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Featured Q&A With Our Board of Advisors

Q In a report to lawmakers this month, Ecuador's Central Bank said that dollarization was at risk in the country if President Alfredo Palacio's proposal to lower debt payments and increase spending is approved by Congress. Do you see a risk to dollarization in Ecuador? What impact would an end to dollarization have in Ecuador?

A **Guest Comment: Gustavo Arteta:** "In an effort to break from the past, President Palacio's administration is proposing broad economic policy changes. He has in Rafael Correa an economy minister that is a firm critic of dollarization. And although he has stated that he will work with dollarization, because he is the first diehard opponent to be in charge of Ecuadorean economic policy since dollarization was implemented in 2000, it is only natural that many in the country have become concerned. The feeling is reinforced by the presence of other cabinet members that share similar views and policy announcements that some view as potentially destabilizing. In particular, the administration faces a sizeable financing gap. To close it, the government needs to keep spending down and handle relations with creditors wisely. However, the economy minister's policy initiative to weaken the Fiscal Responsibility Law (FRL), and unsympathetic words with the IMF, private creditors, and local business leaders do not foretell a judicious course of

events and policymaking that would facilitate the needed financing. Thus, many worry whether, in the event that the government is short of money, it would resort to creating it, or alternatively, opt to stop fully servicing public debt, which would also unfold a crisis where dollarization would be brutally tested."

A **Guest Comment: Claudio Loser:** "Ecuador embraced dollarization more than five years ago as a desperate gesture by President Mahuad to stop inflation, exchange rate instability, and a mounting banking crisis."

Continued on page 4

PHOTO OF THE DAY



Ousted Ecuadorian President Lucio Gutierrez vowed Wednesday to return to Ecuador. See Special Advisor Report on page 3.

Advisor photo.

Inside This Issue

FEATURED Q&A: Is There a Risk to Dollarization in Ecuador?	1
Colombian Senate Fails to Approve Pension Reform	2
Brazil's Central Bank Holds Selic Steady at 19.75 Percent	2
Brazilian Authorities Raid Brewer's Offices in Tax Fraud Bust	2
SEC Requests Information from US Unit of Venezuela's PDVSA	3
Special Advisor Report: Ex-President Lucio Gutierrez Vows to Return to Ecuador	3

NEWS BRIEFS

Mexican Police Nab Pakistani Suspected of Missile Trafficking

Mexican police have arrested a Pakistani man wanted by the United States for trafficking anti-aircraft missiles. The 55 year-old Arif Ali Durrani was arrested after he left a restaurant in Baja California state. Durrani, who was in Mexico illegally, was taken to Mexico City, where migration authorities will process his expulsion from the country. In a statement, the Mexican attorney general's office credited intelligence-sharing with the US for Durrani's arrest.

Source: Mexican attorney general's office.

Brazil's Embraer Lone Bidder for Colombian Defense Contract

Brazilian aircraft maker **Embraer** submitted the only bid—worth \$235 million—to sell at least 22 tactical combat aircraft to Colombia, the Colombian defense ministry said Wednesday. A committee designated by the defense ministry and the Air Force will review Embraer's bid, the ministry said. Other companies, including the US' **Raytheon Co.** and **Lockheed Martin Corp.**, pulled out of the bidding amid complaints the process was biased toward Embraer.

Source: Colombian defense ministry, Reuters.

Mexico's TV Azteca Pays Down \$86 Million in Debt

Mexican broadcaster **TV Azteca** said Wednesday its holding company had paid \$86 million in bonds due this year and in 2008. **Azteca Holdings** redeemed \$60 million worth of 12.5 percent senior notes due yesterday and amortized \$26 million from two bonds due in 2008, TV Azteca said. Azteca Holdings has cut its debt by half to \$140 million since July 2003, according to the broadcaster.

Source: company press release.

Economic News**Colombian Senate Fails to Approve Pension Reform**

Colombia's Senate on Wednesday failed to approve a proposed reform to the country's costly pension system, local daily *El Tiempo* reported. The proposed reform, which needs an eighth and final vote of approval by Colombia's Congress, was not passed amid objections to some of the reform's provisions by the opposition Liberal and Democratic Pole parties. The two parties oppose the reform's elimination of a 14th monthly pension payment and the establishment of a cap on pensions equal to 25 times the minimum salary for individuals retiring after July 2010. The

raising the Selic 3.75 percentage points since September. "Evaluating the perspectives for the trend in inflation, the Bank decided to maintain the Selic at 19.75 percent," the Bank said in a brief statement. Last month, Brazil's IPCA consumer price index rose 0.49 percent, its smallest increase in seven months. On an annualized basis, inflation in Brazil stood at 8.05 percent in May, well above the Bank's year-end target of 5.1 percent for 2005. In the first five months of the year, prices have risen 3.18 percent. In a research note this morning, **Credit Suisse First Boston** said the Bank's decision was widely expected and "reflects the improved balance of risks favoring much lower monthly inflation results over the next few months." In other Brazilian economic news, the government on Wednesday

