

HALLGARTEN & COMPANY



COUNTRY INVESTMENT STRATEGY

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LATIN AMERICAN COUNTRY RISK REVIEW

ARGENTINA

The conventional wisdom is that Argentina's economy is slowing down from its stellar recovery streak. It is true that some statistics point to such a situation, but so far there are few real signs of a major change in trend. Industrial Production in July rose by 8.3%, only slightly below the 7-month cumulative 8.5%, and overall economic activity last month rose by 10%. Hardly a sign of recession. Some sectors are back to the pre-crisis levels, but others reflect the pauperisation of the middle classes. Supermarket sales levels in July were 11.6% above their April 2003 through, but still nearly 40 % below the April 2000 peak. Corporate results in the first semester were the only ones in Latin America to show a negative trend, declining by 51.4% on sales 8.4% higher, and a Return on Equity of 9.8 %. How many will be able to afford the 100 peso (US\$33) minimum wage increase that the authorities wish to impose by decree remains to be seen.



One great area of success about which little is heard, is tax collection, long the Achilles' heel of the region's treasuries. Tax collection in the first 7 months was up 41.9 %. It has doubled in real terms since mid-2002, and as a percentage of GDP, jumped from the historical trend (1993-2001) of 17.4 % to 23.3 % in the first half of 2004. Though some of the improvement is due to the effects of devaluation,

this is not the case for the 2004/2003 comparisons, and detailed statistics show that revenue from all sort of taxes is growing at several times that of the economy (VAT for instance rose 54 % in July). This does not mean that the treasury is flush enough to go beyond the improved offer to creditors (incorporating some past-due interest, as once again correctly forecast by this report). Even servicing non-defaulted debt is not easy. In 2004, out of an expected surplus of U\$ 3.6 bn, there are debt service obligations of U\$ 3.8 bn. Where things become more difficult is in 2005, when U\$ 9 bn is due, and the surplus is likely to shrink. The head of the IMF is about to land in Buenos Aires to try to accelerate the debt negotiations, but the agreement with the Fund itself will be worked out afterwards.

The matter of security is still paramount in the public discussion, and now at the core of political debate. In accordance with historical trends everywhere, right-wing groups are capitalising on the feeling of insecurity by riding Poujadiste populists. It will not end until the social situation improves, and could all end up in tears.

BRAZIL

Though over 58% of the population said in a recent poll that Lula had broken campaign promises, the "feel good" atmosphere on the economy has helped reverse some of the previous decline in his popularity. The president's personal rating rose by 4 points to 58.1%, whereas that of his government jumped by 9% to 38.2% (all changes between June and August).

The good news continues, with July unemployment at 11.2% standing 1.6 points below the year-ago level. Even better is the 2% increase in the average wage (to some U\$ 300 per month), the first positive variation of that index in 16 months. First half retail sales were up 9.3 %, and a record crop is expected in the second semester by the agricultural sector. The July fiscal results were less buoyant. The primary surplus, though a record for the month, covered just 63.5 % of the interest bill (compared to nearly 75% in the first half). U\$ 112 million a day was paid in interest during July (inc. week-ends and holidays), although the interest bill for the first 7 months (U\$ 24.5 bn) was 19% lower than in 2003. There are strong indications that the authorities may push up the SELIC rate soon, which will add to the deterioration seen in July. Though recognising the improvement in fiscal figures so far this year, the problem of the U\$ 320 bn public debt is not solved. At best, it is a long and vulnerable convalescence, and, at worst, a life-threatening chronic disease. Corporate earnings rose by 12.6 % on sales 17.8% higher in the first semester, with Return on Equity at 15.7%.

After 28 years of covering Latin America, I am cynical of most things in the region, one of which is the much vaunted "independence" of central banks. This was clearly proven when the Brazilian incumbent was hastily given ministerial rank, in order to make it more difficult to get at him for some shady financial transactions. Since when is a member of the Cabinet "independent" from the government?

Meanwhile, despite US reservations about another regional emerging on the American continent, Brazil has been strongly lobbying to get the region's permanent Security Council seat if that organism is eventually reformed. In accordance with Brazilian practice, this is done through negotiation, not bullying, and seems to be gathering close to a consensus in Latin America. Brazil, which was once an empire, and for some time even ruled its former colonial power through a sort of reverse takeover, has always been ambitious. Its embassies are palatial; its diplomats speak French and throw lavish receptions. The only possible competitor, Argentina, is not a serious runner any more. The risk is that "folie des grandeurs" may divert attention from domestic problems.

