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INVESTMENT STRATEGY

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RISKING FADING INTO IRRELEVANCE

FOREWORD

It has been fashionable to pretend that in the past two decades or so Latin America has changed. Recent events in Ecuador show that the region's tropical political folklore is alive and well. One thing that has changed is the total, possibly terminal, lack of interest in the region. I had noticed that for some time, but Chilean writer Rafael Gumucio recently put it splendidly in an essay on the second-rate status of the Spanish language (topically, he said it had moved from being the language of Don Quijote to becoming that of Sancho Panza .

Here is how Gumucio describes today's Latin America : (Revista de Libros El Mercurio 8-4-05) :

"What story, what characters can we tell about in Spanish, when our countries have remained in the outer suburbs of the world? Our cities are full of recently inaugurated ruins. Our elected presidents compete with the former dictators in corruption, stupidities and inefficiency. The only really global Spanish-speaking power is that of the drugs trade. We don't even exist for the NGOs, nor for the secret services of the world, now dedicated to the Moslems after previously concentrating on Eastern Europe. Less exotic than the Africans, less interesting than the Indians and less threatening than the Chinese, we waste too much time explaining that we are at the same time totally European and completely non- European. This is even more so when our link with Europe is Spain, a strange country in the grip of a fever of provincialism, where it has been decided that Spanish is the tongue of oppression, whereas Basque, Galician & Catalan are the true repositories of their respective people's soul. "

ARGENTINA

The rise in inflation in Argentina is a phenomenon repeated in other countries, despite the strength of local currencies against the US\$ and the invasion of cheap Chinese consumer goods. Prices went up by 4 % in the first quarter, more than trebling the 1.1% in the same quarter of 2004. The estimate for the full year is in a range of 8 to 10%, which means getting close to two digits again. This is most disappointing considering that lower inflation was the main, not to say the only, clear achievement that the monetarists could claim for their policies. People literally died so that inflation goes down.

Wages have kept up (if you have a job, and measured in local currency), and in fact are partly to blame for the inflation. The February wage index was 62 % higher than 3 years earlier.

The economy continues to tick over nicely. GDP grew by 8.8 % in the first two months, and March industrial production was 8.7 % higher, with the growth well distributed among sectors, including some previously left behind. Tax revenue by the third week of April was running 25 % above last year. The Central Bank is still buying dollars, quadrupling its purchases in April to keep the rate below 3 pesos. The trade surplus declined by 9 % in the first two months of the year, at US\$ 1.58 bn. The tug of war about the "refuseniks" on the debt swap still continues, in and out of courts, whereas the likes of the IMF and the G7 are pressuring Argentina and other countries even getting to insults (such as Japan which accused the country of "bad faith"). All these guys have obviously never seen a default before. I suggest the government sends all remaining holders a CD with the tango Caminito ("Desde que se fue, nunca más volvió"). That describes perfectly the fate of their money. To those in Catholic countries, they could add a recording of the Spanish version of the Lord's prayer : "Perdonanos nuestras deudas como perdonamos a nuestros deudores".

On the political front, president Kirchner and his arch-rival among Peronist leaders, Duhalde are now battling through their spouses. Both wives wish to run for a Buenos Aires Senate seat in the forthcoming legislative elections, for which a primary will be held in early August. Meanwhile, they are both hitting at Menem, now accused of having paid monthly cash "bonuses" to ministers and other senior officials out of the reserved funds. To the extent that this is common practice not just in Latin America but also in France, one wonders what all the fuss is about.

BRAZIL

The first quarter's fiscal results came in just as this report was being prepared. They show a good performance for the primary surplus (+ 34.8 % to US\$ 10.6bn) but the interest bill also jumped by 20.9% (to US\$ 14.6 bn), and was covered to the tune of 73 %. The overall deficit stood at US\$ 4bn (2.1 % of GDP) and the total debt reached US\$ 372 bn. The securitised debt, which rose by some US\$ 23.5 bn during the first quarter, reached US\$ 300 bn. Of this total, 57.7 % were indexed on SELIC and 14 % on inflation, both of which are on an upward trend. SELIC went up again by 0.25 points on April 20. This latest rise, which is by no means the last, brings the rate to 19.5 %. The move was much criticized in all circles. SELIC averaged 16.25 % in 2004. As has been oft mentioned in these reports, market interest rates, particularly for the consumer, are much higher. President Lula blamed this on consumers who are ready to pay 8 % per month. This is true, but there is no regional culture towards thrift, and much towards consumerism, so only government control could bring them down. The IMF repeated its earlier warning on the size of public debt.

