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Latin America Forecasts: 2006

About this report: The *Latin America Advisor*'s "Latin America Forecasts: 2006" is an informal survey of predictions, data and analysis from members of the Board of Advisors, economists, and policy experts covering the Latin American region. The current survey was collected and published in the Inter-American Dialogue's daily *Latin America Advisor* from December 19, 2005 through January 3, 2006.

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Inside ...

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Latin America Forecasts: Economic Growth

Continued Strong Growth in Region is No Passing Occurrence

By **Claudio Loser**

The growth of GDP in Latin America in the last two years has been well above the average for the previous decade: 5.9 percent in 2004, and about 4.2 percent in 2005, compared with 2.4 percent over the period 1994-2003, and some 2.6 percent over the last quarter century. Moreover the projections for 2006 suggest a growth rate of some 4-4.1 percent in 2006. This would entail the first time since 1994 with above-average rates of growth for three consecutive years. Moreover, the trends are broadly in line with global developments, although somewhat below overall worldwide GDP growth in 2005-06.

GDP Growth Forecasts for 2006
Select Latin American Countries

	Bear Stearns	Citigroup	CSFB	General Motors	HSBC	JP Morgan	Royal Bank of Scotland	UBS	WestLB	AVERAGE
Argentina	6.0	5.8	5.0	3.7	6.5	5.5	5.5	5.2	5.1	**5.4**
Brazil	-	3.7	3.0	3.4	3.2	3.5	3.5	3.9	3.8	**3.5**
Chile	-	5.5	5.4	5.1	5.3	6.0	5.6	5.4	5.5	**5.5**
Colombia	5.2	4.0	4.0	3.4	4.2	4.0	3.9	4.0	4.3	**4.1**
Ecuador	3.2	3.0	3.0	3.5	3.4	3.5	-	2.3	3.1	**3.1**
Mexico	3.0	3.5	3.4	3.5	3.4	3.9	3.4	3.9	3.7	**3.5**
Peru	-	4.4	5.2	4.3	5.0	4.5	-	5.0	4.9	**4.8**
Venezuela	6.0	6.5	6.0	4.5	5.5	6.5	-	4.1	4.9	**5.5**

Source: Latin America Advisor.

The central question for Latin America today is whether this constitutes a change in trend or is only a passing exception to the volatile experience of the past. The answer is, unequivocally, a change in trend. Part of the strong growth in 2004 had to do with Argentina, Uruguay, and Venezuela, which were coming out of serious recessions. However, growth is being accompanied by low and declining rates of inflation, as well as solid macroeconomic performance. Fiscal deficits have been declining as a consequence of low interest rates and strong primary fiscal surpluses (the overall fiscal accounts excluding interest payments). With a few exceptions,

The prospects are good for the region in 2006.

monetary policy has been gaining credibility, while competitiveness has tended to improve, as measured by real exchange rates.

In large part, this regional performance reflected a generally favorable external environment, characterized by strong external demand from North America, Asia, and Europe, also reflected in high prices for commodities, particularly but not solely oil. In addition, there has been a strong realization by regional policymakers that they could not pursue their growth objectives without the support of sound macroeconomic policies. The corresponding actions have been paying off in terms of favorable growth results, even though there have been disappointments in the area of income distribution and poverty alleviation.

Significant challenges remain for 2006 and beyond. Under a continued favorable world environment and without any further oil shocks, the region can be expected to grow well. The US, China, India, and Japan are expected to continue performing well, and with high world liquidity, foreign investment, and workers' remittances Latin America can shore up the balance of payments, already registering healthy current account surpluses and foreign reserve accumulation.

Even without major problems at present, serious risks exist, related to a possible deterioration in the energy situation or a decline in confidence in the ability of the US to sustain high public and external deficits. In these circumstances, Latin America and the Caribbean would suffer and GDP growth could decline because of corrections in world demand. However these risks remain low.

Finally, there will be deviations with respect to the average growth rate for the region of 4.1 percent. Brazil can be expected to grow by some 3.0 percent, Mexico by 3.5 percent, Central America, and the Andean countries by some 4-4.5 percent, while Argentina, Chile and the Caribbean could grow in excess of 5 percent. In the end, the result will depend both on domestic policies and world developments, but the prospects are good for the region in 2006.

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Latin America Forecasts: Inflation in 2006

A Prospective View on Inflation

By **Paulo Vieira da Cunha**

CPI Inflation Forecasts for 2006
Select Latin American Countries

	Bear Stearns	Citigroup	CSFB	General Motors	HSBC	JP Morgan	WestLB	Royal Bank of Scotland	UBS	AVERAGE
Argentina	12.0	12.5	14.0	10.0	10.5	14.0	10.9	14.4	15.0	**12.6**
Brazil	-	5.1	4.2	6.1	4.6	4.6	4.6	4.5	4.5	**4.8**
Chile	-	3.9	3.2	3.1	3.5	3.0	3.1	3.0	3.0	**3.2**
Colombia	4.5	5.0	5.0	5.2	4.7	4.5	4.5	4.7	5.0	**4.8**
Ecuador	3.5	3.6	2.0	2.6	2.6	3.4	1.9	-	3.5	**2.9**
Mexico	3.0	3.9	3.3	4.0	3.4	3.5	3.7	3.5	3.3	**3.5**
Peru	-	2.7	2.5	2.6	2.3	2.5	2.8	-	2.5	**2.6**
Venezuela	12.0	17.2	14.0	17.8	15.1	13.0	12.8	-	13.0	**14.4**

Source: Latin America Advisor.

