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August 2015

# PANORAMA

## LATIN AMERICA – WHAT LIFE AFTER THE COMMODITY BURST?

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By Patricia Krause , Coface Economist



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**rowth in Latin America has been slowing down since 2011.** This lackluster result, caused by weak domestic fundamentals, were exacerbated by cyclical factors such as the decline of commodity prices - and particularly the plunge in oil prices experienced since the second half of 2014. In 2015 we have been observing a further deterioration of this downwards trend, with regional GDP expected to contract by 0.2%. It will be the first recession since 2009, when activity shrunk by 1.4% due to the outspreads of the subprime crisis.

Almost all major economies should decelerate in 2015. The main negative contribution will come from countries of the Atlantic, Coface expects Brazil to contract by 2.5% and Venezuela by 7% in 2015. Chile and Peru are the only

two main economies, which should report a slight improvement this year, however considering a strong slowdown reported in 2014. In 2016 growth will come out the negative territory to a meager 0.8% high. Generally external fundamentals will continue to weight negatively on Latin America. Commodity prices will not recover in the medium term, as growth will remain slowing down in China and there isn't any country to replace its role. Growth should be driven by domestic fundamentals, notwithstanding they are also decelerating due the effect of lower commodity prices over investments and over government's revenues. Countries also hold strong infrastructure bottlenecks and a dismantling industry, which hinders its potential growth. The relatively improvement in growth in 2016 should come from a lower recession expected for Brazil in 2016.

**In this edition, we will focus on Argentina, Colombia and Ecuador.** Argentina will hold presidential elections in October and should breakeven in 2015. Colombia has been losing momentum due to the direct and indirect effects of lower oil prices. In Ecuador, the economy remains heavily affected by the low level of oil prices. Oil proceeds are an important source of revenues for the government and the country's growth is strongly reliant on public expenses. Coface included Ecuador's country risk assessment on its watch list in late March (currently a B, see details in table 1). The second part of our updated Latin America sector barometer reveals the financial performance of companies in different industries, highlighting where risk has increased and where it has remained stable. No segments have reported improvements. The third part of this report focuses on sensitive industries in Colombia and Argentina.

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# WHAT LIFE AFTER THE COMMODITY BURST?



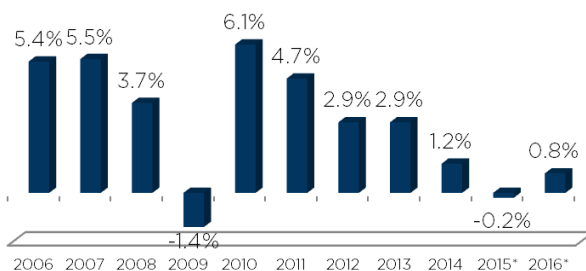
**PATRICIA KRAUSE**  
LATAM Region Economist  
based in São Paulo  
[patricia.krause@coface.com](mailto:patricia.krause@coface.com)

« These lackluster results, caused by weak domestic fundamentals, were exacerbated by cyclical factors such as the decline of commodity prices - and particularly the plunge in oil prices experienced since the second half of 2014.»

## INTRODUCTION

**Growth in Latin America has been slowing down since 2011** (see chart 1). These lackluster results, caused by weak domestic fundamentals, were exacerbated by cyclical factors such as the decline of commodity prices - and particularly the plunge in oil prices experienced since the second half of 2014. In 2015 we have been observing a further deterioration of this downwards trend, with regional GDP expected to contract by 0.2%. It will be the first recession since 2009, when activity shrunk by 1.4% due to the outspreads of the subprime crisis.

**Chart 1 - GDP Annual Growth**



Sources: Coface and IMF

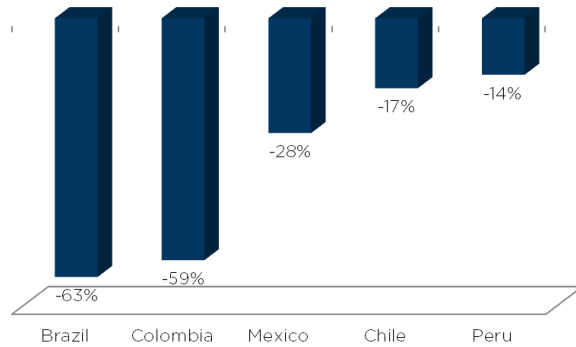
### **Almost all major economies should decelerate in 2015.**

The main negative contribution will come from countries of the Atlantic, Coface expects Brazil to contract by 2.5% and Venezuela by 7% in 2015. Chile and Peru are the only two main economies, which should report a slight improvement this year, however considering a strong slowdown reported in 2014. In 2016 growth will come out the negative territory to a meager 0.8% high. Generally external fundamentals will continue to weight negatively on Latin America. Commodity prices will not recover in the medium term, as growth will remain slowing down in China and there isn't any country to replace its role. Growth should be driven by domestic fundamentals, notwithstanding they are also decelerating due the effect of lower commodity prices over investments and over government's revenues. Countries also hold strong infrastructure bottlenecks and a dismantling industry, which hinders its potential growth. **The relatively improvement in growth in 2016 should come from a lower recession expected for Brazil in 2016.**

