
Country Forecast

Latin America

Regional overview

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London

The Economist Intelligence Unit
26 Red Lion Square
London
WC1R 4HQ
United Kingdom
Tel: (44.20) 7576 8000
Fax: (44.20) 7576 8500
E-mail: london@eiu.com

New York

The Economist Intelligence Unit
The Economist Building
111 West 57th Street
New York
NY 10019, US
Tel: (1.212) 554 0600
Fax: (1.212) 586 0248
E-mail: newyork@eiu.com

Hong Kong

The Economist Intelligence Unit
60/F, Central Plaza
18 Harbour Road
Wanchai
Hong Kong
Tel: (852) 2585 3888
Fax: (852) 2802 7638
E-mail: hongkong@eiu.com

Website: www.eiu.com

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Fact sheet

Latin America	2007	Historical averages (%)	2003-07
Population (m)	544	Population growth	1.4
Population growth (%)	1.4	Real GDP growth	4.6
GDP (US\$ bn; at market exchange rates)	3,435	Real domestic demand growth	5.3
GDP growth (%)	5.4	Inflation	6.9
GDP per head (US\$; at market exchange rates)	6,312	Current-account balance/GDP	1.1
GDP per head (US\$; at purchasing power parity)	9,888	FDI inflows/GDP	2.8
Inflation (av; %)	5.4	Debt/exports of G&S	114.7

Background: Military rule and populist economic policies created instability in Latin America for much of the second half of the twentieth century. A debt crisis that started in 1982 threw the region into recession and triggered political changes as military governments fell and economic policies became less nationalist and more market-oriented. The region is now generally much more stable, but a re-emergence of populist and nationalist sentiment has become a source of concern, particularly—but not exclusively—among the more politically unstable natural-resource intensive economies, and very high crime rates plague many countries, including the largest, Mexico and Brazil.

Political structure: Except for Cuba, all countries have democratically elected governments, most with strong presidencies. Although there is little risk of a return to military rule, confidence in institutions and the political class has fallen during the past decade, reflecting the persistence of widespread un- and underemployment and income inequalities. The loss of support for mainstream parties is leading to more difficult legislative environments and has fuelled instability in several countries (Bolivia, Ecuador, Venezuela). Colombia appears to be gradually emerging from a decades-long guerrilla conflict.

Policy issues: Import-substituting industrialisation policies were abandoned in the 1980s-90s, when trade and investment regimes were liberalised across the region. Most countries have floating exchange-rate regimes, usually supported by an inflation-targeting framework. Government finances remain weak in many countries, despite reforms. Latin America has made a large adjustment in its external accounts in recent years, but the combination of a still-heavy burden of external indebtedness and a rising stock of foreign direct investment (FDI), which generates outflows in the form of profit remittances and dividends, means that its external financing requirement will remain high, leaving the region exposed to the international liquidity cycle. The continued predominance of primary commodities among the region's exports has enabled it to benefit from very high world prices in recent years, but constitutes a persistent structural vulnerability. Many, particularly the smallest, countries in the region, have become highly dependent on family remittances from emigrant workers, mostly in the US and Europe. Low skills levels remain a major weakness. Labour-intensive manufacturing export industries (mostly textiles and apparel) are now under threat from rising Asian competition.

Taxation: Most regional tax systems rely heavily on indirect taxes and royalties from minerals extraction. Efforts to raise generally low levels of tax collection are often thwarted by a culture of tax evasion and weak institutional capacity.

Foreign trade: The region has become more open. The US remains the main export market for most countries, although trade diversification has increased. China is a growing market for the region's raw materials' producers. Mexico accounts for around 40% of regional trade.

Leading markets 2007	% of total	Leading suppliers 2007	% of total
US	40.3	US	33.8
EU	14.7	EU	14.9
China	5.6	China	7.2
Canada	3.3	Japan	4.6

Summary

Rising military spending in South America

- Janie Hulse discusses the factors driving a rise in military spending in South America in recent years, the increase in arms purchases from non-traditional suppliers such as China and Russia amid declining US influence, and the prospects for developing South America's home-grown defence industries.

Corruption: the cost of doing business in Latin America?

- Sebastian Freille discusses corruption in Latin America and the Caribbean, and its impact on the business environment. Patronage politics, red tape, weak institutions and widespread informality are among the chief aggravating factors. Only Barbados, Chile and Uruguay ranked among the world's 30 least-corrupt nations in 2007, but there have been some advances in a few countries.

