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LATIN AMERICA 2014: ECONOMIC, LEGAL AND POLITICAL TRENDS

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CRITICAL THINKING
AT THE CRITICAL TIMETM

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Introduction

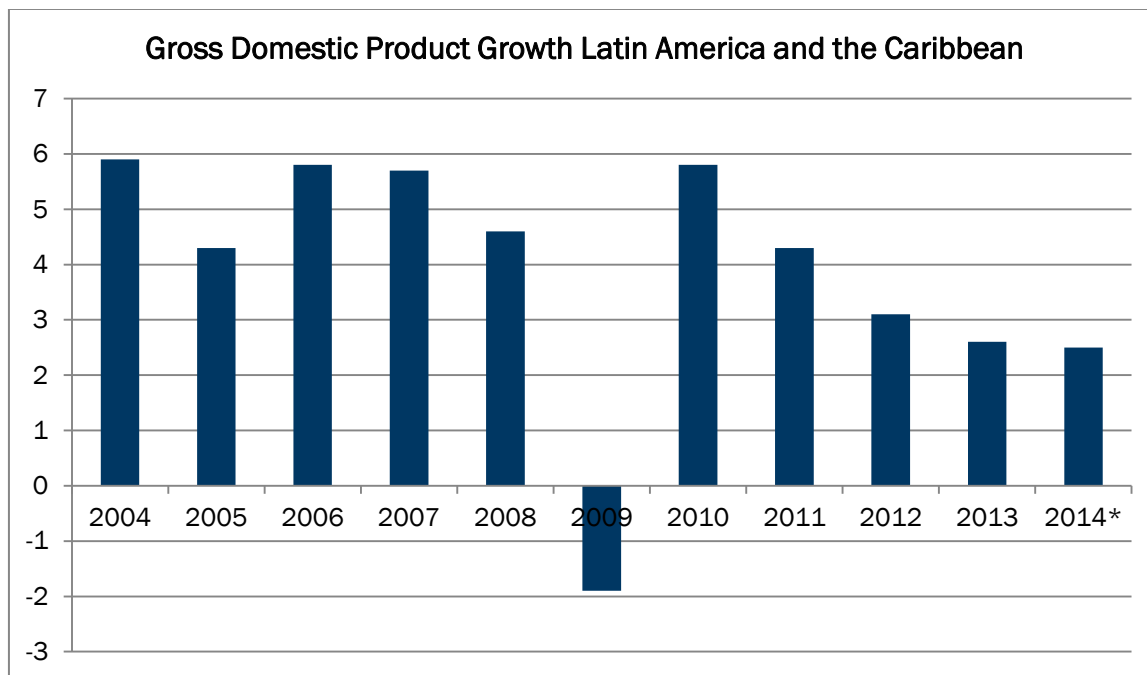
Latin America in 2014 remains a tale of many regions, underscoring ideological, economic performance and political divides among countries that once appeared to march closer in unison. The national economies are further diversified by the varied reactions to the continued volatility of the world economy. With the year well underway, some economic forecasters have trimmed their expectations for economic growth in Latin America and the Caribbean for 2014, from 2.75% to 2.5%. But domestic consumer spending, huge infrastructure projects and world demand for commodities have yielded a level of business activity where no major setback is expected in investment, mergers and acquisitions and demands for professional business services. For the moment, 2014 is not the year of drastic regional reversal, although countries still face major challenges. At the global level, both the easing of the U.S. economic stimulus and the potential for a Chinese economic slowdown will buffet the economies. The two biggest countries – Brazil and Mexico – are experiencing moderate growth. But foreign investors are still eager to take advantage of historic changes in Mexico's energy policies, as well as opportunities in other countries, especially the Andean nations. This year is a key political year, with eight countries holding presidential elections that experts agree may bring in new faces but no radical changes in economic policies. To safely take advantage of the opportunities, companies need to comply with growing regional compliance rules. The new anti-corruption law enacted in Brazil in early 2012 now imposes liabilities on corporations for corruption of government officials. Mexico enacted an anti-corruption law in 2012, and Chile gave teeth to its anti-corruption rules by criminalizing the offering of bribes to government officials. These jurisdictional laws are in addition to the existing U.S. Foreign Corrupt Practices Act and the British anti-corruption legislation, the Bribery Act of 2010.