Rejection of the pension reform would be a major political setback for President Alvaro Uribe, who has launched an all-out campaign to secure its approval.

reform also raises the retirement age to 57 for women and to 62 for men. Rejection of the pension reform would be a major political setback for President Alvaro Uribe, who has launched an all-out campaign to secure its approval. The reform is aimed at reducing the government's budget deficit by more than 990 billion pesos a year (\$US 423 million) for the next 50 years, according to Bloomberg News. In the first three months of this year, the budget deficit grew to 6.25 trillion pesos from 4.29 trillion pesos a year ago. Congress is expected to continue to debate the pension reform today.

Brazil's Central Bank Holds Selic Steady at 19.75 Percent

Brazil's Central Bank on Wednesday held interest rates steady in a move many analysts believe signals an end to a nine-month campaign of monetary tightening to combat inflation. In its monthly meeting, the Bank's monetary policy committee (Copom) voted to hold its benchmark Selic interest rate at 19.75 percent, after

announced 4.8 billion reais (\$US 1.96 billion) in industrial tax breaks for 2005 and 2006, Reuters reported. Finance Minister Antonio Palocci said the government would exempt payment of the industrial products tax, or IPI, on purchases of machines and equipment.

Company News**Brazilian Authorities Raid Brewer's Offices in Tax Fraud Bust**

Police and agents from Brazil's federal revenue service on Wednesday raided the offices and factories of local brewer **Schincariol** as part of what they called the biggest-ever anti-tax fraud operation in the country. In a statement on its Web site (www.receita.fazenda.gov.br), the federal revenue service said some 180 of its agents and more than 830 federal police participated in "Operation Barley" in 12 states, issuing 134 search and seizure warrants and 79 arrest warrants. According to news reports, authorities arrested five members

of the Schincariol family, which controls the brewer, as well as other company executives. Top executives will be charged with several crimes, including money laundering, tax evasion, corruption, and participating in organized crime, according to Reuters. The arrests follow a 14-month investigation which found that Schincariol evaded federal and state taxes with the help of third-party distributors by underreporting sales, buying goods illegally, and falsifying other information, Reuters reported. "We believe this organization was very well thought out and very well put together to have committed all these crimes," Sao Paulo Federal Police Superintendent Jose Ivan Lobato was quoted as telling reporters. Schincariol, which controls about 15 percent of Brazil's beer market, reported sales of 2.5 billion reais (\$US 1 billion) for last year. It is Brazil's second-largest brewer after AmBev, which has long complained of tax evasion in Brazil's beverage market, according to Reuters.

SEC Requests Information from US Unit of Venezuela's PDVSA

The US Securities and Exchange Commission (SEC) has requested information from **Citgo**, the US unit of Venezuela's state oil company **PDVSA**, related to a debt repurchase last year, Reuters reported on Wednesday, citing an unnamed PDVSA official. The SEC has also requested documents related to the move of the company's headquarters from Tulsa, Oklahoma to Houston, Texas and payments made to certain individuals. The SEC requests were revealed during testimony in front of a commission of Venezuela's National Assembly by Citgo's auditor, Vladimir Noriega. The commission is investigating suspected irregularities at Citgo. The investigation is centered on allegations that Citgo entered into illegal contracts with another PDVSA unit to avoid paying Venezuelan income tax, according to Bloomberg News. The SEC's reported investigation of Citgo's buyback of \$550 million in debt last year relates to allegations that some Citgo employees allegedly took advantage of insider information to purchase bonds that were the target of the planned debt buyback.

Special Advisor Report

Ex-President Lucio Gutierrez Vows to Return to Ecuador

By Devin Finn

WASHINGTON - Ousted Ecuadorean President Lucio Gutierrez on Wednesday denounced the Andean nation's current government as "illegitimate" and "immoral," demanded immediate elections, and promised to return to Ecuador.

At a forum hosted by the Inter-American Dialogue, Gutierrez said his aim is to restore "authentic democracy" to Ecuador after a presidency he said was marked by the lowest inflation in the country's history and solid respect for human rights.