The deterioration in economic activity negatively impacted the region's currencies. This movement was reinforced with the recent strengthening of the US dollar, which can be explained by the perception among investors that the US economy will outperform other economies over the upcoming months and the expected tightening of the US monetary policy. Consequently, the five main free floating currencies in Latin America (the Brazilian Real, the Colombian, Chile-

an and Mexican Pesos and the Peruvian Novo Soles) have depreciated sharply (see chart 2).

Chart 2 - Currencies vs USD (% 31/08/2015 – 31/08/2014)



Sources: Central Banks

Currency depreciations were notably stronger in Brazil and Colombia. The Brazilian Real depreciated by 63 % and reflects the sharp deterioration of macro fundamentals and the lower prices of its exported products. The Colombian peso negative movement is associated with the plunge in oil prices. These currency depreciations should improve the competitiveness of the manufacturing sector, by decreasing the price of its exported products - but the results are taking time to materialise and official activity figures have failed to report any rebound so far.

In this edition, we will focus on Argentina, Colombia and Ecuador. Argentina will hold presidential elections in October and should breakeven in 2015. Colombia has been losing momentum due to the direct and indirect effects of lower oil prices. In Ecuador, the economy remains heavily affected by the low level of oil prices. Oil proceeds are an important source of revenues for the government and the country's growth is strongly reliant on public expenses. Coface included Ecuador's country risk assessment on its watch list in late March (currently a B, see details in table 1). The second part of our updated Latin America sector barometer reveals the financial performance of companies in different industries, highlighting where risk has increased and where it has remained stable. No segments have reported improvements. The third part of this report focuses on sensitive industries in Colombia and Argentina.

Table 1



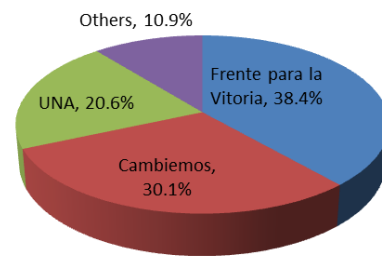
# 1 COUNTRY RISK

## Argentina: presidential elections coming next

On October 25 Argentina, will hold its first round of presidential elections. These promise to be marked by fierce competition. The elections are widely anticipated by Argentines - who are dissatisfied with Kirchner's long incumbency - as well as by foreign trade partners and holdout bondholders. The results of the Primary<sup>1</sup>, held on August 9, were of no surprise. The three pre-candidates who had already appeared the most likely to run for elections, won the competition within the parties/coalitions. They are Sergio Massa from the Peronist dissident Frente Renovador (UNA alliance), Mauricio Macri (Cambiamos alliance) from the right wing party PRO and Daniel Scioli from the Peronist Frente para la Victoria (backed by the ruling party and sole candidate).

As expected, Scioli came first with 38.4 % of the votes (see chart 3), followed by Mauricio Macri (Cambiamos with 30.1 %) and Sergio Massa (UNA with 20.6 %). The close gap between candidates means that the race should be tight. The leading candidate needs 45 % of the vote, or 40 % with a 10 percentage point margin from the second-place candidate. The likelihood of a run-off, in November 22, is high. The results from early August show that the majority desire change. An alliance between the opposition candidates Massa and Macri is not expected in the first round.

Chart 3 - Argentina Primary Election



■ Daniel Scioli ■ Mauricio Macri ■ Sergio Massa ■ Others

Since Argentina defaulted on its foreign debt in 2001, its access to the international credit market has been difficult. Moreover, the government has started to depend on the trade balance surplus, to keep its balance of payments under control. The country was able to maintain a current account surplus until 2009 but, in 2010, started to report annual deficit. The declining international prices of soya (of which Argentina is a major producer and exporter) and the

<sup>1</sup> Primary election: Argentina electoral system requires that all voters should decide which candidate from each party (or coalition) will run for elections.

rising dependence on imported oil, have reduced the trade surplus in recent years. Furthermore, inflation rose to 38.5 % in 2014 (according to unofficial sources) and in October 2014 international reserves reached their lowest level in 8 years (28 billion USD, or approximately 5 months of imports). To contain liquidity and inflation risks, the government raised barriers on imports and increased its control on prices.

Argentina still faces a legal impasse, due to its default in 2001. In June 2014, the country was classified under 'selective default'. An American judge gave a favourable ruling for bondholders, which did not concern the structured debt, but the so-called 'holdout' funds. The country did not make any settlement and refused to comply with the judge's sentence. Since then, other debt holders have obtained similar legal rulings. The payment of all lawsuits would require roughly half of the country's total international reserves. President Cristina Kirchner remains irreducible and will leave this issue as an inheritance for her successor.

