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FEATURED Q&A

Will Higher Interest Rates Stunt Brazil's Economic Recovery?



Brazil's central bank, led by Roberto Campos Neto, last month raised its benchmark interest rate more than expected. // File Photo: Brazilian Central Bank.

Q Brazil's central bank on March 17 raised its benchmark interest rate by a more-than-expected 75 basis points to 2.75 percent. The country was the largest emerging market to raise interest rates in recent months, and the move came as Brazil's annual rate of inflation stood at 5.2 percent, well above the central bank's target. Was the rate increase the right move by policymakers, and how will the decision play a role in Brazil's economic recovery? What is driving rising prices in Brazil, and how are the actions of Brazil's president and Congress influencing them? What are the main external factors that are affecting Brazil's economic recovery and inflation?

A Welber Barral, senior consultant at BMJ Consultores Associados and former Brazilian foreign trade secretary: "In fact, Brazil's central bank did not have alternatives other than raising the benchmark interest rate. It had been reduced to its historic low, following repeated decreases in recent years. However, considering the prospects of raising inflation and the devalued currency, the central bank had to reverse the interest rate trend, and additionally warn of probable additional hikes in the near future. The market's expectation is that the benchmark interest rate will reach 4 percent annually before the end of the year. Some important factors affecting prices in Brazil include the social vouchers distributed during the pandemic, which increased consumption; international prices of commodities, especially foodstuffs, which prompted exports; and a devalued real, which increased

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TODAY'S NEWS

POLITICAL

Fernández Tests Positive for Virus Despite Vaccine

Argentine President Alberto Fernández on Saturday said he had tested positive for the Covid-19 virus despite having received the Sputnik V vaccine in January.

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POLITICAL

Venezuela to Seek U.N. Help With Land Mines

President Nicolás Maduro said Sunday that Venezuela will ask the United Nations to help remove land mines in its territory that he says have been deployed by "irregular" armed groups near the Colombian border.

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ECONOMIC

Ecuador Economy Shrinks Less Than Expected in 2020

Ecuadorian Finance Minister Mauricio Pozo said the Andean nation's gross domestic product decreased by 7.8 percent in 2020, compared to an IMF forecast of an 11 percent decline.

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Pozo // File Photo: via Twitter @MauricioPozoEC.

POLITICAL NEWS

Argentine President First in World to Test Positive With Vaccine

Argentine President Alberto Fernández on Saturday said he had tested positive for the Covid-19 virus despite having received the Sputnik V vaccine in January, the Associated Press reported. He is the first head of state in the world to do so, according to the report. Fernández, who turned 62 on Friday, said via Twitter that he had a slight fever and headache. A surge of infections has taken hold in the capital city of Buenos Aires, where there were almost 2,000 confirmed cases of coronavirus in a 24-hour period this weekend, Clarín reported Sunday. That is a fifth of the 9,955 cases registered throughout the country. Fernández's test result came shortly after Argentina tightened its borders amid an upsurge of Covid-19 infections, with neighboring Brazil in particular experiencing a sharp and deadly increase in cases as new, more contagious variants of the virus spread rapidly. Argentina recently canceled all direct flights with Brazil, Chile and Mexico in an effort to block the new strains, The New York Times reported. The governor of the province of Buenos Aires, Axel

Kicillof, confirmed Sunday that the "Manaus" strain of the virus, technically known as P.1, which has ravaged Brazil's Amazon region, has been detected in Buenos Aires. "In the province and city [of Buenos Aires] there are data on the Manaus variant," he said in a radio statement, warning that the new numbers of infections "are very alarming," La Nación reported. In Peru, scientists have detected the P.1 variant in 40 percent of coronavirus cases, The Washington Post reported Sunday. In Uruguay, it has been found in 30 percent of cases, while in Paraguay, officials say half of cases at the border with Brazil are P.1. Brazil's ambassador to the United States, Nestor Forster Jr., has defended his country's response to the pandemic, telling the Advisor last month that Brazil has been working in close cooperation with U.S. authorities, including by sharing information on Covid-19 variants in regular meetings coordinated by the White House with chief science officials from partner countries.

Venezuela to Seek United Nations Help With Land Mines

President Nicolás Maduro said Sunday that Venezuela will ask the United Nations to help remove land mines in its territory that he

NEWS BRIEFS

Burned Bodies of Police Officers Found in Oaxaca

The bodies of three police officers were found dead in their burned-out car Saturday on a road in southern Mexico, Agence France-Presse reported. Local prosecutors said the victims were the director of the San Pablo Coatlán municipal police and two subordinates. The report did not cite culprits or a motivation for the attack, although the area in southern Oaxaca state is known for violence among rival gangs involved in marijuana cultivation and disputes over farmland.