In a regional context, Venezuela is a case apart: abnormal economics in an oil economy during an oil boom. One would expect a period of prosperity with thriving investment, low inflation and solid fiscal indicators. But President Hugo Chavez' priorities are elsewhere and inflation, in particular, remains high without sign of abating. Meanwhile, pervasive price controls with rationing keep observed inflation in check. In contrast, in the remaining main economies of the region, price controls are the exception and inflation is generally under control; in fact, it is improving given a combination of greater predictability with less volatility.

Ecuador and Panama are dollarized economies, and though the nominal dollar anchor took time to take hold in Ecuador, it is now broadly effective. Monetary policy is not an issue because there is no active monetary policy, by definition. This may not be the regime of choice, especially not in Ecuador. But it is a fact, and is good for inflation.

Brazil, Chile, Colombia, Mexico and Peru are inflation targeters. The positive outlook for inflation in these economies is a vindication of the regime; proof that it works and well when diligently applied by credible authorities. Chile has had the longest and most successful experience with inflation targeting (IT). It has the most solid and flexible fiscal regime, and the combination gives power and confidence to the Central Bank. The Bank's ability to meet its target has been proven, shocks in a small open economy notwithstanding. Peru is another example of a durable and well-tested IT regime, despite the drawback of operating in a dual-currency economy with pervasive currency substitution.

The regime in Colombia was more credible a year or two ago than last month when, de facto, the Banco de la Republica was operating with a dual objective: to hit the inflation target and to slow down the rate of nominal appreciation of the peso. This could be a dangerous combination given the Central Bank's limited capacity to fully sterilize its interventions in the currency market and/or ability to influence interest rate expectations in line with the desired path of monetary policy. Creative liability management operations (the Treasury funding itself abroad in pesos and using the proceeds to purchase reserves from the central bank) helped alleviate the pressure; and, in the event, it seems that the political concern with sustaining a 'competitive' peso is fading. The courts granted President Uribe the right to be re-elected and he remains well ahead in the polls. The threat of an emaciated Central Bank has been reduced, significantly.

Mexico's IT regime is now fully operational and effective, Banxico having for all practical purposes given up the 'corto.' It now operates with a straightforward interest rate instrument. It has also, for the first time, achieved a convergence of expectations with its ambitious target (a monthly rate of inflation of 3 percent per annum with a margin of +/-1 percent) even while implementing a fairly aggressive easing program that has reduced the overnight interest rate by about 150 basis points (bp) in the last four months, and could reduce it by another 50bp by April 2006.

Brazil's experience with IT is more controversial, given the magnitude of recent shocks and the inheritance of extraordinarily high real interest rates with determinants largely outside the realm of monetary policy. Even so, the post-2002 experience has been successful and, more particularly, the long tightening episode from September 2004 to September 2005. Possibly, the extent of tightening was excessive and core inflation could have been reduced by 200bp (and 12 month forward inflation expectations by 350bp) with something less than the observed 375bp increase in the policy rate. Possibly, but not likely—and the gain in credibility of the monetary authority has been a key factor in sustaining macro stability through the unprecedented political crisis. The outlook for 2006 is a convergence of actual inflation to the midpoint of the target (4.5 percent) for the first time since 2000 even as Bacen continues in its measured path of rate cuts.

Which brings us to Argentina. The coun-

see **Inflation**, *page 12*

Latin America Forecasts: Foreign Direct Investment (FDI)

Growth is an Opportunity for Stability

By **Enrique Iglesias**

FDI Forecasts for 2006
Select Latin American Countries

	Bear Stearns	CSFB	HSBC	WestLB	Royal Bank of Scotland	UBS	AVERAGE
Argentina	3.0	0.5	4.4	4.2	3.5	2.0	**2.9**
Brazil	-	15.5	12.1	15.0	15.0	16.0	**14.7**
Chile	-	5.0	4.6	8.0	4.5	4.3	**5.3**
Colombia	4.5	3.0	4.2	3.2	2.9	3.0	**3.5**
Ecuador	1.4	0.8	1.0	1.3	-	0.7	**1.0**
Mexico	20.0	15.0	10.9	17.4	14.0	13.5	**15.1**
Peru	-	1.6	2.2	2.3	-	1.8	**2.0**
Venezuela	1.5	1.3	1.4	1.5	-	1.1	**1.4**

Source: Latin America Advisor.

Latin America has been growing since 2003 and the growth cycle is expected to last. GDP growth is projected to remain above 4.25 percent in 2005, and a similar trend is expected in 2006. This are good news when compared with the 1.4 percent average rate of growth for 1999-2002.