Views on how this sensitive economic environment should be dealt with vary among Argentina's presidential candidates. Right wing candidate Mauricio Macri is the one most likely to implement a "deliberate shock" solution. This would include the removal of exchange controls on December 10 (the first day of the new mandate) and regulating the public debt service. Sergio Massa has mentioned that controls could be dismantled within 100 days of taking office, while Scioli is presenting a smoother discourse.

Despite this scenario of economic turmoil, Kirchner's popularity remains high, due to the positive effect of the artificially strong Peso on real income. In order to count on her support, in late June 2015, Scioli announced that Carlos Zanini (the incumbent government's Legal Secretary, who has been working with Kirchner for many years), would be his vice president. Scioli has thus gained Cristina's open endorsement and, in exchange, is praising the current government. He has indicated that if he is elected, controls over exchange rates could start to gradually normalise.

Furthermore, part of Congress is to be renewed this year, with half of the Lower Chamber and one third of the Senate. The support of Congress is very important and Kirchnerism could maintain a role in the economy, as two relevant allies are running in congressional elections. These are Cristina Kirchner's son, Máximo Kirchner and Axel Kicillof, the incumbent Minister of Economy. Regardless of who wins, the current deep economic imbalance is not sustainable and adjustments need to be made as soon as possible.

Table 2

	2013	2014	2015f	2016f
<b>GDP</b>	2.9 %	0.5 %	0	-0.5%
<b>Inflation</b>	26%	23.9 %	30%	26.4 %
<b>Budget Balance</b> (% of GDP)	-2%	-2.7 %	-4.1 %	-4%
<b>Public Debt</b> (% of GDP)	40.2 %	48.6 %	49.5 %	50.5 %
<b>Current Account Balance</b> (% of GDP)	-0.8 %	-0.9 %	-1.2 %	-0.2 %

Sources: Coface, IMF, Oxford Economics and Itaú bank

## Colombia: a weakened but resilient economy

In the first quarter of 2015, Colombia's activity decelerated, to grow by 2.8 % compared to the same quarter of 2014 (after +3.5 % reported for 4Q2014), according to Dane, Colombia's statistics agency. This result is slightly better than the market consensus, but is the lowest growth rate since 3Q2012 (which was somewhat impacted by a high base for comparison). On a quarterly basis, the situation seems more positive, with a continuation of the moderately upwards trend (+0.8 % in Q1, following +0.6 %), driven by gross fixed investment that gained momentum (+3 % q/q, following +0.5 % in 4Q2014).

The loss of pace was widely expected and the situation will not improve significantly in the upcoming quarter, given the backdrop of the sharp decline in oil prices since mid-2014. Colombia remains heavily dependent on oil, which accounts for roughly half of the country's exports and a sixth of government revenues. This situation is confirmed by the fall in manufacturing production recorded in the first half of 2015 (-2% compared with the 1H 2014).

For over a decade, countries in Latin America reported strong growth rates associated with the high demand for commodities and the subsequent impact on prices. Some economies suffered from 'Dutch Disease' (an increase in the development of natural resources, combined with competitiveness loss in the manufacturing sector), while high commodity prices encouraged strong capital inflows. Over the last decade, the increase in foreign direct investments to Colombia (from 2.6 % of GDP in 2004, to 4.3 % of GDP in 2013) mainly focused on the oil and mining sectors (50 % of total FDI in 2013). These investments generate positive effects in the short term, but make activity vulnerable to possible downturns in commodity prices.

The current context of lower commodity prices has therefore negatively impacted Colombia and other Latin American exporters. With the exception of Mexico, which is oriented towards manufacturing rather than commodity exports, the economic activity in all other major Latam countries decelerated in 2014. Colombia's economy was the last one to be hit, as the price of energy commodities started to fall later. The country's GDP has been losing momentum and the Colombian peso has assumed a devaluating tendency (-52 % against the USD in the one year until end of July 2015). Manufacturing remains the most sensitive arm of the economy (-2.1 % for 1Q 2015 YoY, see chart 4).

Chart 4 - Colombia Manufacturing Industry (YoY)



Source: Dane – National Statistical Institute



From the macroeconomic side, risk stems from the twin deficits (fiscal and current account) that will remain problematic over the medium term. The government budget deficit forecast was recently reviewed upwards, from 2.8 % to 3 % of GDP in 2015 and from 3.3 % to 3.6 % in 2016 (as part of the decline in oil prices this year will only impact revenues in the following year). These budget deficit figures compare to 2.4 % in 2014. However the gross public debt per GDP ratio should remain at manageable levels, at around 40 % for 2014-2015. As to external accounts, the current transactions deficit rose from 3.3 % in 2013 to 5.2 % in 2014. It reached 5.7 % of GDP (four-quarter rolling) in 1Q2015 and is forecast to grow to 5.8 % this year (the deficit of trade balance already reached USD 11.9 billion in the 12 months accumulated to June 2015, compared with a deficit of 1.3 million one year earlier). Foreign direct investments will not be enough to offset this high level of deficit, which may result in the use of the country's international reserves.