Economic Trends

In the first economic forecast for the region, the Economic Commission for Latin America and the Caribbean late last year predicted the region's average rate of economic growth to rise to 3.2% in 2014, with much of the growth spurred on by higher domestic demand. In March, the Inter-American Development Bank issued its forecast of 3% economic expansion for the region in 2014 and 3.5% next year as the countries in the European Union and the United States recover from the recent recession. But just days later, the International Monetary Fund made a modest cut in its economic forecasts, from 2.75% to 2.5% in 2014, based on greater volatility in emerging markets and other pressures on the regional economies. The experts agree growth will be moderate, although the region experienced better performance during the commodity boom of the prior decade.

Even the regional average hides stark differences in performance, with Panama expected to lead the region with a 7% growth rate, and strong growth averaging 4% to 5% in the Andean nations. But Venezuela and Argentina represent the other side of the economic performance divide, as the two economies experience high inflation, weak growth and risks of currency devaluations and capital flight. The strength of much of the region can be viewed as Mexico, Colombia, Peru and Chile remain favorites for foreign direct investment, boosting mergers and acquisitions.

Both Brazil and Mexico experienced modest economic growth in 2013, one of the reasons the region's overall expansion rate was so low. The latest economic forecasts show Brazil expanding by less than 2% in 2014; and economists also see Mexico recovering slowly. However, Mexican Finance Minister Luis Videgaray is on record forecasting the Mexican economy will grow by just under 4%, a major improvement over 2013. The outlook is particularly good for Mexico, which is now writing the enabling laws, or "secondary legislation," to implement its historic reform of the energy sector that opens oil and gas exploration and production and national electricity to greater private foreign and domestic investment. The legal regime has been bolstered by increased confidence based on recent enforcement actions by the administration of Mexican President Enrique Peña Nieto.



Sources: *United Nations Economic Commission for Latin America and the Caribbean; International Monetary Fund*
*Forecast

U. S. public companies with operations in Latin America have highlighted in the risk factor disclosure sections of their public filings, certain recent trends in economic and social events that are likely to affect their businesses. The risk factor disclosure requirements for public companies are a necessary part of such companies' registration statements for securities offerings and periodic financial statement filings. The examples of economic and social trends public companies doing business in the region have recently disclosed as risk factors to their businesses include (i) risks associated with operations in Venezuela due to government actions related to business and currency regulations; (ii) exchange, import authorizations or pricing controls in certain countries, including Venezuela and Argentina; (iii) high levels of currency, political, compliance and economic risk in certain countries, including Argentina, Brazil and Mexico and (iv) violence and crime in Mexico. Aside from social and economic trends, public companies also disclose risk factors associated with companies' compliance with regulatory requirements, including compliance with anti-corruption laws. For example, one public company doing business in Mexico disclosed that the company might have "difficulty in international markets due ... to regulatory barriers, the necessity of adapting to new regulatory systems and problems related to markets with different cultural biases and political systems and strict adherence to all anti-corruption laws including the United States Foreign Corrupt Practices Act." The recent devaluation in Argentina as well as the effects of the devaluation on other countries in the region is likely to be included in risk factors disclosure by public companies doing business in the region. It is likely that given increased scrutiny by regulators regarding compliance with anti-corruption regulations, as well as shareholder litigation alleging inadequate disclosure of risks, that companies will need to focus more closely on identifying and disclosing potential risks facing them in the region.