CHILE

Wonderful economy. Pity about the workers. On the one hand, some very good statistics in the past month: July retail sales were 6.9 % up, and the sale of new housing 32.6 % higher. GDP grew by 4.9 % in the first semester, with the second quarter coming in at 5.1 %. The fiscal surplus hit 1.3 % of GDP

(including interest payments, which contrary to the rest of the region are not swept under the carpet here). The 7-month trade surplus jumped by 184% to US\$ 5.6 bn, whereas the first half's current account surplus was 19 times higher at US\$ 1.92bn. Corporate earnings in January-June rose by 26 % on sale 13 % higher. What about the workers? Well, unemployment in the quarter ending July was 9.7 %, 0.6 points above the year-ago figure. No less than 40 % of Santiago workers are in fear of unemployment. As mentioned before, growth is inflated by good commodity prices and a debt-financed consumer spree. Household debt rose from 34 % of disposable income in 2000 to 44 % in 2004.

With the municipal elections just two months away, the populists are having a field day, particularly in the opposition ranks. As the September independence holidays (18th & 19th) fall on a week-end, they have called for extra vacation days to be given in lieu (there is normally no such tradition in Chile). In a country where productivity is the pits, many shops do not open before 10.30 AM, bank tellers often have no cash out of the vault until well after opening time, and school children are kept home because it is raining, etc.. One is reminded of the old Hungarian Communist joke about why the workers did not go on strike ("because nobody would notice"). To his credit, the president stood his ground and refused. Where he deserves less credit is in the new plans to "help" small and medium sized firms, by giving them soft credits for (wait for it) being able to pay court fees and fines arising from their having stolen their workers' social security contributions (now accumulating several hundred millions US\$). Impunity must be a national culture in Chile. In which other nominally democratic country can senior figures sodomise young boys, torture and murder young girls, and then put both their accusers and the journalists reporting the news in jail? In a country where the president of the journalists' professional association states that press freedom is at its worst level since 1985, when there still was five years of military dictatorship left to go.

COLOMBIA

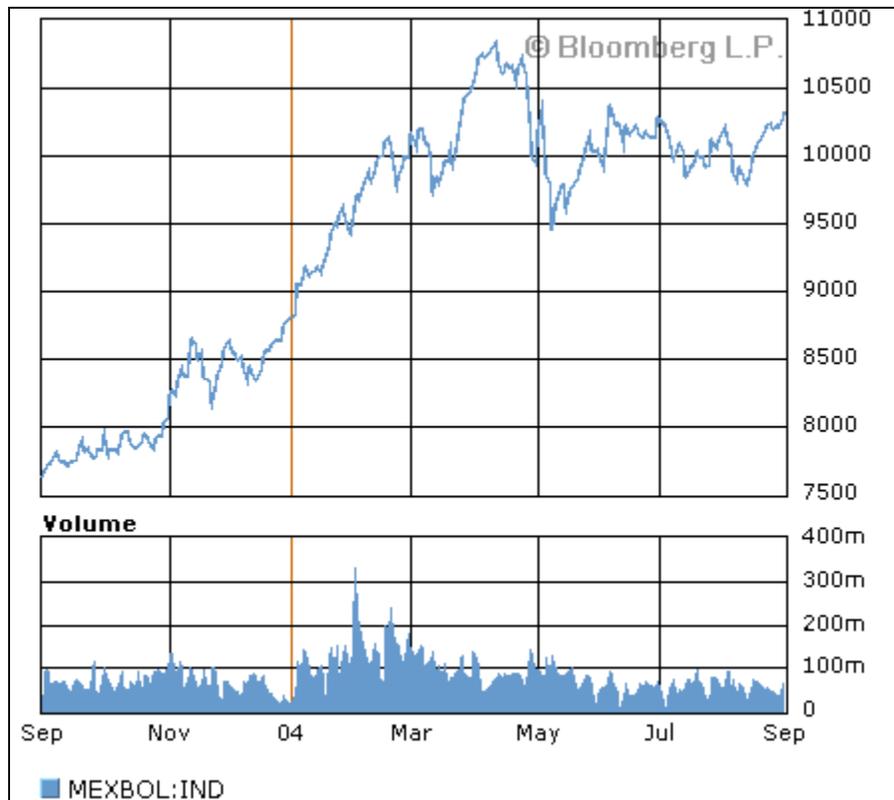
At the end, they all give-in, always. From Mrs. Thatcher to one day George Bush. They all have or will negotiate with "terrorists", despite the macho talk. President Uribe is now considering the FARC prisoner exchange he steadfastly ruled out previously (presumably being photographed with freed hostages may help his reelection bid). The 2005 budget will increase expenditure by 19%. Though the Return on Equity (5.1%) was the lowest in the region, corporate results in the first semester were 36% up on sales 8.7% higher. Relations with the US, once the administration's main champion, are also cooling off. It is no coincidence that someone leaked a 1991 DEA report referring to Uribe's possible links with the drugs trade, and the White House drug czar saying soon afterwards that the country's eradication efforts had had no impact in the USA.

