiz Inacio "Lula" da Silva said last week he was the most optimistic about Brazil's economy since he took office in January 2003. Is Brazil now well on the path to sustainable growth? How vulnerable is the country to external shocks? What is the outlook for Brazil's public debt-reduction strategy?

A Guest Comment: Paulo Vieira da Cunha: "President Lula is where former President Fernando Henrique Cardoso wished to be: enjoying the fruits of effective macro policy and luck. We believe Brazil is entering a new era, one in which macro policy is on course. Now all that stands between its economy and growth are supply-side obstacles, but celebrate at your own risk. Brazil invests too little and yet has a production structure that demands increasing capital (in use and out of use) per unit of output. Given historical inefficiencies, the relative cost of capital *vis-a-vis* consumption goods has increased. However, given low growth and a very unequal income distribution, the political tolerance for postponed consumption is low. Too little is invested, at too high a price, on inefficient choices—and the public sector gobbles up private savings. Potential GDP growth is low (in the range of 2.4-3.4 percent per year) and the obstacles to make it expand faster are deep-rooted. It would take far-reaching policy changes, potentially with a high political price tag, to beat them. Meanwhile, growth at about 3 percent per year should not be ridiculed. It could be enough to stabilize and likely bring down the debt-to-GDP ratio, and the country is today much less vulnerable to external and fiscal shocks."

A Guest Comment: David Malpass: "Brazil's economic and financial situation has improved since President Lula and his advisors took office. Their expressed goal has been

Continued on page 4

PHOTO OF THE DAY

Ali Rodriguez, the president of state-owned Venezuelan oil company PDVSA, on Monday announced the firm's plans to repurchase up to $2.6 billion in outstanding foreign debt. Analysts are worried the debt buyback may increase Venezuela's sovereign risk. See related story on page 2.

Photo: BBC.

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NEWS BRIEFS

Canada's Liberal Party to Lead First Minority Govt. in 25 Years

Canada's ruling Liberal Party lost outright control of Parliament in national elections on Monday, but retained enough seats to command the country's first minority government in 25 years. Yesterday's vote ended an 11-year monopoly on power by the Liberal Party, which is expected to form a governing coalition with the New Democratic Party (NDP). However, the NDP, which is critical of free trade, could clash with the Liberal Party on hemispheric issues such as efforts to create an FTAA [Editor's note: see related Q&A in the June 14, 2004 issue of the *Latin America Advisor*].

Source: Associated Press.

AES Completes Restructuring of $2.7 Billion Brazil Debt

AES Corp. completed a $2.7 billion debt restructuring in Brazil Monday with the refinancing of $316 million in bank loans. Under the terms of the deal, AES will pay $50 million to the banks, which agreed to extend maturities worth $266 million in syndicated loans to 2011. The bank debt refinancing follows the restructuring in March of $739 million in debt by AES' **Eletropaulo Metropolitana** and the restructuring late last year of $1.2 billion in debt owed to Brazilian development bank BNDES.

Source: Bloomberg News.

Two Killed in Ecuador Jailbreak

Two inmates of an Ecuadorean prison were killed during an armed escape attempt on Monday. Three more inmates and a guard were wounded during the escape. It was unknown how many inmates actually escaped.

Source: Reuters.

Economic News

PDVSA Announces Offer Buy Back $2.6 Billion in Foreign Debt

With its earnings boosted by high global oil prices, state-owned oil company **Petroleos de Venezuela** (PDVSA) on Monday offered to repurchase as much as $2.6 billion of its foreign debt, Reuters reported. The transaction, which analysts say would cover almost all of PDVSA's outstanding foreign debt, would apply to notes maturing in 2006 and 2028, although PDVSA President Ali Rodriguez declined to give details. "Normally, when a company is solvent enough and needs to ease its costs ... it carries out these kinds of operation," Rodriguez said. "This year, we have the company's financing requirements more than covered." The buyback will allow PDVSA to lower its overall debt and free up for sale oil that has been used as collateral to guarantee debt servicing. However, **Credit Suisse First Boston** analyst Jan Dehn said in a research note this morning that the debt buyback program would increase the risks for sovereign bondholders. "We think this would indirectly increase sovereign risk by making it easier to divert oil revenues away from the government's coffers." According to Reuters, PDVSA's debt buyback offer comes as the government of President Hugo Chavez, who faces an August 15 recall referendum, is using $3 to $4 billion of oil income to finance populist social programs and development funds company. In response to the debt buyback announcement, **Standard & Poor's** said it might cut its "B+" rating on PDVSA's outstanding debt. Aspects of the debt repurchase "may reduce the credit quality of any notes that remain outstanding upon completion of the tender offer," S&P said in a statement. Venezuela is the world's fifth-largest oil exporter.