Economic Indicators

Inflation

Venezuela and Argentina are suffering from high inflation rates, with the rate in Venezuela officially reaching 57% in February as the country suffers from a shortage of basic goods. The Argentine government reported its inflation rate was 10.9%, while private economic consultants believe the rate was almost three times as much. Both countries are experimenting with price controls. Brazil also has regulated prices for some state-controlled firms. High inflation rates mean fewer government policy choices.

Currencies

Venezuela, Argentina and, to a lesser extent Brazil, all are facing overvalued currencies. In both Argentina and Venezuela, the unofficial exchange rate is much higher than the official rate, reflecting a higher demand and lower supply of U.S. dollars. In Caracas, the government of President Nicolas Maduro has established a series of exchange rates, ranging from official rates of 6.3 bolivars to \$1 to alternate rates that are around 55-55 bolivars to \$1. In parallel markets, the greenback is worth more than 10 times the official rate. While cross-border transactions involving Venezuelan companies are few under best of circumstances, the currency issues and exchange restrictions will continue to negatively impact transactions involving Argentine and Venezuelan companies. As the Venezuelan government restricts access to dollars, international companies, particularly airlines, have found their ability to repatriate earnings restricted. Argentina witnessed its exchange rate drop from 6 pesos to \$1 to 8 pesos to \$1 in January, while the Brazilian real has also been losing value against the dollar, dropping to 2.32 to \$1 in March. Other countries, such as Chile and Colombia, will also face pressures on their currencies. Mexico is expected to see its currency strengthen in 2014, according to financial analysts.

Commodity Prices

The region is coming off a period of historic highs for commodity prices, from soy beans to copper, oil and iron ore. This allowed countries that exported minerals, ores, agricultural goods and oil and gas to vastly increase the volume and revenue. Additionally, this spurred greater foreign investment, particularly in the oil and gas sector throughout the Andean region.

“It was a phenomenal decade,” said Gray Newman, chief economist for Latin America at Morgan Stanley. “If you look at Chile, Peru, Colombia, Brazil, Argentina – excluding Mexico – all of them saw one of the biggest upticks in their terms of trade.”

Newman is quick to point out that while commodity prices have fallen from the highs of recent years, prices are still higher than in the past and he does not see a complete reversal of the favorable trends for the commodity-exporting nations of the region. Instead he views the economic recovery in developed countries, like the United States, as helping emerging markets, such as Brazil, make the transition as commodity prices drop.

The commodities boom did mean that more industrialized countries like Brazil entered a period of deindustrialization as overvalued currencies and plentiful export earnings pushed up the prices of manufactured goods and lowered exports – risking different parts of the manufacturing sector. This change in Brazil is part of the transition underway in the country’s economy.

A drop in oil prices forecast by some economists for this year has not taken place. Instead, uncertainty in Ukraine has pushed oil prices higher for the year. But economists still believe continued slowdown could push oil lower, and some believe that Ecuador would be the most vulnerable country to a falling price of petroleum. But clearly Venezuela is also vulnerable since it turned to borrowing in 2013 as its falling oil production and rising non-cash oil sales to China to repay loans meant dwindling oil revenue to fund its spending. On the flip side, countries in the Caribbean and Central America would benefit from lower energy prices.

Foreign Direct Investment

Foreign investment was 18% higher in the region in 2013, reaching US\$294 billion, according to figures from the United Nations Conference on Trade and Development. Large increases in Mexico, Central America and the Caribbean helped offset a fall of 3.9% in foreign direct investment in Brazil, the largest recipient of FDI in the region. Brazil, Chile and Mexico rank among the top 20 countries of the world that are large recipients of foreign direct investment. Latin American foreign direct investment across borders into countries like the United States was lower in the first half of 2013, but large corporations in the region continue to expand with global purchases, such as the Mexico’s Grupo Bimbo’s planned \$1.83 billion acquisition of Canada Bread, announced in February 2014. Mexican energy sector investments as well as infrastructure investment throughout Columbia, Peru and Chile coming to market could boost FDI in 2014.