Lula is still odds on for any re-election, though his popularity, still at 60 %, slid 6 points in two months. The political situation remains agitated. The Central Bank president and the Social Security minister are under legal investigation for various financial misdeeds, and an earlier Central Bank president was sentenced to 10 years in jail. The landless movement has stepped up its invasions again, and even occupied the Finance Ministry in Brasilia. In the capital, wives of the military demonstrated against low wages. Internationally, the US secretary of state Condoleezza Rice visited Lula and tried hard to drive a wedge into his support of Chavez in Venezuela. Lula himself played the grandee when in Senegal by apologizing for Brazil's treatment of its black population. A bid for a Brazilian to be the new head of the WTO got nowhere. The news on the economy is mixed. São Paulo industrial capacity utilization rose from 79.3 % to 82.4 % between February & March, but unemployment also rose to 17.3 % in March and incomes were stagnant. March supermarket sales rose by 13 %, but bounced cheques were at a 15-year high. If any indication as to the real economy was needed, what about the 122,000 applications received by Rio's municipality for 1,200 road sweeper jobs paying less than US\$ 190 per month? The external sector does well, with a 45 % increase in the first quarter's surplus., but tax revenue rose only 5.1 % in the same period. Last year was a good one for corporate profits. Results of

287 leading companies rose by 42.5 % to US\$ 31.6 bn on sales 16.2 % higher at US\$ 300 bn of the total, 169 companies improved earnings but 73 saw them decline and 65 made a loss.

The authorities are on a public-relations exercise on economic policy. A conservative has just been named as Treasury Secretary at the Finance Ministry. A budgetary law is aiming at limiting expenses to 17 % of GDP, keep the increase in the minimum wage only as much as inflation, and guarantee a primary surplus of 4.25 % until 2008. One should not get too excited as there is still a law (might even be a constitutional article) also restricting interest rates at a level much below the present one. It is known by historians as the Kasparian amendment, after the dreamy deputy who proposed it. As it is more likely that interest rates increase faster than the primary surplus, you should continue to be worried about a developing country which is spending over US\$ 160 million a day in interest payments on its public debt.

CHILE

Editorial and personal necessities force me to close this report before the vote on May 2nd, which should confirm Chile's candidate Insulza as the new secretary-general of the OAS. Though the result is not in doubt, following the surprise withdrawal of the Mexican contender, Insulza leaves behind the post of Interior Minister, regarded as the senior ministry in the Cabinet. His replacement will mean a reshuffle of ministerial posts, to add to changes made recently after a couple of ministers and several under-secretaries resigned to take part in the political campaigns. For the moment, there is no change in the line-up and expectations, which show that former Defense minister Bachelet can easily win over her colleague Alvear at the July 31 primaries, and go on to beat Lavin at the December 11 polls. Acts of God, scandals or crimes are the only events, which could upset this scenario.

The latest unemployment statistics show a slight improvement in the unemployment rate to March (down 0-2 to 7.9%) and a 3.5% increase in the workforce (though at a much lower rate than the 6% growth in GDP). With the first 6 weeks of autumn having been rather dry, and the gas supply cuts from Argentina increasingly deep. The energy situation could turn critical both for industry and households. The various solutions aimed at importing gas from elsewhere could not be implemented until the end of the decade.

Consumer activity continues buoyant, as does foreign trade with a stable first quarter surplus of US\$ 2.5 bn, resulting from 23% higher exports and 35 % higher imports. There are some striking discrepancies. Fast rising property sales (with massive financial incentives and cheap interest), and a 48.2 % increase in January/February building permits do not really square up with cement sales growing at just 3 % in the first quarter. However, there is no mystery in the fact that the already balanced treasury accounts have received a substantial boost from fuel taxes and copper revenue. Instead of using the money to tackle all the outstanding needs (badly equipped public schools and hospitals, bankrupt volunteer fire brigades, tens of millions of US\$ in arrears on health and education contract and wage payments, etc.. etc..), the minister of finance is insisting on pre-paying the country's insignificant public debt. This Dickensian miserliness may one day come to haunt the administration, and for longer than three Xmases.

COLOMBIA

Latest drug statistics from the US side show no significant change in the supply situation there, which has put strong doubts on the worth of Plan Colombia, one of the most expensive US security aid programmes of recent times.

Colombia's existing agreement with the IMF expired on May 1st, and an *in-extremis* renewal was announced a few days before. The US\$ 613 million stand-by facility comes with strings attached. The Colombian authorities will need to reintroduce proposals to increase taxes, end fuel subsidies and

privatise the energy sector by November 2006. Though the 18-month deadline gives some respite, this has all been tried and failed before, so do not hold your breath, with guerrillas on one side and elections on the other distorting the margin of manoeuvre. Some taxation can be counter-productive. The superintendent of banks admitted recently that the 0.4 % financial transaction had only resulted in driving operations outside the banking system. There was some good news on the energy front. After several years of decline, the country's oil reserves are being increased by 191 million barrels, which should ensure self-sufficiency by a few more years. Colombian production is currently running at 0.53 million barrels per day. We were once led to expect an oil export boom, but then in the past 29 years, this analyst has seen many such expectations end up in disappointment. They all looked so good when the countries made presentations.