The debt buyback will allow PDVSA to lower its overall debt and free up for sale oil that has been used as collateral to guarantee debt servicing.

Company News

Telmex Seeks to Acquire Up To 60 Percent of Brazil's Net

Telefonos de Mexico (Telmex) said Monday it has agreed to buy a 30-60 percent stake in Brazil's largest cable television operator, **Net Servicos de Comunicacao,** for between $250 and $370 million from local media group **Globopar,** Reuters reported. Telmex, which dominates Mexico's local and long-distance telephony market and in recent months has embarked on a buying spree in South America, said the acquisition of Net would complement its $400 million purchase of a controlling stake in Brazilian long-distance operator **Embratel** in April. "After Embratel's acquisition ... Net makes a lot of sense to tap the 'last mile,'" Telmex chief spokesman Arturo Elias Ayub said, according to Reuters. "This will make it much easier to reach homes and offer … video, voice and data." Net has 1.36 million customers in Brazil, and its cables pass 6.6 million out of Brazil's 48 million households. The deal is also part of Net's efforts to restructure its 1.4 billion reais ($US 450 million) in debt following its default on $870 million worth of bonds in December 2002. Under the terms of the agreement, Telmex will buy shares in Net and guarantee a portion of up to 1.8 billion new shares to be issued. The deal is conditioned on approval by creditors representing at least 95 percent of Net's debt. So far, creditors representing 70 percent of the debt have okayed the transaction. If creditors fail to approve the deal, Globopar will still have the option to sell Telmex about 34 percent of Net for $130 million between October 31, 2004 and July 1, 2005. In addition, after the deal closes Telmex will have the right to buy control of Net if Brazilian law permits. Current law bars foreign investors from owning more than 49 per-

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cent of local media firms.

Wells Fargo Lowers Fee for Money Transfers to Mexico

US bank **Wells Fargo** said Monday it would lower its fee for sending remittances to Mexico to $8 per transfer from $10. The fee reduction, which goes into effect on Thursday, is part of the San Francisco-based bank's plan to attract more business from the growing population of Mexican workers in the United States who send money home to relatives and follows Wells Fargo's June 10 announcement of a partnership with **HSBC Mexico**. That partnership will more than double the size of Wells Fargo's current consumer remittance distribution network in Mexico to over 3,000 banking stores and 8,200 ATMs. "This 20 percent fee reduction, combined with our recent doubling of our consumer remittance distribution network in Mexico, and the recent increase in our daily transfer limit from $1,000 to $3,000, all position Wells Fargo as the clear choice for customers with US–Mexico consumer remittance needs," said Daniel Ayala, head of Wells Fargo Cross Border Payments, in a press release. Critics of the remittance industry have said the fees charged by companies to transfer money are too high due in great part to a lack of competition. Manuel Orozco, a senior researcher at the Institute for the Study of International Migration at Georgetown University, hailed Wells Fargo's announcement. "This is a significant step in cost-effective remittances for unbanked Latinos," he said. "At a time when banks are seeking to provide an affordable remittance service, Wells Fargo's commitment sends a signal to competitors about the importance of developing initiatives that support immigrant needs." According to a Pew Hispanic Center report authored by Orozco and the Inter-American Development Bank, remittances to Mexico totaled $13.3 billion.

Arcelor Announces Deal to Gain Control of Brazil's CST

Luxembourg-based **Arcelor**, the world's largest steelmaker, said Monday it had agreed to pay $579 million to gain sole control of Brazil's **Cia. Siderurgica de Tubarao** (CST). In a press release, Arcelor said it would up its stake in the Brazilian steelmaker from 28 percent to 61.8 percent by buying shares and options from iron-ore producer **Cia. Vale do Rio Doce**. Arcelor expects to close the deal in the second half of 2005. It said it would finance the purchase through the issue of 1.17 billion euros ($US 1.42 billion) in share warrants. Arcelor, which called Brazil "one of the world's most attractive steel making regions" because of the high quality and low cost of steel production there, said the deal would reinforce its commitment to Brazil, where it also has a 28 percent stake and 54 percent stake in steelmakers **Acesita** and **Cia. Siderurgica Belgo-Mineira**, respectively. "Arcelor is positioned to play a leading role in the consolidation of the steel industry, both globally and within Brazil," the company said. "The transaction is another major step forward for Arcelor with respect to growth and investment in Brazilian steel." In May, Arcelor Chief Executive Guy Dolle said the company might try to increase its holdings in its Brazilian operations to 100 percent, focusing on areas with lower production costs and rising demand, according to Bloomberg News. CST makes carbon steel used in automaking, shipbuilding, oil pipelines and construction.