Focusing down into sectors of activity, construction has been slowing compared to the strong growth reported in previous years. This situation is expected to persist, due to the backdrop of shrinking public resources, lower oil prices and slower activity. Segments that depend on imported raw materials are the most sensitive, as a result of the recent overshooting in exchange rates (over 80 % of materials are imported for the automobile and agro segments). Retail activity and the services sector will also show reduced growth rates. However they remain lower risks, due to the growth in employment and in GDP per capita over the last decade.

The business climate remains weak and the country is ranked in 66<sup>th</sup> position in the 144 countries classified in the World Economic Forum Global Competitiveness Index 2015. The fact that institutions ranked at 111, goods market efficiency ranked at 109 and infrastructure ranked at 84, remained hindrances to growth. However, a possible peace agreement with the FARC rebel group should improve the business climate. Moreover, during the 2000's, international reserves in foreign currency increased (from USD 9 billion in 2000, to USD 47 billion in 2014), trade agreements were signed (with the US, the EU and the Pacific Alliance) and the investment rate rose significantly (from 15 % of GDP in 2000, to 24 % in 2014). Within this context, Coface expects GDP to grow by 2.5 % in 2015, which is still higher than the other major economies in the region.

Table 3

	2013	2014	2015f	2016f
<b>GDP</b>	4.9 %	4.6 %	2.5%	2.7 %
<b>Inflation</b>	1.9 %	3.7 %	3.7 %	3%
<b>Budget Balance</b> (%of GDP)	-2.2 %	-2.4 %	-2.9%	-2%
<b>Public Debt</b> (%of GDP)	35.8 %	38%	40.6 %	40.1 %
<b>Current Account Balance</b> (%of GDP)	-3.4 %	-5.2 %	-5.8%	-4.9 %

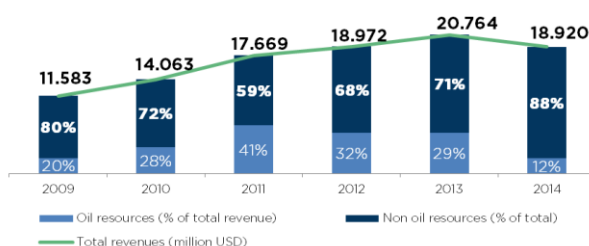
Sources: Coface

**Ecuador: the economic situation, affected by low oil prices, is unlikely to show strong improvement**

In the decade leading up to 2013, Ecuador grew by an annual average of 4.8 %. GDP started to decelerate in 2014 (+3.8 %), due to the backdrop of lower oil prices. The figures for the first quarter of 2015 corroborated this tendency, with activity growing by 3 % YoY (the lowest YoY rate since 2010) and falling by 0.5 % compared with the previous quarter. The slowdown was mainly driven by investment (+1.5 % YoY). In early June, the Central Bank reviewed its GDP estimation for the year, from a high of 4.1 %, to a more modest increase of 1.9 %. This revised estimation still seems a little optimistic and Coface forecasts a rate of 1 %.

Exports stand at around 27% of GDP. Historically, these exports were mainly agricultural products, such as bananas, coffee, cocoa, shrimps and tuna. In recent periods, newly discovered oil fields have made energy commodities an important source of tax revenues (see chart 5) and the main export product. As an example, oil represented, on average, 48 % of total exports during the 2000-2006 period, but reached 57 % in 2013. Furthermore, the high prices of the past helped to increase government funds and enabled public expenses and investments to grow to 44.1 % of GDP in 2014 (see table 4 and chart 6). It is worth noting that in 2009, when oil prices were also at low levels, the government was able to maintain its expansionary behaviour thanks to resources from stabilisation funds. Now this source has dried up and oil prices are unlikely to recover to previous levels - or at least not within the next few years. The 2015 budget was estimated using a barrel price of USD 79.7, but the Ecuadorian oil export price stood at just USD 53.2 in June 2015 (compared to USD 99.9 USD one year earlier), which could lead to difficulties.