The macroeconomic policies undertaken in most countries of the region made the economic expansion more stable and less vulnerable. Many countries have reduced public debt ratios, their current accounts are in surplus, and external reserves have increased. Moreover, many governments have taken advantage of international financial conditions to finance external debt service and improve debt maturity profiles. As macroeconomic policies in most countries rest on the adoption of inflation targets and the commitment to exchange rate flexibility, external shocks are expected to be smoothly absorbed.

Although the prospects are in general positive, there are differences among countries: some have already reached macroeconomic stability, while others are still working on it. Nevertheless, the current and expected economic growth for next year still provides an opportunity for the more delayed countries to take a position on the path of macroeconomic stability.

... More private investment and open trade are the policy options.

Latin American countries should be aware that a slowdown of international trade and a tightening of financial conditions may occur. The first risk, possibly triggered by a continuous increase in oil prices, would affect most economies around the world. Ensuring diversified trade and avoiding export concentration are the best tools for confronting a dip in the cycle. In the meantime, more private investment and open trade are the policy options.

As to the second risk—an abrupt tightening of world financial market conditions—the region is more vulnerable than others because external debt ratios remain high, investment participation in GNP still needs to grow, and local capital markets are still poorly developed. Therefore, managing this second risk demands further reducing public debt burdens and maintaining low inflation with smooth monetary policies.

But as necessary ingredients of the policy agenda, such macroeconomic steps are not enough. The economic agenda should give special attention to three areas: 1) eliminating the obstacles to private investment and improving the business climate for local as well as foreign investors to increase the ratios of investment; 2) developing local financial markets to ensure that diversified and competitive financial services are available to the population; and 3) diversifying country and trade partners, taking advantage of regional strengths.

Many countries in the region will have elections in 2006. These elections provide an important opportunity to secure mandates for renewed structural reforms and fiscal sustainability efforts. However, the elections also provide space for political parties to look for popular support by bringing unsound economic policies to the arena. The long-term prosperity agenda requires the commitment of social and political actors. The challenge of new authorities is to find mechanisms to ensure that the benefits of prosperity reach all citizens without jeopardizing the fundamentals of macroeconomic stability.

Enrique Iglesias *heads the Secretaría General Iberoamericana and is the former President of the Inter-American Development Bank.*

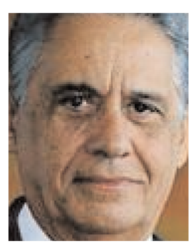
Latin America Forecasts: Elections in 2006

Q Several countries in Latin America will hold presidential elections in 2006. Which will be the most important and why? Will there be a continuing drift to the left? What are the implications of these elections for the region's economic policy/performance?

A **Cesar Gaviria:** "Of the 16 elections that will take place next year, elections in two countries will be followed especially closely—Brazil and Mexico. Arguably, however, from a market perspective, the Brazilian election is getting more attention than it deserves. After all, the markets already know Lula, they understand how orthodox he has been with regard to economic policy, and Brazil has remained stable despite the recent corruption scandal. Ultimately, either way the election goes, the market should not face turbulent, uncertain times. The possibility of a Serra victory does not concern anyone. On the other hand, close market attention to the presidential election in Mexico is well warranted. Although Mexico is presently stable and there is little uncertainty with regard to economic policy or performance—the way PRI and PAN governments deal with economies were well known—a victory by Andres Manuel Lopez Obrador could quickly change all of that. Perceptions that he is driven by populist tendencies raises fears about the politics and policies of a Lopez Obrador administration. With a shared border, the United States, undoubtedly, has the greatest concerns—after all, it would be the first time the US would have a leftist government as a direct neighbor. And while the actual consequences of this are difficult to determine, it could create the same 'pre-Lula victory' effect that impacted Brazil—investors holding back until they fully understand Lopez Obrador's economic policy."


Gaviria

A **Fernando Henrique Cardoso:** "There is no single answer to this question, since political and electoral trends are far from homogenous throughout Latin America. In the Andean region, ethnic-based and populist forces are obviously gaining momentum, with the exception of Colombia, where Uribe is geared to win his second term in office. The victory of Evo Morales in Bolivia might mean a boost to that trend. Added to Hugo Chavez' growing influence, the election of Morales could have a significant impact in Ecuador's and Peru's coming elections. The political picture, however, is much different in other countries of the region. And this does not apply to Chile only, where Michelle Bachelet and Sebastian Piñera share, in spite of all, a consensus when it comes to the basics of the social and economic 'model' set up by the three Concertacion administrations. This also applies to Brazil. First, because in Brazil there is wide agreement among main social and political forces that there should be no relapse into populist policies. Second, because, with the current electoral trends, it looks like the next president would be more committed to an encompassing reform agenda than Lula has shown to be. In Mexico, a few months ago, a president with populist proclivities seemed to be a sure thing for next term. Not anymore. Mexico's elections now look wide open, with candidates committed to a more predictable set of policies on the upswing. Argentina shows a mixed picture. For one, President Kirchner has been committed to sound macroeconomic policies, notwithstanding micro policies and a personal style that sends signals in the opposite direction. In the last mid-term election, he gained a lot of political capital, but has chosen, in my view, to spend it in a dangerous and eventually self-defeating way, taking a more interventionist stance to fight rising inflation. How will things unfold in what looks like a less-promising second half of Kirchner's presidential term? One thing is for sure: what happens in Argentina, Brazil and Mexico will make a difference in determining to which side the balance tips in the region. So will US policy. A confrontational stance will certainly not help."


