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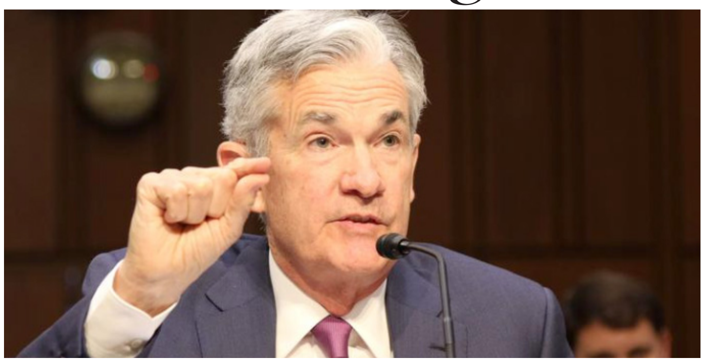
FEATURED Q&A

Will Changes in U.S. Interest Rates Rattle the Region?



U.S. Federal Reserve Chairman Jerome Powell has said policymakers will be "flexible" regarding interest rate decisions. // File Photo: U.S. Senate.

Q The U.S. Federal Reserve hiked short-term interest rates on Dec. 19, bringing them to their highest level in more than a decade. At the same time, the Fed signaled that it would increase interest rates at a slower pace than expected, just twice in the coming year. Last Friday, Chairman Jerome Powell said the Fed would be "patient" and "flexible." What consequences are the Fed's moves on interest rates having on Latin American and Caribbean economies? Which countries are most vulnerable to the tightening cycle? What should countries in the region do to prepare for adverse effects of U.S. monetary policy?

A Alicia Bárcena, executive secretary of the United Nations Economic Commission for Latin America and the Caribbean: "Effects of policy rate increases have been transmitted to Latin American countries through several channels during the past year. The first is the effect of Fed decisions on general market volatility and uncertainty. Although the markets had expected the Fed to increase interest rates, uncertainty regarding the speed and intensity of such hikes have triggered spikes in financial volatility. The second is the effect on the value of the dollar and financial flows. Rate hikes were accompanied by an appreciation of the dollar against Latin American currencies and induced portfolio adjustments that affected financial flows to the region. Currency depreciations can have adverse impacts in some Latin American countries that have currency mismatches in public and/or private debt. The third effect is on the cost of financing for the region. After a long period of exceptionally abundant liquidity and very low financing

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TODAY'S NEWS

POLITICAL

Venezuela's Maduro Sworn in for Second Term

Venezuelan President Nicolás Maduro was sworn in for a second six-year term. Dozens of countries have called his re-election last May fraudulent. The presidents of Cuba, Bolivia and Nicaragua were among the few foreign dignitaries attending the ceremony.

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ECONOMIC

Chile Eyeing 19% Tax on Digital Commerce

The country's finance minister said the government is considering a tax of as much as 19 percent on companies such as Amazon, Netflix and Uber.

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BUSINESS

Bolsonaro Won't Block Embraer-Boeing Deal

Brazilian President Jair Bolsonaro will not block the proposed joint venture between Brazilian aircraft manufacturer Embraer and U.S.-based Boeing, his government said.

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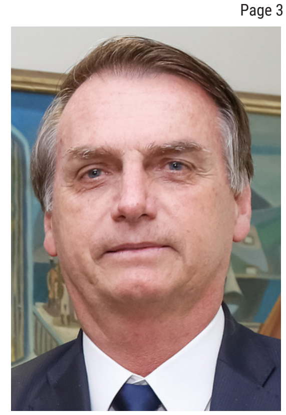

Bolsonaro // File Photo: Brazilian Government.

POLITICAL NEWS

Venezuela's Maduro Sworn in for Second Six-Year Term

Venezuelan President Nicolás Maduro was sworn in Thursday for a second six-year term, following his re-election last May in a vote that dozens of countries have said was fraudulent. Among the few foreign dignitaries attending the ceremony were the presidents of Cuba, Bolivia and Nicaragua, The Wall Street Journal reported. A week ago, 13 Western Hemisphere nations of the so-called Lima Group said they would no longer recognize Maduro as Venezuela's president and called on him to cede power. On Thursday, two of those countries, Peru and Paraguay, moved to distance themselves further from Maduro's government. Peru recalled its chargé d'affaires from its embassy in Caracas in protest of what it said was Maduro's "illegitimate" new term, Peru's foreign ministry said in a statement, Reuters reported. Peru's government also said it would prohibit Maduro and 100 people linked to him or to his government from entering the country. Also on Thursday, Paraguayan President Mario Abdo said his government was cutting diplomatic ties with Venezuela and was immediately recalling Paraguay's diplomats from Caracas. Within minutes of Maduro being sworn in, the Organization of American States voted not to recognize Maduro's new government as legitimate, The Wall Street Journal reported. Maduro, who took office after the 2013 death of Hugo Chávez, delivered an hour-long speech at his swearing-in ceremony that included claims of an international conspiracy to topple his government. In addition, he acknowledged shortcomings of the country's socialist policies, but he did not specify any details for economic recovery in the country, which faces hyperinflation, shortages of several basic goods and the outward migration of millions of people who have fled to surrounding countries. "I want a change and profound correction of the errors of the revolution," said Maduro. "Rest assured, as we have in our 20 years of revolution, we will know how to overcome the obstacles, the difficulties, and we're going to come out of this victorious." Venezuela's opposition-controlled National Assembly, which Maduro stripped of its powers in 2017, called Maduro an "usurper" and called itself Venezuela's only "legitimate power," The Washington Post reported. Juan Guaidó, the legislature's newly named president, said the assembly would work with foreign actors to seek a political transition in the country.