Chart 5 - Government Revenues



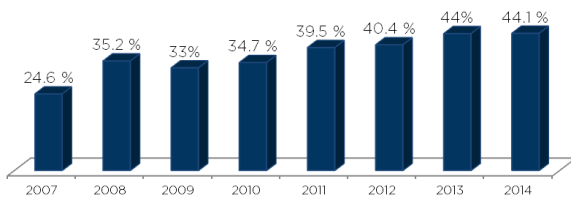
Source: Central Bank of Ecuador

Table 4

	GDP Growth Breakdown (average annual growth)					
	GDP	Household Consumption	Government Consumption	Investments	Exports	Imports
2000-2006	4.3 %	4.8 %	2.3 %	10.3 %	6 %	12.6 %
2007-2014	4.3 %	3.9 %	8 %	8.2 %	2.1 %	5.4 %

Source: Central Bank of Ecuador

Chart 6 - Total Government Expenses ( % of GDP)



Source: Central Bank of Ecuador

The government will face big challenges if it is to balance its twin fiscal and current account deficits. In 2014, the budget balance recorded a deficit of 5.3 % of GDP and a negative current account of 0.6 %. A 4 % cut was announced in the initial 2015 budget and charges and tariffs were raised. Import quality standards and tariffs were squeezed through, in an attempt to control the dangerous deterioration in the current account. The efficiency of this measure is questionable, as it may work as a palliative in the short term for trade balance, but the side effects could be worse. It has already caused pressure on prices (inflation stood at 4.4 % until July 2015, hindered local industry (which depends on imported raw materials) and deteriorated relations with foreign trade partners. Its legality is also to be reviewed by the Community of Andean Countries and by the World Trade Organization.

The dollarization of the economy, which was legalized in 2000, precludes a devaluation to adjust public accounts. The recent strengthening of the US dollar against other currencies has therefore made non-oil exports less competitive. In fact trade figures are not encouraging. Oil exports shrank sharply between January and June 2015 (by -47.2 % YoY), non-oil goods reported a marginal decline of 3 % and imports contracted by 13.3 %. The trade balance thus recorded a six month deficit, until June 2015, of USD 1.1 billion (-277.9 % compared with the same period in 2014).

Ecuador has a history of sovereign debt defaults, with the most recent being in 2008, so access to external capital is neither abundant nor cheap. Foreign direct investments stood at only 0.8 % of GDP in 2014 and may not be enough to cover the current account deterioration expected for this year – a deficit estimated at 3.3 % of GDP. Deficit in 1Q2015 stood at 0.9 % of GDP, which was the worst result for the period since 2009. This deficit was not fully offset by the capital account of +0.7 % of GDP. As at July 31 2015, international reserves stood at USD 4.8 billion, which would cover roughly only 2 months of imports.

China has become the main funder of Ecuador's government. It is estimated that from 2009 to 2014, loans from China to Ecuador exceeded USD 12 billion. However most financing has been tied to barrels of crude oil - and with lower barrel prices, a number of loans have been delayed. In order to raise reserve amounts, policymakers have already issued bonds twice this year, totaling USD 1.45 billion. Public debt is relatively low, but it increased from 24 % to 29.3 % in the year to May 2015. A national law sets a debt ceiling of 40 %, so the country's leverage should continue to increase to avoid deeper budget cuts.

Table 5

	2013	2014	2015f	2016f
<b>GDP</b>	4.6 %	3.6 %	1 %	0.5 %
<b>Inflation</b>	2.7 %	3.6 %	4.5 %	3 %
<b>Budget Balance</b> (% of GDP)	-4.6 %	-5.2 %	-5.4 %	-4.8 %
<b>Public Debt</b> (% of GDP)	24.2 %	29.8 %	34.3 %	36.6 %
<b>Current Account Balance</b> (% of GDP)	-1 %	-0.6 %	-3.3 %	-3 %

Source: Coface and IMF

## 2 SECTOR BAROMETER

Coface's sector barometer reveals the financial performance of companies in different industries, coupled with its payment experience. In the Latam region, risks have generally increased in recent months, against the backdrop of lower commodity prices and the effect on activity. Most sectors are now classified as high risk.

These results are also based on a weighted average of the countries' GDPs. The five main economies are Brazil, Mexico, Argentina, Colombia and Chile. Together they represent 83 % of the region's GDP. In a context of slower regional GDP growth, many sectors reported a deterioration of their risk perception. In this section of the panorama, we will examine the outlook for each segment.

Table 6

	Latam Sector Barometer	Panorama ▲ (February 2015)
	Risk Level	
Agro-food	●	▼
Retail	●	=
Textiles – clothing	●	=
Metals	●	=
Automotive	●	▼
Construction	●	=
Pharmaceuticals	●	=

● Moderate risk ● Medium risk ● High Risk ● Very high risk

### Agro-food: high risk

Risk for this segment has been reviewed downwards since the last Panorama. The agro sector usually works with long terms of payment and is naturally vulnerable to two factors: weather conditions and commodity prices. Brazil and Colombia were impacted by droughts, El Niño caused floods in Peru and Ecuador and Chile was impacted by both phe-

nomena. Despite these climatic issues, record crops have been observed in some countries, as was the case for Brazil and Argentina.

Despite this, producers have seen their profitability squeezed, due to increasing costs and lower international commodity prices (for example, soya prices dropped by roughly 33 % in the year to end June 2015). The region's dependence on imported fertilizer is high and all the major free floating currencies depreciated over the last year, which increased the price of imported products. The Brazilian Real and the Colombian peso in particular depreciated sharply, by -49 % and -52 % respectively, in the year to end July 2015.