Cardoso

Major 2006 Elections
selected countries

January	Canada Chile Haiti
February	Costa Rica
March	El Salvador
April	Peru
May	Colombia Dominican Republic
July	Mexico
October	Brazil

A **Andrés Rozental:** "The most important of the presidential elections in 2006 will be in Mexico (July) and in Brazil (October), since these are the two most populous countries, and represent the region's largest economies and democracies in which the results for the moment are very much up in the air. In Mexico's case, Vicente Fox's single term ends on November 30, with three main candidates competing to replace him. Current polls indicate a fairly close race among Felipe Calderon (PAN), Andrés Manuel Lopez Obrador (PRD) and Roberto Madrazo (PRI), but the campaign has not yet begun. Although the PRD has never won the presidency, there is a fair chance that next year it could. In Brazil, President Lula will try for re-election to another four-

see **Elections**, *page 11*

Latin America Forecasts: Anti-Americanism in 2006

Q The popularity of the US government in Latin America was on the decline in 2005, amid what is seen as US unilateralism and interventionism. Will anti-Americanism continue to rise in 2006? Will Hugo Chavez gain strength? What will the US do, if anything, to rebuild its relations with Latin America?

A **Rep. Dan Burton:** "Rest assured 2006 will not be a dull year. Also, rest assured that the United States is a steady partner and friend to the democracies in the region. There will be many challenges in the coming year to balance our commercial and security foreign policy goals in Latin America and the Caribbean. The Bush administration, policy makers and Members of Congress are mindful of the need to counter anti-Americanism and we are working in earnest to address the roots and sources of this sentiment. There will be many elections in 2006 and opportunities for electorates in the region to vote on whether they want their elected leaders to advance reforms, pursue long-term economic and social development and political stability and respect the rights and freedoms of individuals. President Chavez has made it abundantly clear that he has contempt for the United States and categorically dismisses as 'Neo-Imperialism' all that we are doing. He says we are trying to dominate the rest of the world. Setting aside all the editorializing and propaganda, I believe President Bush has laid out a roadmap for cooperation to consolidate democracy in the Western Hemisphere, and trade is a catalyst for positive growth in the region to create the conditions by which we can alleviate poverty, promote the rule of law and strengthen democratic institutions. Some want to participate in this forward-looking model for stability in our Hemisphere. Twenty-nine of the 34 Western Hemisphere nations that met in Argentina in November are in favor of moving forward on negotiations with the FTAA. The boycott of elections in Venezuela by opposition parties underscores growing concerns about the integrity of the entire electoral process. The bottom line is that this continues a disturbing pattern in Venezuela and one that I am deeply concerned about. President Chavez is tightening his grip over Venezuelan electoral politics and over all the institutions of governance. We will continue to show our support for freedom in Venezuela and elsewhere in the Hemisphere, for human rights defenders, and for democratically-elected leaders throughout the region. We want to work with President Chavez and other leaders in the region, whenever possible, however we need to continue sending a message of protest to Caracas and other places where abuses occur and where freedoms are threatened."

> "We need to continue sending a message of protest to Caracas ..."
>
> *- Rep. Dan Burton*

A **Rep. William Delahunt:** "The most striking aspect of the decline in popularity of the US government in Latin American is its breadth and depth. For example, four out of five respondents (81 percent) in a recent poll gave President Bush a negative approval rating. Particularly disturbing is that this was a survey of those whom one would anticipate would be predisposed toward a Republican administration—the political, academic, and economic elite. Unfortunately, this trend will persist until the administration ends its obsession with Fidel Castro's Cuba and recognizes that Hugo Chavez, Evo Morales, and others like them are symptoms, not causes, of other and more fundamental problems in Latin America. This is compounded by the Administration's insistence on free trade as a panacea, which contradicts the popular perception that the Washington Consensus has failed to reduce poverty and inequality. What is needed is a respectful effort at dialogue based on reality, not ideology; we must engage in more listening and less lecturing, or our problems in the region will only grow."

> "...We must engage in more listening and less lecturing, or our problems in the region will only grow."
>
> *- Rep. William Delahunt*

A **Thomas F. McLarty III:** "The November Summit of the Americas offered a hopeful opportunity to change the tenor of relations between the US and Latin America. Sadly, this did not happen and the US enters 2006 disconnected from the day-to-day life of Latin America and alarmingly unpopular in many countries. The year ahead will likely be a one-step-up-one-step-back affair unless there is some dramatic change in Bush administration foreign policy priorities or a seismic shift in Latin American political life. We will celebrate vibrant democracies in Mexico, Chile, Peru, Bolivia and Brazil; we will be encouraged by solid and growing economies in Chile, Peru, Argentina; we will hope that the region's impressive energy resources in Mexico, Bolivia, Peru, Colombia, Venezuela and elsewhere spur hemispheric cooperation and foreign investment while delivering economic dividends to the region. But we'll watch Hugo Chavez with concern, hoping that regional democracy and diplomacy are not undermined as his hostile and at times obsessive view of the US amplifies beyond

see **Anti-Americanism**, *page 11*

Latin America Forecasts: Trade Liberalization's Outlook in 2006

Q Hopes for giant steps in global trade liberalization were for the most part dashed in 2005. What are the prospects for trade liberalization in 2006? Is there any chance at all that the Doha Round or FTAA talks will make any progress? What prospects are there for completing negotiations and US congressional approval of a US-Andean FTA? Do you foresee any progress toward a Caribbean/Haiti FTA with the US?