Trade Deficits

The overall current account deficit rose from 1.8% of the GDP to 2.5% of the GDP, a large jump because of higher imports and falling commodity prices. But this amount is lower than it has been in the past. Surging current account deficits have always spelled trouble in the past, but for the major countries of the region, the current account deficits are not likely to be a major concern this year.

Tighter Budgets

Lower commodity prices, higher borrowing costs and tighter international financial markets will squeeze government spending in 2014. A number of governments, such as Chile and Brazil, have pledged to increase education and social spending to deal with social protests in 2013. Rising expectations and tighter budgets will present governments with challenges.

With the United States headed into an era after the Federal Reserve's "Quantitative Easing," Latin America could face higher borrowing costs, which would come as earnings from commodities continue to fall and governments search for funds to maintain or increase social spending. Any abrupt shift in U.S. interest rates could cause problems in the short run, but no one is predicting that higher interest rates would trigger major financial problems in Latin America and the Caribbean. Instead, economists see 2014 as a year of continued financial adjustment as lagging economies continue a measured recovery.

Political and Social Events Affecting the Region

Politics – The Ideological Divide

There is no unified pattern or theme in the current Latin America politics except that the ideological divide continues. But beyond the divisions between more left-oriented and right-oriented governments; there are signs of citizen weariness with current governments, the status quo and the failure to resolve some of the problems that residents face in everyday life, such as education and transportation. Frustration with the status quo was illustrated by the resounding election of Michelle Bachelet for a new presidential term in Chile, where she pledged to make universities more accessible for students. Bachelet's win also brought a new record for the region. Three of the largest countries in South America – Argentina, Brazil and Chile – are all led by women presidents.

Costa Rican voters elected an outsider for the first time in decades as leftist Luis Guillermo Solís from a third party won in an April 6 run-off, after his opponent dropped out of the race. In El Salvador, leftist FMLN Party candidate Salvador Sánchez Cerén recently won another four years for the FMLN by beating his ARENA party contender by the slimmest of margins.

But elsewhere, in Panama, Colombia, Brazil, Bolivia and Uruguay, polls show high chances voters will re-elect the same leader or party, with conservative candidates projected to win in Panama and Colombia. But with months before Brazilian elections, President Dilma Rousseff's popularity has been slipping in what will be an important election coming after the country hosts the World Cup. President Rafael Correa in Ecuador is highly popular; and even President Nicolas Maduro pulled off a victory for his Bolivarian revolution side in municipal elections last December. But the elections, questioned over the fairness of the voting, are not the only chapter in divisive politics in that country. The recent protests in Venezuela have underscored the deep middle-class discontent with the economic shortages, the stagnant economy and the politics of the Maduro government. Although his government has weathered the storm for now, and there are ongoing efforts to bring the different sides in the conflict to hold a dialogue, no consensus has emerged, dimming hopes for a better economy that could spell improvements in trade or company transactions. "For Venezuela, this is really the lost decade," said Russ Dallen, managing partner at Caracas Capital Markets. "Chavez, he left nothing, he left a mess. This is a lost generation."

The impact on the business and legal environment of many of these elections varies by country. In Chile, the return of President Bachelet is not expected to have much impact on the continued focus on public-private partnerships and related financings. On the other hand, in Ecuador, the implementation of higher bank taxes to finance a welfare program in advance of local election in February has hit the bottom line of financial institutions in that country. In addition, the recently enacted restrictions on shareholders of financial institutions exhibit some of the lengths that politicians will go to retaliate against political opponents (such as banker-turned-politician Guillermo Lasso, who is already a candidate in the 2017 presidential elections).