**Retail: medium risk**

In most of the region's countries, the retail sector enjoyed strong growth rates over the last decade, due to the significant increase in GDP per capita. Part of this gain in income was thanks to the commodity bonanza period. Now that high prices are over, the retail segment has started to report lower growth rates.

The retail sector decelerated in Colombia, Peru and Chile. In Mexico it remained stable, as it was favoured by higher employment and decreasing inflation (at 2.7 % in July 2015, the lowest value on record). In Brazil, however, the scenario is more sensitive. After many years of robust growth, retail is expected to contract in 2015 and show the first negative result since 2003. Sales decreased by 0.5 % in the year to May 2015. Activity has been hit by high inflation (9.6 % YoY to July 2015), rising unemployment and the country's ongoing confidence crisis.

Latam's recent exchange rate depreciation has also squeezed profitability on imported goods, and on those goods which depend on imported inputs (such as electronics, home appliances and auto parts).

**Textile-clothing: high risk**

Over the last thirty years, China has become the world's largest textiles exporter. China's very low labour costs and improved openness to trade have brought it major competitive advantages. In more recent years, further countries (such as India, Turkey and Vietnam) have also become competitors, thanks to their very low labour costs.

In this context, countries in Latin America have become very dependent on imports, as the region in general has high taxes, challenges with infrastructure and high labour costs. The recent depreciations in the main free floating currencies will not be enough to offset the general lack of competitiveness. Coface maintains the assessment at high risk.

**Metals: high risk**

As China is responsible for 50 % of the world's total steel production and consumption, it plays a major role in the determination of steel prices. Many Chinese steelmakers are state-owned and decisions on how much to produce are

not necessarily connected to economic reasons. There is currently, therefore, an oversupply in the steel market, which has led to lower prices. In parallel to the supply factor, steel prices are being negatively impacted by lower world demand, mainly driven by the slowdown in investments in China.

In addition to these external factors, the domestic economic environment is not helping. In Brazil, the metals segment was also impacted by lower demand from its main customer segments, notably the automotive, construction and capital goods industries. The delicate scenario currently seen in Argentina's automobile industry has also been reflected in its metal industry. Reduced revenues from commodities are also negatively impacting the industry, due to lower investments.

**Automotive: high risk**

The automotive industry was recently reviewed to high risk. Mexico is an exception, where the risk is classified as moderate. Since the implementation of NAFTA in 1994, Mexico's auto production has taken a major leap and become export-oriented. Mexico has benefited from its proximity to the USA and its cheap labour force, which makes it very competitive. Over the first seven months of 2015, production increased by 6.7 %, sales by 20.9 % and exports by 8.9 %.

This scenario differs with other producers in the region, such as Brazil and Argentina. Brazil's automotive crisis began in early 2014 and has continued since then. From January to July 2015, production decreased by 18.1 % and sales by 21 %. Faced with economic turmoil, Brazil's population is not motivated to purchase durable goods. Around 36,000 employees (25 % of the total auto workforce) have been laid off or are in collective vacations. In Argentina, the segment is being impacted by high inflation, deteriorating wages, lower activity, the effect of the crisis in Brazil (Argentina's major trade partner in the segment) and high taxes on luxury autos.

The remaining countries generally depend on imported vehicles and auto parts. Therefore their sales and profitability were also influenced by lower GDP growth and the recent depreciations in exchange rates.

**Construction: high risk**

In Brazil the perspective is negative. In the corporate segment, this is explained by the oversupply of real estate and weak demand. This weakened demand is due to the slowdown in economic activity and the side effects of the big corruption scandal involving state-owned oil giant Petrobras. The scenario for the homebuilding segment is slightly better, due to country's housing deficit and strong mortgage credit supply. Interest rates are, however, increasing and credit supplies from public banks have become more limited. In the first quarter of 2015, construction contracted by 4.7 % compared to the same period of the previous year.

Global risks increased for all major economies. Construction was negatively impacted, directly and indirectly, by lower commodity prices. Not only did they reduce the attraction of

investing in production expansion, but they also impacted economic activity and public investment (due to lower tax revenues).

In Colombia growth slowed down to 4.9 % in 1Q2015, compared with a high of 14 % in the same period of the previous year. Despite the still-considerable rate achieved, late payments have been reported. The Mexican construction sector has also been affected by the postponement of a number of government-led infrastructure projects. In Chile, the sectorial activity index IMACON increased by 1.6 % YoY in May 2015, the third consecutive positive result after nine consecutive months of contraction. The weak result is explained by the slowdown in investments, mainly in the mining segment.

**Pharmaceuticals: moderate risk**

Despite the lower growth of disposable income in many countries in the recent period, GDP per capita improved significantly over the last 15 years. This has contributed to boosting Latam’s pharmaceutical industry. In addition, the population is ageing, leading to increased consumption of medicines. Finally, the industry is favoured by the low price elasticity of its products (as consumers tend to maintain the purchase of essential medicines, even if the macroeconomic environment has deteriorated).