VINCI Acquires ACS Energy Unit for \$5.75 Bn

France-based construction firm VINCI said last week it will spend \$5.75 billion to acquire the energy business of Spanish rival ACS. The deal involves ACS Industrial Services' contracting business with a work force of around 45,000 employees and a heavy footprint in Spain, Mexico, Brazil, Peru and Chile. Over the past three years, the unit's average revenues were above 6 billion euros (\$7.05 billion). In a statement, VINCI said it will focus on electricity transmission projects and renewables development.

Brazilian Environment Minister Seeks Foreign Aid

Brazilian Environment Minister Ricardo Salles is seeking \$1 billion in foreign aid to help reduce deforestation in the Amazon by between 30 percent and 40 percent, according to an interview published on Saturday in newspaper O Estado de São Paulo, Reuters reported. "The plan is \$1 billion over 12 months," Salles said. Brazil led the world last year in annual primary forest loss with a total loss of 1.7 million hectares in 2020, more than three times the next-highest country, according to the World Resources Institute. Primary forest loss in Brazil increased by 25 percent in 2020 as compared to the year before.

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the prices of imported goods. Also, the reduction of industrial production in the first half of 2020 provoked less offering of industrial goods in the second half. Thus, except for services, we see an overall inflation on consumer and industrial goods. On the positive side, the demand for commodities—including minerals—will guarantee an important surplus on the Brazilian trade balance. Agricultural exports are also increasing, benefiting from a very productive harvest in 2021 as well as beneficial prices. The financial liquidity on the international market should also benefit investments in Brazil and other emerging economies. However,

political instability and economic uncertainty in Brazil affect investors' appetite, and thus, Brazil will probably experience lower growth than other Latin American economies in the following years."

A **Helen Harris, senior research associate at McLarty Associates:** "The Brazilian central bank's decision to increase the benchmark interest rate for the first time in six years was prudent. While the hike might slow demand in the struggling economy, it can help the country address its economic vulnerabilities. Inflation, presently at 5.2

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says have been deployed by “irregular” armed groups near the Colombian border, Reuters reported. Two Venezuelan soldiers were killed last week by a land mine during military operations in the state of Apure, where clashes between soldiers and armed groups have forced as many as 5,000 Venezuelans to flee across the border to Colombia. Colombian President Iván Duque has long accused Venezuela of sheltering members of the National Liberation Army rebel group and dissident members of the Revolutionary Armed Forces of Colombia, or FARC, who have refused to lay down their weapons following a 2016 peace deal. Maduro’s alleged protection and complicity with the rebels took a sharp reversal last month, when Venezuela’s military launched what analysts describe as its most concerted military campaign in years with airstrikes in Apure, The New York Times reported. The Venezuelan assault, which has escalated into ground fighting in recent weeks, has centered around the town of La Victoria, home to a faction of FARC dissidents known as the Tenth Front.

ECONOMIC NEWS

Ecuador Economy Shrinks Less Than Expected in 2020

Ecuador’s economy shrank by a smaller amount than the government had expected in 2020, Finance Minister Mauricio Pozo said last week, Agence France-Presse reported Friday. Due largely to the coronavirus pandemic, the Andean nation’s gross domestic product decreased by 7.8 percent in 2020, compared to an International Monetary Fund forecast of an 11 percent decline, Pozo said at a press conference. Last November, the IMF readjusted its estimate to a 9.5 percent fall. A country of 17.4 million inhabitants, Ecuador received external financing of about \$8 billion in 2020 in order to contend with the pandemic, according to the report. “The public debt has grown, but the structure is much cheaper, the terms are much longer and the interest rates are much lower,” Pozo said.

THE DIALOGUE CONTINUES

Will Investment in a Space Agency Benefit Costa Rica?

Q **Costa Rica’s Legislative Assembly last month approved a bill to create a space agency to conduct research and explore technological innovations in the field. The measure prompted some criticism, with opponents citing existing financial constraints to providing sufficient basic services as well as other areas in need of investment, including infrastructure, health and education. What advantages will the creation of a space agency bring Costa Rica? Will investing in a space program now pay off in the long term, and in what ways? Is it the right time for the Costa Rican government, and others in the region, to be investing in science and technology, or should they be prioritizing other areas with more pressing, short-term needs instead?**

A **Franklin Chang Díaz, former NASA astronaut and founder and CEO of Ad Astra Rocket Company in Costa Rica:** “At the end of April, Costa Rica will unveil the most advanced space radar in the world, capable of tracking orbiting objects as small as three centimeters. The project will position our nation front and center in the space age, with unimaginable opportunity for the country in new industries of great value to our economy. The radar site, already a multi-million-dollar foreign investment, happened partly by chance and partly by the timely involvement of a team from the public and private sectors. It is also one of many potential ‘space tenants’ that Costa Rica could welcome, given the right conditions. We have done it before in electronics and again in medical devices. In each case, a bold national bet paid off. The Costa Rica Space Agency will become a direct way for the nation to participate in the \$38 billion space market. The agency will have negotiating

power and voice at the table of space-faring nations. The potential dividends from such an investment are immense in high-paying jobs, education, quality of life and business diversity. Some have criticized the new law as too expensive at a time of fiscal crisis. However, while the law allocates 0.4 percent