A Mario Marconini: "December 31, 2004 was supposed to see the end of the Doha Round, of the FTAA, and of Mercosur-European Union—none of which happened. 2005 would then focus on Doha while both hemispheric co-chairmen went out of their way to avoid the four-letter word (FTAA). Despite the focus, the Hong Kong ministerial was just a few words away from a full-fledged debacle. The last-minute deal, on commitments which in principle did not need Hong Kong to be put into force (cotton, end of export subsidies, etc.), revealed the lowest of low expectations. The effect of the lack of ambition at this crucial time is to put yet more pressure on negotiators to cut near-impossible deals within a short period of time. There is, in addition, no reason to believe that things that were not deliverable in Hong Kong suddenly could become so in the next few months. Europe may need to move backwards. The US may need to be quiet. The G-20 may need to listen to another 90 developing countries with which it decided to fudge its own ambitions in agriculture. The prospects are not good for the WTO and seem to be nonexistent for the FTAA. The US-Andean FTA still has some way to go itself. The US-Caribbean/Haiti FTA may go forward and keep the Washington establishment 'pedaling' the trade bicycle. No 'giant steps,' however."


Hills

A Carla Hills: "The best hope for trade liberalization in 2006 is the Doha Round. Thanks to US leadership at December's Hong Kong ministerial, the 149 member governments signed a Declaration pledging an end to export subsidies for cotton by the end of 2006 and all farm goods by 2013. Both wealthy and advanced developing nations committed to provide tariff-free, quota-free access for 97 percent of exports from the 32 poorest countries and to help them participate in the global economy by giving 'aid for trade.' Ending the 'me first' stalemate, members promised 'balance between agriculture and nonagricultural access' and greater cuts of higher tariffs. Not huge steps, but as WTO Director General Pascal Lamy stated at the closing, they put the negotiations 'back on track.' Ministers committed to achieve an outline of an agreement by April 30, and to finalize it by the end of 2006. That timetable would enable the Bush administration to give Congress the required notice of an agreement 90 days before the June 30, 2007 expiry of the president's trade promotion authority. A Free Trade Area for the Americas is highly unlikely in 2006. The best near-term hope for hemispheric liberalization is for Brazil and the United States to persuade Latin American governments, after a Doha deal is reached, to join a 'Doha-plus' accord. Unwilling regional governments might join later."

A J. Anthony Smith: "It does not appear that many trade agreements in the Americas, under US bilateral initiatives or the WTO Doha Round, have much of a chance in 2006. The Caribbean/Haiti FTA and passage of the Andean FTA may be possible, but the fate of major agreements are slim. This does not mean that bilateral and multilateral agreements with China, India, Europe and other countries, and among countries in the region, will not take place. I believe that globalization is a fact of life and can't be stopped, in spite of the efforts of the US Congress, and others, to try to change that. The problem for the US in the Americas is that CAFTA set the upper limit for the US negotiators. The close vote was not a pro-trade vote, but a political vote. Thus many of the limitations in CAFTA were reflective of the specifics of the US and Central American industries, and unacceptable to many other countries. CAFTA was also unacceptable to a number of importers, multinational companies, and to others in the private sector. For example, the proposed agreement between the Andean countries and the US follows the CAFTA model. However, even so it will likely face an uphill struggle for approval in the US Congress. It similarly will face challenges in each of the Andean congresses, which will be dealing with how to adjust to the eventual influx of subsidized US commodities (grains, corn, meats). In terms of some sectors and the US markets, CAFTA was a step forward. For others it was a retrenchment from globalization. It is unlikely that a number of countries, particularly the Mercosur bloc, will agree to a trade agreement modeled on CAFTA, and they have made that clear. In fact, the US strategy with CAFTA was to get as much as it could because of


Amb. Rob Portman will have his work cut out for him in 2006. Photo: USTR.

See **Trade Outlook**, *page 11*

Latin America Forecasts: Energy in 2006

Q Record oil prices were the headline energy story in 2005. What will be the big energy story in Latin America in 2006? What single event or happening will have the greatest impact on Latin America's energy sector in the coming year?