The Dialogue Continues

A continuation of the June 28, 2004 Q&A

Q The US' largest underwear maker, Sara Lee, earlier this month said it was laying off more than 4,000 employees in the US and Latin America. The announcement came almost six months before the Multi-Fiber Arrangement (MFA)—a global trade agreement that allows countries to limit textile and apparel imports—is set to expire on January 1, 2005. What will the end of the MFA mean for the textile- and apparel-producing sector in Central America and the Caribbean? Would the US-Central America Free Trade Agreement (CAFTA) shield the region from the impact of an expected flood of textile and apparel imports from Asia?

A Guest Comment: Gary Horlick: "CAFTA suppliers of apparel to the US currently have both advantages and disadvantages over suppliers from China and elsewhere. CAFTA's proximity, established ties, and existing trade arrangements, favor it over China, which despite its larger scale and lower production wages (in current dollar terms) is still hampered by a plethora of quotas. Most importantly, both are subject to very high US tariffs, ranging up to 30 percent, compared to an average of under two percent for other manufactured products. On January 1, 2005, almost all the quotas will disappear (despite increasing calls for their continuation—the government of India has made clear that it will block any move to extend them). This removes one of China's major disadvantages. If CAFTA can be passed this year and go into effect January 1, it will include 'locked-in' tariff cuts for CAFTA exporters. Since China does not have those tariff cuts and has no chance of getting even minor tariff cuts in the US until the WTO Doha Round goes into effect in 2007 or 2008, congressional approval of CAFTA—though difficult—this year is essential."

Gary Horlick *is a Partner in the International Trade Practice Group at Wilmer, Cutler & Pickering.*

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Featured Q&A
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stable growth leading to social equity and away from the boom-bust cycles of the past. There has been some growth this year, but it is too soon to know if it is just a cyclical bounce. The modest growth is somewhat disappointing relative to the strong growth in the US and Asia. High interest rates (16 percent overnight Selic versus 12-month inflation of around 5.5 percent) remain a major obstacle to faster growth. I think Brazil could lower interest rates substantially without causing more inflation or a weaker real currency. This would allow faster economic growth and more fixed investment without sacrificing the other economic goals. Structural reforms are also needed to enhance growth prospects. The two major reforms of 2003—social security and tax reform—started the process, but additional reforms are going slowly. Brazil has reduced its dollar-linked debt (from 40 percent of the total in 2002 to less than 17 percent currently). This lowers its vulnerability to external shocks. It is working to lengthen maturities, reduce the level of both external and domestic dollar-linked debt, and increase the level of fixed-rate and inflation-linked debt. I think the best strategy for reducing Brazil's vulnerability to external shocks is fast, sustained growth. The best recipe would be currency stability, substantially lower interest rates, low inflation, and structural reforms."

> "There has been some growth this year, but it is too soon to know if it is just a cyclical bounce."
>
> *- David Malpass*

A Guest Comment: Maria Velez de Berliner: "Lula can be optimistic: GDP grew by 2.7 percent in the first quarter; his economic team continues to support expectations of sound macro management; and new contracts in China will bring $5 billion by 2009. However, to sustain growth, Lula needs to be cautious about statements such as the creation of the G-5 (Brazil, China, Russia, India, and South Africa) to counter the influence of the US and the EU, which are Brazil's two largest foreign investors and might perceive such statements as counter to their interests in Brazil. Given the predominance of agricultural exports in the recovery, Lula needs to bring an effective solution to the invasions of productive lands by the MST; these are spooking investors in the sector. Were China to reduce imports of grains and other commodities from Brazil, Brazil will suffer an external shock in agriculture. Another threat is India's high levels of technical education and the commercial agreements between the two countries. Lula has been slow in increasing Brazil's technical skills pool. Therefore, dependence on India's superior technical capabilities will place Brazil in a precarious position to sustain growth. If exports continue to increase, Brazil will be well positioned to satisfy the requirements of public-debt reduction. But if Brazil falters in its payments, it might create a '*caipirinha* effect' that would be felt throughout the Hemisphere as FDI packs and leaves, or decides against Brazil in favor of more dependable markets."

Paulo Vieira da Cunha *is Chief Economist and Head of Research for Latin America at HSBC Securities.*

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Maria Velez de Berliner *is President of Latin Trade Solutions.*

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