MEXICO

The disappointing performance of the US economy in the second quarter may eventually be reflected in Mexico's own performance, though its economic growth accelerated to 3.9 % in the second quarter from 3.7 % in the first, and was at a three-year high. The all-important motor industry already gave a pointer during July, when production was down 1.4 %, exports plunged 18.2 % and domestic sales rose by just 1.4%. This is a pity, as the export-oriented sector of industry had pulled the figures up (in-bond activity rose by 10.1 % in June). Corporate results rose by just 4.1 % on sales 17.7 % higher during the first semester. Return on Equity was 10.1 %.

Politically, the lameness continues. The undersecretary of public security left, supposedly "having reached retirement age", one of the more ridiculous excuses to come out from an administration whose forte never was communications. Attempts to remove the immunity of the Federal District's mayor ("AMLO") are not being successful, as their main aim is to discredit him and affect his presidential ambitions. He is still running ahead in the presidential polls (53 % of intentions). The PRI told the government that it would not help in that campaign ("doing its dirty work"). The Interior Secretary

himself, the PAN's front-running candidate Santiago Creel, has trouble with justice too, in relation with contributions to his 2000 campaign for Federal District mayor.



PERU

Nothing is new under the Inca Sun God. A beleaguered administration with corruption scandals thrown at it on a daily basis, contrasting with enviable economic figures. Though it is a fact that growth has slowed down, and the Central Bank expects it to do more so, particularly if the slide of the dollar against the New Sol continues, the statistical panorama is fine. The economy grew by 4.2 % in the first semester (though only 3 % in June). This was slightly below the 4.6 % achieved last year, but all sectors did well except agriculture. The current account deficit more than halved to just US\$ 310 million, with exports and imports continuing to do well. Reserves are at a record US\$ 11 bn plus, and there was a 1 % fiscal surplus in January-June. Corporate results jumped by 85.2 % in the first half, on sales 22 % higher and Return on Equity of 16.1%.

VENEZUELA

Think about it. Maybe some nations preferred to be ruled by the likes of Chavez, after all the man won decisively with nearly 60% of the vote, in a record turnout (75%) and the blessing of the most respectable international observers. Though his early reaction was cautious and amenable, I still insist that victory may make him insufferable and more unpredictable. He has just withdrawn his ambassador to Panama in solidarity with Cuba, who did the same after Panama's president freed anti-Castro terrorists. The economy continues to recover well (+ 13.6%), and now that the main uncertainty is lifted, could try to recoup the existing slack (capacity utilisation is still 50% in industry). Corporate earnings led regional performance in the first semester, rising 157 % on sales 22% higher and a Return on Equity of 14.5%.

SMALLER COUNTRIES

Faced once again with social unrest, **Bolivia's** president is having a hard time translating the referendum results into practical new energy policies. **Ecuador's** economy appears unable to capitalise on the oil boom, with the trade surplus shrinking 3% in the first half and the economy growing at less than 1%. **Paraguay's** shady Triple Frontier area may have once been populated by Palestinians only because an Israeli "resettlement" plan sent them there. **Uruguay's** economy continues to recover nicely with unemployment in the second quarter down 4.4 points to 13.1% and Industrial Production up 30.2% in the first semester.