A **R. Kirk Sherr:** "The two big stories for next year are closely related and neither results from a single event. First, by the end of the year, the region's continuing underinvestment in energy infrastructure will likely force some countries into a 'crisis' investment mode, especially regarding electric generation capacity. Across the region there has been a general failure to attract significant new energy sector investment. Ongoing project delays due to environmental issues, slow permitting and politicized regulatory processes (i.e., tariff increases) all compound the problem. As a result, many countries are now at risk for more widespread electricity shortages. Second, governments will continue recent efforts to renegotiate terms for energy projects. With oil and gas prices high and stable, and considering that many countries will have new governments in place by the end of the year, the desire for better terms is not surprising. What remains to be seen, however, is the effect that this contractual uncertainty has on foreign direct investment in the region. It's probably a safe bet that investors will take a 'go slow' approach until there is greater clarity on the new leaders and the new regional dynamics. As a result of these two trends, expect to see many energy sector opportunities in the region, but relatively few investors."

A **David Goldwyn:** "The most significant event in Latin America's energy sector in 2006 will be the emergence of Bolivia's new gas framework under Evo Morales and industry's reaction to it. A pitched battle is under way in Latin America between the private/capitalist model for energy investment and the state owned/social model. Brazil and Colombia represent the capitalist model, with competitive frameworks that allow private companies to majority own and operate concessions. This model attracts foreign capital, but does not predominate in the countries with the greatest reserves. Venezuela and Bolivia represent the social model where state-owned companies may retain majority ownership and/or control, with levels of tax or royalty shares heretofore believed to be uncompetitive. The social model will see state-owned companies (from inside and outside the region) invest in infrastructure and in concessions for strategic reasons despite rates of return that international oil companies find marginal at best. If the Morales model follows Venezuela's example and succeeds—by attracting state-owned or foreign capital and increasing investment—then we will see a transformation in the frameworks of the entire region. The hurdle rate for international oil companies (IOCs) will be officially lowered, the gateway for dominance of state-owned investors will be open wide and Mexico's potential for a reform allowing foreign capital into its upstream sector will be further diminished. Only a failure of the model to increase capacity or a crash in oil prices will reverse the trend for years to come. If the Morales model fails—by not attracting investment, by leaving Bolivia impoverished, by establishing a floor on rates of return below which IOCs or even modern state-owned companies like Petrobras will not step in, then the future of the sector will remain in play. Bolivia will be both a bellwether and a battleground."


David Goldwyn

A **Roger Tissot:** "I think there are a number of energy issues that will grab attention in 2006. In Venezuela, having achieved the transition of nearly all the petroleum contracts to the Chavez regime, it is time now to make the process work. That's not an easy task considering the number of regulatory and operational uncertainties. Moreover, will oil prices allow President Hugo Chavez to go ahead with proposed petro-diplomacy projects or will he be required to reconsider if oil prices weaken. In Bolivia, with the election of Evo Morales, the hydrocarbon issue will become even more relevant, with implication for the entire region, including the future of a Southern Cone energy ring. Then look at Colombia and Peru for possible surprises. These two countries are the region's 'contrarians' in terms of petroleum policies. Will a significant discovery make either of these two countries 'popular' again? Initially only small players visited the offices of ANH in Bogota, but increasingly large companies are paying attention to Colombia, and Peru's Camisea is also attracting the interests of IOC executives. Next, Brazil is moving toward oil export status. The success of Brazil petroleum policies is reducing the country's energy dependency, and it is expected to become an important petroleum exporter. Finally, and perhaps the most important, is the outcome of Mexico's elections and the future of that country's energy sector. Will Mexico open up, and under what conditions? Would a more 'open' Mexico result in a realignment of investment strategies by IOCs in, for example, Venezuela or Brazil?"

A **Roger Stark:** "Assuming Evo Morales has the necessary votes to avoid a run-off before the Bolivian Congress, his presidency has the potential to effectuate a sea-change in the framework for owning, developing and allocating natural

See **Energy**, *page 12*

Latin America Forecasts: Telecom in 2006

Q This year saw continued consolidation in Latin America's telecom markets, led by the telecom holdings of Mexican billionaire Carlos Slim—America Movil and Telmex—while Telecom Italia made a partial retreat from the region. What are your predictions for Latin America's telecom sector in 2006? How will competition for new and existing customers play out?

A **Wally Swain:** "The coming year will be another trial for state-owned companies throughout the region, but the only possibility for real change is in Colombia, and Carlos Slim will be a central figure. In Ecuador, the soap opera will continue with multiple announcements that Andinatel and/or Pacifictel are for sale, not for sale, seeking a strategic partner, seeking a manager, etc. In Bolivia, the arrival of Evo Morales will probably scare Telecom Italia into a fire sale of ENTEL Bolivia to the cooperatives, increasing the degree of state ownership in the sector. There will be increased state participation in Argentina as well, where a consortium of cooperatives expect to get free mobile spectrum, assuming Telefonica can keep to an aggressive schedule for handing back its excess. But the interesting story this year will be Colombia, where the government has high hopes that Carlos Slim will come back to save Colombia Telecom after being spurned on legal grounds in the fall of 2005. We are not so sure a deal can be consummated. Because of its pension fund liabilities the company is practically worthless, but the public (and interested public officials) will be unable or unwilling to understand. Thus any price for Colombia Telecom that makes sense to an investor will be unacceptable politically, and any price that makes sense politically will be unacceptable to an investor."