**3 SECTORS**

This section will focus on two segments of the Colombian and Argentinean economies. For this edition we will examine Colombia’s retail industry and Argentina’s agro-food sector. The first has reported growth due to the weaker economic activity, while the second has been suffering from the government’s strong interventionism.

**Colombia**

**Retail: starting to feel the effect of headwinds in the economic environment**

With 47.7 million inhabitants, Colombia is the third most populous country in Latin America, after Brazil and Mexico. Retail sector spending represents around 58 % of GDP and in the last decade a positive demographic trend and increasing real incomes, emerged as strengths. This conjunction of factors made it possible for Colombia to report strong growth in retail sales in recent years. Despite this, the sector has started to feel the effects of the less favorable economic fundamentals.

Attracted by the country’s potential, many foreign retailers (such as Chilean, Mexican and Portuguese groups) have entered the Colombian market. The entrance of these big players contributed to generating employment and investment. However profitability within this market is still limited,

as incomes remain low. A new middle-class has emerged, but the percentage of households with net annual income of over USD 10,000 is projected to reach only 24 % of the population in 2015 (BMI forecast).

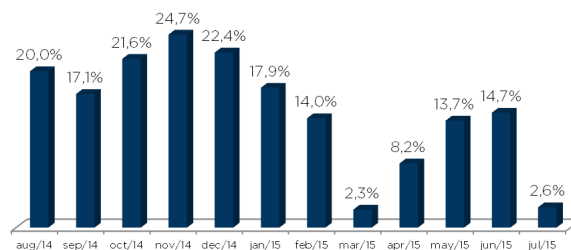
In 2014 retail sales increased by 7.7 %, but growth was not homogenously spread throughout the country. The main metropolises of Bogota and Medellin reported below average retail growth rates, at 4.3 % and 6.1 % respectively. Urban populations have been rising and entrepreneurs, aware of this movement, have increased their investments in smaller cities (some with fewer than 500,000 inhabitants).

According to the 2015 Global Retail Development Index of consulting firm A.T. Kearney, Colombia is the world 20<sup>th</sup> most attractive country for investments in the sector. Despite the strengths already highlighted, the local market does have some important weaknesses – such as infrastructure bottlenecks, high crime rates and drug cartels.

The sector’s positive trend is, however, not immune to the slowdown in the country’s activity. From November 2014 until March 2015, consumer confidence deteriorated sharply (see chart 7), driven by a bearish view of the current situation and expectations for the coming periods. From April to June 2015 it rehearsed a rebound, but in July a new sharp decline was reported. Retail sales figures for 2015 are aligned with the expectations for lower growth in the near future.

According to DANE, retail sales increased by 3.4 % from January to June 2015, against 5 % for the same period last year. This weaker result is exacerbated by the effects of: 1) the plunge in international oil prices unleashed in mid-2014; 2) the depreciation of the exchange rate (- 52 % in the year to end July 2015) and 3) higher inflation (4.42 % YoY in June 2015, against 2.79 % in the same period for 2014). The big ticket items and subcategories which rely on imports are the most impacted, such as vehicles and home appliances. Auto sales, for example, dropped by 7.9 % during the six first months of the 2015 (vs +1.2 % for Jan-June 2015). However some segments remain promising, such as e-commerce. This segment has grown, with the main retailers creating online purchase platforms and the increasing use of mobiles.

**Chart 7 - Consumer Confidence Index**



Source: Fedesarrollo <sup>2</sup>

<sup>2</sup> Fedesarrollo Consumer Confidence Index: calculated as a result of subtracting the percentage of negative answers from the percentage of positive answers to 5 questions (related to the current economic environment and expectations)



Conditions are certainly not as favourable as they were a year ago, and the economy will not return to its earlier growth path in the near future. Nevertheless, risk is expected to remain at moderate levels, thanks to the increase in GDP per capita achieved in recent years, the continuing resilience of the job market and the expected easing of price pressures in the following months.

## Argentina

### Agriculture: missing market opportunities due to the government's interventionism

Argentina, covering 2.8 million square kilometers and blessed with fertile lands, is an important agricultural player. The country is a major producer of soya, wheat, barley, sunflower and sorghum. The agricultural sector accounts for roughly 8 % of Argentina's GDP and was a growth driver in the first quarter of 2015, as the 2014/2015 season resulted in record crops. This was mainly due to one of the best weather conditions in years, with rainfall at the right time. Nevertheless, this has not necessarily meant higher profitability for farmers.