The region also lacks a moderate president who can bridge the differences between ideological groups and work to achieve compromise or at least dissipate threats of violence. This was a crucial role played by former Brazilian President Luiz Inácio Lula da Silva. No other leader has stepped into this position, and there are no signs yet that any of the newer presidents will attempt to raise their profile in regional leadership, although UNASUR, or the Union of South American Nations has attempted to mediate in the Venezuelan conflict. The lack of a leader to bridge differences exacerbates disputes, but could allow political space for the United States or the European Union to act as mediators.

Countries like Chile, with greater consensus around economic policy (although this was challenged by numerous student protests over inequality), have underscored that such a consistency has led to steady economic expansion. President Bachelet referred to the vital need for consensus in her inaugural speech on March 11. "It is time to begin together the journey to that developed, just, modern, tolerant and prosperous nation that we deserve," she said.

Mexican President Enrique Peña Nieto also used a unique pact with the opposition of the right and left to forge crucial reforms, particularly a constitutional amendment to open the energy sector to private national and international investment.

Another political trend is the absence of a charismatic and uniting figure on the left with the retirement of Fidel Castro and the 2013 death of Venezuelan President Hugo Chavez. An important question raised by Chavez's departure from regional politics and growing economic pain in Venezuela is the future of Venezuelan "low-cost" oil for many of the smaller countries.

A Flurry of Presidential Elections in 2014

Chile – President Michelle Bachelet was returned to the presidency after four years out of office

El Salvador – Salvador Sánchez Cerén, the candidate of the leftist FMLN party, won by a very slim margin in March 9 elections that allowed the FMLN to retain power

Costa Rica – Third-party candidate Luis Guillermo Solís won the presidential run-off election on April 6

Panama – Presidential elections to be held on May 4.

Colombia – Presidential to be held on May 25

Brazil – Presidential and Congressional elections to be held on October 5

Bolivia – Presidential elections to be held on October 5

Uruguay – Presidential elections to be held on Oct. 26

United States and Its Growing Energy Production

The growing strength of U.S. oil and gas production will have two lasting effects on Latin America. First, energy self-sufficiency in the United States will reduce reliance on the region, with all the trade, economic and political effects. Second, cheaper energy in the United States will help reduce manufacturing costs and are expected to spur manufacturing as oil and natural gas are transformed into petrochemicals and other manufactured products. While this will not dent regional trade flows in the short term, it could boost the nascent rebirth of U.S. manufacturing and have important consequences for Latin America. As manufacturing grows in the United States, this will present an opportunity for Latin American regional corporations to invest in or acquire U.S. facilities to stay competitive or spur on regional production sharing for Latin American corporations and multinationals seeking the most efficient production and trade locations.

China

The Asian giant is looming larger than ever in trade and investment in Latin America, snapping up assets, extending loans to be repaid with oil and investing in giant infrastructure projects, all in the name of its economic interests. In Nicaragua, for instance, all eyes are on the proposal by a Hong Kong business leader to build a new canal across the country, fulfilling a dream of the 19th Century.

In recent years, 20% of China's overseas investment has been directed to Latin America to open up new markets and also gain access to raw materials for China, such as copper, oil, soybeans and others. In addition, China is a major lender. Chinese development banks in the past year lent more to Latin America than the International Monetary Fund, the World Bank and the Inter-American Development Bank combined. China has become Ecuador's main banker in return for oil, which is being shipped to the United States and other consumers, and not necessarily to China. China has loaned Ecuador \$9 billion and has made promises of \$7 billion more in lending. One-third of Venezuela's oil exports go to China to repay loans, with the government reporting that the petroleum shipments have repaid some \$20 billion.

Still China is also learning that investing in Latin America is not always a smooth undertaking. A \$10 billion pledge from China to help build a highway in Argentina never was acted on and now there are doubts as to a Chinese financing of the \$21.6 billion construction of two hydroelectric projects along the Santa Cruz River. Opportunities remain, however, for greater economic ties between China and Latin America.