A **Marta Castelli:** "During 2006, mobile operators in the Southern Cone are expected to continue registering attractive growth levels in their client bases, but at lower rates than in the past two years, as penetration is already high in many countries. Apart from the growth in the mobile base, an increasing participation of value-added services would continue to be an additional growth factor for operators. In addition, after the M&A activity registered in 2005, Telefonica Moviles will continue dealing with aspects related to the merger of the operations acquired in Chile and Argentina to BellSouth (including the return or sale of spectrum that surpasses the maximum limit). Likewise, in Chile, America Movil is making the final strategy alignments of the acquired mobile operator Smartcom. Looking forward, there is still some room for M&A activity in the medium term, with the existence of some assets left by Telecom Italia and other opportunities. Regarding fixed telephony, growth should continue deriving from broadband, which should help mitigate the increasing substitution effects from mobile and VoIP (which are quite different among countries)."

> "... There is still some room for M&A activity ..."
>
> *- Marta Castelli*

A **Jose Otero:** "Latin America's telecommunications market will continue its consolidation path during 2006. However, the route will be different from previous years as linear consolidation (that happening within a specific telecom sector such as the mobile industry) gives way to vertical consolidation. The arrival of new technologies such as WiMAX, UMTS/WCDMA, and IMS will drive the need by telecom players to start securing their market position. Thus, linear consolidation of the highly fragmented CATV sector will prepare it for a new round of M&A that places them together with mobile companies or fixed companies. Signs of this new era are already present in Chile with the rumored acquisition of VTR by Entel and in Colombia, where EPM Bogota constantly reminds the market of its interest in acquiring a CATV operator that would allow the operator to implement a triple-play strategy. In addition, small operators, such as Brazil's CTBC or Ecuador's Etapa, are in a better position to fully take advantage of the implementation of a fixed/mobile convergence strategy. Nevertheless, as has been seen with Mexico's ban on allowing CATV to offer telephony services without the need of an intermediary, regulatory constraints will continue to hinder and slow innovation in the region. The main regulatory challenges will be the enactment or at least amendment of the current telecommunications legal framework in countries such as Bolivia, Colombia, Ecuador, Mexico, Panama, Paraguay, etc. In addition, regulators will be challenged by different market actors on issues like spectrum licensing policy (challenged by operators), content (consumer groups and the church on issues like pornography), and broadcasting rights (CATV players), etc. Finally, the signing of free trade agreements will have repercussions in markets such as Costa Rica and Panama in Central America, and could potentially have repercussions in countries such as Suriname and Guyana. But overall, most of the attention will be centered on what Telmex/America Movil and Telefonica are doing."

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Elections

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year term, but recent corruption scandals involving his Worker's Party and members of his inner circle have led to a significant drop in his popularity. Since the party conventions to nominate candidates to compete against him won't be held until next year, it is difficult to predict who his opponent might be, or how strong a challenge he or she might represent. These two elections, together with seven others scheduled for 2006, could result in further victories for the left in Latin America, especially in the case of populists such as Evo Morales in Bolivia, Lopez Obrador in Mexico or Chavez in Venezuela."

Cesar Gaviria *is a former President of Colombia and was Secretary General of the Organization of American States.*

Fernando Henrique Cardoso *is a former President of Brazil and co-chairs the Inter-American Dialogue.*

Andrés Rozental *is a member of the* Advisor *board and President of the Mexican Council on Foreign Relations.*

Anti-Americanism

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Venezuela. If coca growing is legalized in Bolivia and elsewhere it will be a troubling signal to the world. And if hemispheric trade remains on the back burner, that will be a major lost opportunity. It is not clear whether the US fully understands its real standing on the street in Latin America or is focused on rebuilding and reviving US-Latin American relations, and the worry is that only a real crisis or challenge to US stability and security—an oil cut-off, a free flow of drugs, an economic meltdown, a terrorist attack—will push the US to attention and action in the Americas."

A **Jonathon Flott** "The US will remain a foil for Chavez, Morales and others of this ilk to rail against, while Uribe in Colombia uses US support to continue the peace process there. It may be time for the US to be more pragmatic in its relations with Latin America. Chavez and company will speak against the US and its policies regardless of what those policies are. The key are leaders such as Kirchner who may lean towards Chavez, but who are also looking for support on substantive issues, and are willing to moderate their positions in the pursuit of broader national interests. Chavez is a one trick pony, using oil wealth to buy friends and speaking against all US policy. As oil prices weaken, his ability to spend and thereby expand his influence will weaken. Otherwise, the recent Venezuelan legislative elections have given him a large enough majority to enact legislation that will allow him to serve as long as he wishes. Only lower oil prices and profound dissatisfaction with his policies domestically will weaken his position. A significant change in US policy towards Latin America is not expected. The priority will continue to be the war on terror and operations in Iraq and Afghanistan, after which China looms as the most significant foreign policy issue. The US-Andean FTA will (hopefully) occupy attention as it reaches completion and ratification in Congress. Issues such as immigration reform may reach the agenda, but the disagreements within the Republican party over how this should proceed are profound, so success will be slow, if visible at all."