"There is no price without a market and there will be no production without price". This quote from a recent statement by the Rosario Grain Brokers Center, refers to the government's increasing interventionism and its widespread effect on the efficiency of the agricultural segment. In order to contain inflation and secure food supplies, in 2007, policymakers established an export quota system known as the Registry of Export Operation (ROE). Established with the aim of preventing local food prices being influenced by high international prices, the ROE is primarily applied to wheat, corn and beef. It limits potential exports and the quotas are established without a fixed pattern. This means that farmers' prices are artificially low, as there is no competition between the domestic and export market buyers. Export taxes are also high (see table 6) and according to estimations from the Argentina Foundation for Agricultural Development, the state absorbs over 93.5 % of rural profitability.

Table 7

Argentina Export Taxes	
Rice	5-10 %
Barley	20 %
Corn	20 %
Wheat	23 %
Soya	35 %

Source: USDA

Data from Argentina's National Institute of Agricultural Technology (INTA) reveals that the average area of wheat planted has not surpassed 5 million hectares since policymakers started to intervene in the market in 2007 (against

an average of 6.2 million hectares in the five previous years). The final planted area of the 2014/15 wheat crop was 4.2 million hectares and is expected to be 4 million hectares for 2015/16. Landowners are also discouraged from planting corn, as it is the crop which requires the highest investment and its return is significantly lower than soybean. In the face of this scenario, many farmers have shifted from corn and wheat production in favour of soya (which is not affected by export quotas).

The current economic scenario of an over-valued peso, high inflation and limited financing has forced producers to reduce their wheat and corn planting plans for the 2015/16 crop. Over a thousand producers recently protested in Cordoba, Santa Fe, Buenos Aires and Chaco. Producers are lobbying for urgent changes in the current policies, as they are also being impacted by the fall in agricultural commodity prices and by increasing costs.

The production of soya reached 60.8 million tons for the 2014/15 crop. This is a high of 17 % compared with the previous year and the best yield (53 bags/hectare) since the 2006/07 crop (49.3 bags/hectare). Despite not being subjected to the ROE system, soybean producers are challenged by high export tariffs (35 %) and strict controls. Over the past years farmers have stockpiled soybeans as a hedge against high inflation, lower commodity prices and the fear of a further strong currency devaluation (the last one was in January 2014).

The government, faced with difficulties in accessing foreign capital since its default in 2002, has pressured producers to sell them inventory in order to collect export taxes and to feed the Central Bank with scarce foreign exchange reserves stock. Under a new rule, growers are required to report their tenure certificates of deposit and warrants to the Ministry of Agriculture. The aim is to make producers liquidate their inventory faster. Furthermore, the National Bank has warned that it will close funding if producers do not sell the accumulated grain from their fields.

Argentina is blessed with good agricultural lands and weather conditions for the last crop were favourable, but the sector is capital intensive. Activity in the short term appears well-oriented, but unfortunately problems are caused due to the significant interventionism. As profitability is directly impacted, the segment is currently classified at high risk. The country will hold presidential elections on October 25 2015 and the main candidates have already argued that the segment needs reforms (such as eliminating the ROE and reducing export tariffs). However the leading candidate, Daniel Scioli, recently announced an important ally of President Christina Kirchner as his vice-president (Carlos Zanini, the incumbent Legal Secretary). This has raised the fear that interventionism is not going to step aside in the near future.

Table 8

USDA July 2015 Survey			
Argentina Production (million tones)	2013/14	2014/15 est.	2015/16 f
Wheat	10.5	12.5	11.5
Corn	26	26.5	25
Soya	53.5	60.8	57

## 4 CONCLUSION

Regional GDP has been decreasing since 2011 and 2015 will be no different. Commodity prices are not expected to increase in the near future, and these low prices are directly making negative impacts on trade balances and private investments. Falls in public investments and government expenditures (due to lower resources from taxes), are also side effects.

In a context of currency depreciation and lower revenues obtained from basic products, economies tend to shift their attention to exports of products with higher added value. Nevertheless, entrepreneurs are encountering two main hindrances: the general lack of competitiveness of local industry and the fact that currencies in other parts of the world have also reported strong depreciations against the USD in the same period.

The region's manufacturing industry has lost competitiveness over the years, due to poor infrastructure, security issues, inadequate justice, high taxes, heavy bureaucracy, limited trade agreements and low investments in research and development. Of course not all these factors can be applied to the whole region. For instance, the manufacturing industry has developed significantly in Mexico since the implementation of the NAFTA agreement. However security issues are still a sensitive point.

The other Pacific Alliance countries, Chile, Peru and Colombia, have also been increasing their trade agreement in recent years. In counterpart, Brazil and Argentina are stuck in the Mercosul agreement and still hold import barriers. In Argentina barriers are stricter, as a way to control the shortage of international reserves and in Brazil they are associated with high import tariffs in an attempt to protect local industry.

In face of the factors exposed above, the scenario will remain challenging and further increases in insolvencies may be reported.

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**Coface Brasil S.A.**  
34 João Duran Alonso Square  
Brooklin Novo District - 12 floor  
São Paulo – Brazil  
T. +55 (11) 5509-8181

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