> **"Rest assured, as we have in our 20 years of revolution, we will know how to overcome the obstacles..."**
>
> **— Nicolás Maduro**

ECONOMIC NEWS

Mexico Fuel Shortage May Halt Production at Auto Plants

Some Mexican auto plants may have to suspend operations if the country's widespread gasoline shortages continue, an industry group said Thursday, Reuters reported. "We need logistics to flow, and that's why, when there are blockages, our operations are put at risk," Eduardo Solís, president of the Mexican Auto Industry Association, said. "We are worried because it could lead to the suspension of a plant." Solís added that the shortages have affected workers' commutes to their jobs and could cause auto parts to not be delivered on time. Gas stations across at least six Mexican states have been facing fuel shortages since Mexican President Andrés Manuel López Obrador last week deployed troops to protect the country's oil pipeline network from theft, prompting several pipelines to close. López Obrador on Wednesday asked Mexicans to

NEWS BRIEFS

Trump Threatens to Declare Emergency to Build Border Wall

U.S. President Donald Trump spent much of Thursday in Texas near the U.S.-Mexico border to highlight his call for a multi-billion-dollar wall along the border and threatened to declare a national emergency if he cannot reach a deal with congressional Democrats to build it, the Associated Press reported. Such a declaration would allow him to order the military to build the wall, Trump has said.

Chile Considering 19% Tax on Digital Commerce Companies

Chile is eyeing proposals for a new tax of up to 19 percent on multinational digital commerce companies with operations in the country, including Amazon, Netflix and Uber, Finance Minister Felipe Larraín said Thursday, Reuters reported. The tax rate, which would match the value-added tax paid by Chilean companies, is nearly double what the government had originally proposed at 10 percent. [Editor's note: See related **Q&A** in the Sept. 4 issue of the Advisor.]

Energy Ministers Discuss Pipeline to Transport Gas From Bolivia to Peru

The energy ministers of Peru and Bolivia on Thursday agreed to discuss the possibility of building a pipeline to transport natural gas and liquefied natural gas, or LNG, from Bolivia to Peru, Reuters reported. The pipeline would give Bolivia access to the Pacific Ocean at Peru's southern port of Ilo. Land-locked Bolivia had previously wanted to construct a similar pipeline through Chile, but the International Court of Justice in October ruled against Bolivia's demand that Chile negotiate granting it access to the sea.

remain calm, adding that supply would be restored soon.

BUSINESS NEWS

Bolsonaro Won't Block Embraer-Boeing Tie-up: Gov't

The Brazilian government on Thursday said that President Jair Bolsonaro would not exercise his veto power on the proposed joint venture deal between Brazilian airplane manufacturer Embraer and U.S.-based Boeing, Valor Econômico reported. The two companies reached an agreement last year for the U.S. aircraft maker to control 80 percent of Embraer's commercial operations unit for $4.2 billion, but first needed to get the government's go-ahead. The tie-up has also faced legal challenges over concerns that the joint venture would threaten Brazil's national sovereignty, since Embraer also produces the country's military aircraft. In December, a federal judge issued a ruling that blocked the deal after lawmakers from the leftist Workers' Party submitted an injunction, but that decision was later reversed. Following a meeting with cabinet members, including the defense minister, on Thursday, Bolsonaro said on Twitter that "the sovereignty and interests of the Nations are preserved." The government also said the two companies would "maintain the current jobs in Brazil," a move seemingly seeking to appease union workers and politicians that opposed the deal, Reuters reported. Embraer and Boeing "have welcomed approval by [the] Government of Brazil of the strategic partnership that will position both companies to accelerate growth in global aerospace markets," the airplane manufacturers said in a statement, the Financial Times reported. The deal must now be ratified by Embraer's board, and it also needs shareholder and regulatory approval, but the companies expect it to close by the end of the year. [Editor's note: See **Q&A** on Bolsonaro's economic team in the Dec. 4 issue of the Advisor.]