“ **The potential dividends from such an investment are immense...**

— Franklin Chang Díaz

of the noncommitted funds of the country’s nonfinancial institutions, the absolute claim on the country’s finances can and should be quite modest. Moreover, the costs of the AEC can be controlled, and responsibly managed, by the entity’s five-person unpaid governing board. Critics also point out that the PhD-level formal education required for the AEC’s executive director unfairly eliminates talent and limits the pool of otherwise qualified leaders. This is a valid concern that should be corrected with future legislation, but it is not sufficient to send the law back to the drawing board. Costa Rica, fortunately, has an ample supply of qualified leaders that meet these requirements. A crisis is a terrible thing to waste, and this one is no exception. It is our opportunity to reinvent ourselves. The AEC must move forward. It is our bet to bring economic dividends to our country and hope, opportunity and optimism to younger generations.”

EDITOR’S NOTE: The comment above is a continuation of the Q&A published in the March 18 issue of the Advisor.

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percent, has been rising rampantly, led by high oil prices, booming commodities and food prices, and a weakened real. Brazil's fiscal situation has worsened this scenario: government debt is 89.7 percent of GDP, the highest level on record. With Covid-19 still ravaging the country, additional fiscal measures to combat the pandemic might yet be approved, and government debt could surpass 90 percent of GDP shortly. Meanwhile, external factors have not been kind to emerging economies. For instance, the United States is recovering faster than expected, and thus its market interest rates are pushing up rates around the world. This affects emerging markets such as Brazil, which are subject to foreign-exchange volatility, exchange rate depreciation and higher import prices. By increasing the benchmark interest rate, the Brazilian central bank can combat the real's depreciation, thereby attenuating one element of inflationary pressure. While a higher interest rate may help address the country's short-term vulnerabilities, it doesn't tackle Brazil's underlying problems. The country's fiscal stability remains a risk, so it is imperative that Congress move forward with fiscal and tax reforms, shoring up investor confidence in Brazil. As this is not likely in the short term, we can expect the central bank to continue increasing interest rates, likely reaching 5 percent at year-end."

A **Paulo Vieira da Cunha, partner at Verbank Consulting in New York:** "The fear is that past inflation spreads to future inflation.

A greater fear is that past inflation deanchors inflation expectations amid destabilizing political and fiscal uncertainty. That is why the central bank acted precipitously. The rise in commodity prices pressed wholesale price inflation, while, contradictorily, the currency depreciated, driven by the unstable political domestic backdrop. The result was a yearly gain of 46 percent to February 2021 in agricultural commodity prices, as expressed in domestic currency. And because inflation

in wholesale migrates to retail prices, there has been a yearly gain of 12.9 percent in the price of food to consumers. Will the passthrough continue? No, it will not, if the research on similar episodes is right. Past inflation will not likely cause future inflation. Indeed, most analysts expect inflation to slow down toward year-end after reaching a peak of possibly 8 percent year-on-year in mid-year, influenced by base effects. The central bank's action on March 17 was not addressed to the past. Rather, it seems that its primary concern was the worsening fiscal scenario, how it would play on expectations about asset prices, the exchange rate and,

“ Past inflation will not likely cause future inflation.”

— Paulo Vieira da Cunha

thus, ultimately, about future inflation. The Brazilian central bank may be the only inflation-targeting central bank that explicitly models the impact of deteriorating fiscal expectations on inflation. By its most recent estimate, the fiscal risk could cause an increase of 2.4 percentage points in inflation between the fourth quarter of this year and the fourth quarter of next year. Moreover, by its calculations, the output gap may be closing at a faster-than-expected speed. But this is not because economic activity is expanding more quickly than expected. On the contrary, the issue is that new data indicates that, since the fourth quarter of 2016, the volume of CAPEX is so low that it does not cover depreciation, thus the capital stock is decreasing. Therefore, it acted, precipitously. The combination of decreasing investor confidence, increasing adverse expectations about a possible fiscal blowout and an economy that shows lower capacity to grow when it reaches its cruising speed signaled the need for a policy change toward a reduced monetary stimulus."

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Erik Brand

Publisher
ebrand@thedialogue.org

Gene Kuleta

Editor
gkuleta@thedialogue.org

Anastasia Chacón González

Reporter & Associate Editor
achacon@thedialogue.org

Diana Roy

Editorial Intern
droy@thedialogue.org



Michael Shifter, President

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