Mexico's Energy Reform

The historic energy reform approved by Mexican Congress in December has sparked global interest in Mexico since this change will allow private national and international investors to hunt for oil and gas in Mexico for the first time in nearly eight decades. It is Mexico's bid to re-energize their ailing oil sector and boost economic growth. The change is said to allow companies to list crude reserves as assets for accounting purposes, a stipulation that was keenly sought by international companies because it will allow them to access project financing. The oil remains the property of the state until it is pumped. Still the details remain to be unveiled. The National Congress is still awaiting the new laws that will implement the constitutional reform over oil and gas and electricity and put into place new regulations. Potential investors will be looking at these rules for the types of contracts related to exploration and production, the transparency of the bidding process, new competition rules, clear legal contexts, as well as environmental laws, all part of the risk factors that will be weighed alongside the potential of high returns.

Mexican President Enrique Peña Nieto also announced a \$316 billion infrastructure plan to build or improve railroads, roads and ports. Observers remain upbeat.

Greater Demands for Compliance – Within the Region and Internationally

While corporations and observers wait to see how Britain intends to enforce the UK Bribery Act of 2010, Washington has pursued enforcement of the Foreign Corrupt Practices Act, which saw a number of large fines from cases that had been under investigation. Hewlett-Packard recently agreed to a fine of \$108 million to settle FCPA violations in three countries, including Mexico. But Latin America has also been enacting anti-corruption rules, particularly Brazil. The country lacked anti-bribery rules for corporations previously, but a January 2013 law now imposes liability on both individuals and corporations. Social unrest in Brazil last year showed how deeply populations reject corrupt practices as “business as usual.”

Chile tightened the rules of a 2002 anti-corruption law in 2009, making offering compensation or bribes to public officials a criminal offense, and extending jurisdiction to bribery of foreign officials. The Anti-Corruption Law in Mexico, enacted in 2012, holds both individuals and corporations accountable for offering bribes or payments. Like Chile’s laws and the FCPA, this law has extraterritorial reach, extending to Mexican citizens or companies acting abroad. With the pro-business administration holding the presidency in Mexico, enforcement of the law is expected to be more consistent and even-handed.

While the administration in Colombia seeks to bolster its enforcement of the Anti-corruption Act of 2011 and further empower the relatively new anti-corruption office in the Presidency, the country has not improved on its worst score in more than 10 years on the Transparency International’s 2013 Corruption Perception Index, maintaining its ranking of 94 in 2013 (as compared to a ranking of 57 in 2002).

Regional Violence

Domestic and foreign companies normally include security and safety costs in their operating budget. But for companies in higher risk areas, ranging from Mexico and Venezuela to Central American countries like Honduras and Guatemala, drug and gang violence, regular crime and other risks mean planning and attention paid to keeping employees and facilities safe. Companies face increasing pressure to maintain safety, as governments grapple with measures from increasing military participation in trying to curb the violence to trying to work through social networks to reduce gang violence. Mexico’s new government still faces major challenges in reducing the drug cartel-related violence, but 2014 could be an important year in opening new fronts.

Colombia could also gain economic dividends if the government and the Revolutionary Armed Forces of Colombia, the FARC, reach a peace accord to end the longest and currently the only leftist guerrilla conflict in Latin America.

For U.S. companies and other foreign companies starting operations in areas of violence or where gangs charge protection payments, the stakes are even higher. For example, parts of Mexico with possible rich reserves of shale gas are also areas of drug cartel violence. Direct payments or through third-party vendors could bring major legal problems with U.S. authorities or local government, requiring the close attention to the legal regime.

But while government law enforcement actions can help stem violence, the issue of education, jobs and opportunity remains a major challenge across the region. Larry Birns, the director of the Council on Hemispheric Affairs in Washington, said ultimately Mexico needs to ensure that the expected economic gains from the energy reform benefit all levels of society. “If Peña Nieto doesn’t produce a country whose wealth is less concentrated, then the country could face trouble.”



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