MEXICO

Was it his own idea, or some over-zealous members of his entourage? Whatever the case, President Fox finally withdrew from the brink in his attempt at trying to eliminate the front-runner for the July 2006 presidential election, on some legal technicality. It took time, and as the world watched bemused, not thinking that the authorities would or could achieve their purpose and put themselves at the level of Robert Mugabe in terms of the democratic game. The intended target, Mexico City's PRD mayor AMLO, was finally arraigned with the help of the votes of the PRI (themselves thinking, probably rightly, that they stood to benefit more than Fox's PAN from AMLO's demise). The PRI had recently won, just about, elections in the state of Colima, which they already controlled. AMLO played the stage rather well, shifted between playing the martyr and then appearing to challenge the legality of it all, whilst getting massive but well-behaved crowds of supporters on the streets. Finally, it took less than 3 weeks for the authorities to back down, with the Procurator General and others losing their jobs, and AMLO improving his score in the polls. Mexico suffered another blow when its candidate had to withdraw from the race to become secretary-general of the OAS. There may have been no violence around AMLO's problem but overall in the country, the number of journalists killed (mainly for denouncing drug cartels) during Fox's tenure reached 25, to which was added this week a well-known actress killed in a robbery attempt.

The economy appears to be ticking over at a slower pace (industrial production rose by only 2.7 % in the first two months), and real wages are stagnating, though consumer imports are growing fast. Short-term interest rates have been rising rapidly. In a strange declaration, President Fox told off Mexicans for seeking jobs in the USA illegally when, according to him, the maquiladoras had a 90,000-worker shortage. To the extent that the in-bond industries have been hit by Chinese competition and were if anything shedding staff, not to mention the fact that they pay 5 to 10 times more across the border, it sounded like a pointless remark. It seems that agreement has been reached for a selective process of postal voting by Mexicans abroad, but they will have to be registered in Mexico.

At this stage, with the Fox administration having failed to provide decent growth or lower corruption, nor succeeded in improving the security situation, but created a political divide which has all but paralyzed most legislative processes, I have yet to see the apologies from all the analysts, commentators and journalists who were so lyrical at the demise of the PRI presidency in July 2001.

PERU

Oblivious to the scandal-a-day surrounding President Toledo and his family, the economy continues to race ahead with GDP rising 6.8 % in February. Trade and fiscal statistics are also upbeat, but as is the regional norm, high growth is failing to create jobs. Unemployment in Lima during the first quarter was at a record 11.3 %, a problem affecting mainly smaller firms as the big ones actually increased their workforce by 3.7 %.

Scandal-a-day in domestic politics is matched by row-a-week in the relationships with Chile, where every slight (and the Chileans are admittedly masters at provocation) is countered by over-reaction, cancelled meetings. The amazing thing is that the regime has managed to survive to this day, and may actually make it to its 2006 term.

VENEZUELA

I think Col. Qaddafi of Libya rather than Cuba's Fidel Castro is a closer image of Hugo Chávez, but with the US obsession with Cuba and their frustration at not being able to topple its leader after decades of trying, the temptation to associate the two is irresistible.

Many Latin American leaders must secretly envy Chavez, apart from those closely flirting with him. He bullies through the sort of thing that they would not dare attempt. Not worried about the consequences (compare his attitude to the Chilean and Peruvian pussy-footing on a small mining royalty), he raised the income tax on oil companies from 32.5 to 50%, on top of the 16.5% royalty. The state oil company PDVSA has also announced that it will review all oil contracts of the 1991-97 period (there are 32 of them) to "adapt" them retroactively to new legislation. Dangerous? Maybe, but despite the threats that the companies always utter, can you really believe that in the present conditions of the oil or copper markets will make them get up and leave the countries and the billions invested there? Who dares wins.

Chavez has also raided 20% of the Central Bank's US\$ 25 bn reserves and the FIEM oil reserve fund, to pay for all his populist largesse. This includes decreeing a 26% increase in the minimum wage (to \$186) for all public and private employees. The Central Bank (probably pressured) has also decreed minimum and maximum interest rates that banks can pay or charge, as well as restrictions on commissions. So far, you could pay 40% on your credit card balances but get less than 4% on your savings account. The maximum lending rate will be 28% and deposit rates closer to 10%. Before you cry out about market forces etc., what is the justification for Chilean stores charging 100% and Brazilian banks 200% on consumer credit when their inflation is less than 3 and 10% respectively. Chilean banks are paying 3% annualised on 30-day deposits. When the market ends up in abuse, the market should be restrained. As Jimmy Carter said when starting the liberalisation trend: more freedom requires more supervision.

The NYT says that the USA is not only pressuring neighbors to stop smiling to Chavez, but will also finance opposition groups domestically. Chile in the 1970's all over again? Not really.

SMALLER COUNTRIES

Violence is raising its ugly head again in **Bolivia** with no sign of agreement on any of the pressing issues. **Ecuador's** new president has yet to get recognition and has his work cut out, in a country totally disillusioned with politicians and having had 8 presidents in 10 years. In **Paraguay**, drought in rural areas may cut the crucial soybean harvest by 30%. **Uruguay** is seeking a new 3-year agreement with the IMF.

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