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rates, the cost of financing starts to increase gradually as global liquidity decreases with the withdrawal of the Fed's quantitative easing, together with rises in its policy rate. In this context, the impact on countries will depend on how exposed they are in terms of external financing needs and their share of dollar-denominated debt, as well as short-term debt that would have to be rolled over at a higher cost. Countries with significant imbalances and little room for implementing countercyclical measures will be the most exposed. Thus, it is important that Latin American countries address their public debt profiles while maintaining their fiscal spaces. In this sense, it is essential to reduce tax avoidance and evasion and illicit financial flows. In terms of expenditures, to stabilize and invigorate growth, public investment must be reoriented toward projects that support sustainable development, with emphasis on public-private partnerships and on productive reconversion, new technologies and green investment. All of this is necessary while protecting social spending, above all in periods of economic deceleration, so that it is not affected by cutbacks."

A **Paulo Vieira da Cunha, partner at Verbank Consulting, LLC in New York:** "Ecuador is most vulnerable. Why? Consider two types of economies: First are those with significant exposure to dollarized debt, principally public debt. (Corporate dollar-debt is also a problem, but corporates have been faster to hedge their exposure.) Second are those with relatively larger domestic capital markets, relying primarily on local currency debt, whether public or private. Each of these types has two important subgroups. Take the case of Ecuador. As a dollarized economy, all its debt is dollar denominated—linked to U.S. interest rates and to movements in the dollar. Moreover, its public debt is large relative to GDP. And it continues to post fiscal deficits year after year. It is vulnerable; indeed, the market expects the IMF to be called in soon to provide emergency funding. Argentina falls into the same category: It has a large dollarized debt with ongoing fiscal deficits. However, it has its own currency, thus a modicum of monetary independence. And, it already has an IMF program. In contrast, Peru, also a partially dollarized economy, has a small public debt burden, runs a prudent fiscal policy and is, by comparison, less sensitive to swings in U.S. interest rates and the dollar. Consider now the other type, economies with relatively large domestic capital markets. Again,

> **"Changes in U.S. market conditions ripple through the Mexican economy almost immediately."**
> **— Paulo Vieira da Cunha**

there are those with large public debts and questionable public finances (such as Brazil and Mexico) or small debt ratios with prudent fiscal policy (such as Chile). Brazil is the region's largest debt holder. It is not, however, as exposed to swings in U.S. short-term interest rates; the problem is its own policies, or lack of. The key external short-term impact variable is the cost of debt protection, the so-called credit spread—and it varies, primarily, in response to domestic events. The yield on the 10-year Treasury is the main external interest-rate transmission mechanism. Mexico is similar. Only because its economy is financially integrated with that of the United States, changes in U.S. market conditions ripple through the Mexican economy almost immediately. The central bank still has considerable power. However, this is mainly through its influence over the exchange rate."

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A **Amy Glover, CEO for Mexico at Speyside Corporate Relations:** "Without a doubt, an increase in U.S. interest rates and the uncertainty regarding the future health of the U.S. economy is unfavorable news for the region. An increase in the cost of debt and doubts over policy direction in most of the major economies of the region mean that Latin American governments will have less room to maneuver in acquiring debt to fund fiscal priorities, and countries that are already highly indebted, such as Argentina, will face additional pressure. The market jitters caused by President Donald Trump's questioning of the Fed's decisions have negatively affected stock markets and currencies regionally, and we can expect that to continue this year. Ironically, the most worrisome political instability in the region is coming from the largest and most competitive economy, the United States. The U.S. economy is heavily driven by consumer spending, which is very credit-dependent, and increasing rates will tamp down demand generally, which may also harm countries, such as Mexico, that export heavily to the United States. To protect themselves during these uncertain times, countries can maintain conservative fiscal policies and promote pro-competitive policies that attract investment and decrease their risk profiles. Mexico's new government just announced it will lower taxes on initial public offerings, a measure that was well received by financial markets, boosting stocks after months of battering. Offering policy certainty can calm markets across the board. Beyond potential future Fed rate hikes, the lack of political certainty in the United States will continue to affect markets adversely in the coming months, having knock-on effects in Latin America."

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> **— Amy Glover**

A **Daniel Velandia, director and chief economist for research at Credicorp Capital in Bogotá:** "Although the increase of interest rates should affect economic growth through higher financing costs and lower commodity prices, the extent of its effect will differ among Latin American economies, depending on their external position and thus, their degree of vulnerability. Accordingly, countries with sustainable fiscal and current account deficits, low indebtedness levels and an adequate level of international reserves are likely to have a smoother transition toward lower growth amid higher funding costs. In addition, solid macroeconomic institutions and a floating foreign exchange regime are key factors since (more expensive) capital will compete for high quality assets and investments among emerging markets. Countries such as Chile, Peru, Colombia and even Mexico seem able to withstand the current environment of higher global rates, considering healthy vulnerability indicators, including the ratio of international reserves to short-term liabilities and the current account deficit. In the case of Mexico, we think that economic policy from AMLO's administration will be a crucial factor for the future of economic growth. Since higher volatility is expected in the upcoming months and global growth is set to slow down, Latin American countries should focus on reducing external and fiscal imbalances as well as on diversifying production, particularly in the case of commodity-based economies. Finally, although it may sound trite, carrying out structural reforms to ease rigidities in local markets and enhance competitiveness remains a long-term need."

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