Rep. Dan Burton (R-IN) *chairs the US House Subcommittee on the Western Hemisphere.*

Rep. William Delahunt (D-MA) *is a member of the House Subcommittee on the Western Hemisphere.*

Thomas F. McLarty III *is a member of the* Advisor *board and President of Kissinger McLarty Associates.*

Jonathon Flott *is a member of the* Advisor *board and Economist for Latin America, Africa, and the Middle East at General Motors Corp.*

Trade Outlook

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the needs of the Central American countries with the end of textile quotas, then use that as a model for the negotiations with other countries in the Hemisphere. USTR considers CAFTA as good as we can get, but others don't. The explosion of regional markets and trading blocs in Asia, Europe, North America, and elsewhere is a reality. The US eventually needs an integrated trading bloc in the Americas. Factor in the divide between the developed and undeveloped countries with the internationalization of hybrid products, and the problems and future are clear. In trade it is always easier to get the policy right than the politics. The fact is that globalization is in high gear. The efforts to stop it will only have momentary success when compared to the course of history. Someday there will be an FTAA. Market pressure will cause that, but right now the existing situation, and the various positions countries are taking, indicate that it is too soon."

Smith

Mario Marconini *is a Senior Partner at MM Associados and former Foreign Trade Secretary of Brazil.*

Carla Hills *served as US Trade Representative from 1989 to 1992, and now is Chair & CEO of Hills & Company, International Consultants.*

J. Anthony Smith *is a member of the* Advisor *board and a Partner at Schmeltzer, Aptaker & Shepard.*

Energy

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resource revenues in the region. Relations between the US and various countries in the region (including Bolivia) are approaching an all-time low. While trade in natural resources, technology and energy know-how could serve an important role in regional integration (not to mention create opportunities to exploit comparative advantages in lieu of 'zero sum' competition), the regional politics are trending away from the collaborative spirit required to make integration work. Morales' platform centers on legalization of coca farming and on asserting greater control over Bolivia's natural resources (most notably oil and natural gas). The former is already irritating US/Bolivian relations, while the latter may threaten the economic interests of US energy companies and other foreign investors. Together, these policies have the potential to eliminate any 'middle ground' available for compromise. Morales can follow the Chavez model of foreign relations, he can emulate the more moderate leftists in the region, or he can chart his own path. With respect to regional energy markets, the key issue in coming months comes down to a simple, but profoundly important, choice: adhere to doctrinaire populist ideologies that have won over voters, or pursue pragmatic policies that achieve social justice goals AND encourage foreign investment."

Giusti

A **Luis Giusti:** "Highlights for 2006 in the Latin American energy network include an expansion of Trinidad-Tobago LNG facilities, which currently account for 10 million tons per annum of liquefied gas to the US. In Colombia, the recent institutional reform of the oil and gas industry has oil companies flocking to that country. The new activities will arrest the production decline and perhaps return Colombia to the oil export market. In Peru, progress continues in the Camisea gas development, the most ambitious project in the history of that country, with a ca. $2 billion investment. Camisea will alleviate the trade deficit and convert Peru into an exporter by 2007. Brazil will continue improving its oil and gas industry, spearheaded by Petrobras and with a wide participation of private capitals. Nevertheless, there are also concerns in the energy sector. In Bolivia the result of Sunday's elections will translate into a deeper rejection of private participation in the natural gas developments, which will most certainly result in a paralysis of future possibilities. In Venezuela, the frequent changes of rules and breaches of contracts by the government have instilled confusion and uncertainty, jeopardizing the possibilities of future expansions. Ecuador is seeing international investors leave the country, as a result of excessive bureaucracy, political volatility and an unstable investment climate. Finally, the Mexican presidential elections of next June should prove definitive for the future of oil and gas in that country. Oil reserves have plummeted in recent years as a result of insufficient investment. Unless a serious reform to allow private investment in the oil industry is undertaken, the country is bound to a short-term demise as an exporter."

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Inflation

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try continues to function without a clear monetary arrangement. This may not be a problem when inflation is low and is expected to remain low. But it is a concern now that inflation is in double-digit territory and accelerating. The signs are not propitious: the Central Bank will continue to intervene to buy reserves and 'maintain the competitiveness' of the exchange rate even while, through inflation, the real exchange rate appreciates ever more rapidly. A regime of financial repression with negative real interest rates keeps the cost of sterilization low but reduces its effectiveness in limiting the expansion of liquidity. Utility prices are

> "...The problem is that fighting high inflation after it has taken hold is a lot more difficult (and costly) than trying to avoid it."
>
> ***- Paulo Vieira da Cunha***

seriously misaligned and repressed inflation (with underinvestment to maintain the supply capacity) was already a problem even before the government opted for the dubiously effective policy of 'policing prices' through moral suasion. Wage agreements in the private sector are running well ahead of official price expectations. On the positive side, the twin surpluses in the fiscal and external accounts help drain demand. But the situation is unstable and the balance may tip to an acceleration of inflation. Likely, it would be short-lived. The indications are that President Kirchner would not tolerate it: the problem is that fighting high inflation after it has taken hold is a lot more difficult (and costly) than trying to avoid it.

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