On April 20, Gutierrez became the third democratically elected president in Ecuador in eight years to fail to finish his term when he fled the presidential palace in Quito amid massive street protests calling for his removal from office.

The former army colonel said a coalition of former bankers, left-wing forces, and traditional political parties was responsible for plotting his ouster, which came after the military and armed forces withdrew their support for his mandate.

Gutierrez explained his support for Congress' controversial dismissal of 27 of 31 Supreme Court justices in December as an effort to restore the constitutional principle of judiciary independence and separation of powers.

He said the Court was "politicized" and "partisan," and what he did sought to address the corruption in the judiciary. The shake-up of the Court paved the way for the return to Ecuador of ex-President Abdala Bucaram, who had also been dismissed early, amid charges of corruption.

Gutierrez, who recently renounced his political asylum in Brazil, is now coming under fire in Ecuador for tarnishing the country's image abroad and further weakening its institutions through his public appearances in the US—including trips to New York, Washington, and Miami.

Ecuador's current minister of government, Mauricio Gandara, on Monday brought a lawsuit against Gutierrez for "making an attempt against state security," an allegation which would allow authorities to detain the ex-president upon his return.

Gutierrez said everything he did while he was in power was to benefit his country.

"My hands are clean," he said.

Gutierrez called on the Organization of American States (OAS) to intervene in Ecuador and, at the least, demand early elections.

Former OAS acting Secretary General Luigi Einaudi told the *Advisor* recently that he repeatedly made personal offers of assistance to the Gutierrez government, which it did not accept.

An OAS delegation visited the country soon after Gutierrez's ouster, urging Ecuador to carry out a broad national dialogue.

Featured Q&A*Continued from page 1*

Against all odds, the move worked, and Ecuador's economic financial conditions improved over time. Under the current dollar regime, Ecuador cannot afford to run large public deficits, and to a large

“Under the current dollar regime, Ecuador cannot afford to run large public deficits, and to a large extent has been recently saved from disaster by high oil export prices.”

— *Claudio Loser*

extent has been recently saved from disaster by high oil export prices. If the government decides to unilaterally reduce debt payments and increase other expenditures by a large amount, Ecuador faces two scenarios: the Panamanian scenario of the early 1990s would mean that people still believe that the dollar will remain the currency, but that the government will run out of money. People may withdraw their deposits from banks, the economy could run into a recession, and the government would run into arrears. The more likely is the Argentine scenario of 2001. There could be run on the banks because there is no confidence in Ecuador's ability to survive without a massive Central Bank rescue. Eventually, the Central Bank would yield and issue new currency. The complications could be enormous, particularly in the financial sector, although in the end Ecuador would become more competitive internationally.”

A **Guest Comment: Luis Oganés:** “The proposal to reform the FRL, which Ecuador's Congress is debating now, will undermine the fiscal foundations of dollarization in the long term, but will not lead to an imminent risk of its abandonment. Since dollarization was adopted in 2000, the expenditure limits established by the FRL helped the governments of

Noboa and Gutierrez to contain spending pressures and deliver high primary surpluses of 4.5-5 percent of GDP. This fiscal discipline helped to reduce Ecuador's total public debt ratio from 89 percent of GDP in 2000 to 49 percent of GDP in 2004. The part of the FRL that was not observed strictly was the provision to use 70 percent of the FEIREP fund, which captures the oil windfall, for debt reduction (the domestic debt buybacks that took place last year were made only to enable new domestic debt issuance), so this will not change with the amendments to the FRL. The most disturbing aspects of the FRL changes are the increased vulnerability that Ecuador's fiscal accounts will face with a potential decline in oil prices—as more budget expenditures will depend on the revenues coming from oil—and the higher discretion that the current and future governments will have to spend the excess oil revenues. It is hard to conceive an orderly exit from dollarization that does not involve another banking crisis or a debt default, so no government will likely pursue it of its own will. In turn, the future viability of the dollarization regime will largely depend on where oil prices are.”

Gustavo Arteta is an Economist and Academic Director at the Corporation for the Study of Development in Ecuador.

Claudio Loser is a Senior Fellow at the Inter-American Dialogue and former Head of the Western Hemisphere Department at the IMF.

Luis Oganés is Co-head of Latin America Research at J.P. Morgan Chase & Co.

Editor's note: Ecuador's Congress on Wednesday voted to use 35 percent of the money currently destined for the FEIREP oil fund to stimulate economic growth and pay for debt buybacks. Previously, 70 percent of the FEIREP money had been reserved for debt payments.

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