Political outlook

- The most important election for the region will take place in the US in November as its outcome will set the tone for US-Latin American relations until at least 2012. Electoral activity in Latin America will be stepped up in 2009-10. The majority of left-wing governments espouse broadly pro-market policies, and administrations sympathetic to the Venezuelan president, Hugo Chávez, which hold power in Bolivia, Ecuador and Nicaragua, will face more pressure to temper their radicalism. Most governments in the region do not control a working majority and legislative fragmentation will constrain political effectiveness.

Economic forecast

- Latin America is the most heavily dependent of all the world's regions on the US in terms of trade, remittances and financing flows. However, it will be more resilient in the face of this US recession than it was in 2001, owing to improved fundamentals underpinning domestic demand growth and some export diversification. Regional growth is forecast to slow from 5.4% last year to 3% by 2009 before rising to 4% per year in 2010-12, led by domestic demand. Inflation poses the main risk to domestic demand in the remainder of 2008-09.

- A combination of policy improvements and favourable international conditions have allowed the region to strengthen its external accounts in recent years. But the rise in the financing requirement, to levels not seen since the late 1990s, is an important source of concern. Although the region will be able to weather the US recession, growth and exchange rates will not be immune from the international financing crisis or from commodity price swings.

- Business environments are not expected to improve rapidly enough to prevent most countries slipping down the Economist Intelligence Unit's global rankings. Wide income inequalities will curb the growth of consumer markets.

Key indicators

	2007	2008	2009	2010	2011	2012
GDP growth (% real change)	5.4	4.1	3.0	3.9	4.0	4.0
Consumer prices (av)	5.4	8.2	8.0	6.5	6.0	5.3
Current-account balance (US\$bn)	22.6	-4.6	-31.8	-48.4	-58.4	-65.7
Current-account balance (% of GDP)	0.7	-0.1	-0.7	-1.0	-1.2	-1.3
External financing requirement (US\$bn)	-94.0	-117.7	-141.7	-155.4	-168.1	-175.6

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All queries: Tel: (44.20) 7576 8000 E-mail: london@eiu.com **Next report:** Full schedule on www.eiu.com/schedule

Basic data, 2007

	Population (m)	GDP (US\$ bn)	Per head (US\$)	GDP at PPP (US\$ bn)	Per head (PPP; US\$)	GDP growth (% change)	Inflation (av; %)	Current-account balance (% of GDP)
Argentina	39	262	6,665	524	13,306	8.7	8.8	2.7
Bolivia	10	13	1,360	40	4,159	4.6	8.7	13.7
Brazil	189	1,314	6,938	1,836	9,695	5.4	3.6	0.2
Colombia	47	172	3,664	321	6,841	7.5	5.5	-3.4
Chile	17	164	9,876	231	13,896	5.1	4.4	4.4
Costa Rica	4	26	5,869	44	9,900	6.8	9.4	-5.8
Dominican Republic	9	44	4,701	90	9,692	8.5	6.1	-5.1
Ecuador	14	41	3,035	99	7,257	1.9	2.3	2.6
El Salvador	7	22	3,261	29	4,231	4.7	4.6	-5.1
Guatemala	13	42	3,171	77	5,758	5.7	6.8	-3.9
Honduras	7	12	1,733	26	3,710	6.3	6.9	-9.9
Jamaica	3	11	4,013	13	4,777	1.2	9.5	-17.0
Mexico	109	893	8,219	1,346	12,381	3.3	4.0	-0.8
Nicaragua	6	6	948	18	2,951	3.5	11.1	-18.1
Peru	29	109	3,787	219	7,615	9.0	1.8	1.4
Paraguay	6	12	1,896	27	4,420	6.4	8.1	5.1
Panama	3	20	5,920	46	13,803	10.8	4.2	-8.0
Trinidad & Tobago	1	21	15,886	23	17,438	5.5	7.9	16.3
Uruguay	3	23	6,953	37	11,230	7.4	8.1	-0.8
Venezuela	27	228	8,359	335	12,261	8.4	18.7	8.8
Regional totals	544	3,439	6,320	5,381	9,888	5.4	5.4	0.6

Latin America and the Caribbean: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Trinidad and Tobago, Uruguay and Venezuela

Latin America 12: Argentina, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Mexico, Peru and Venezuela

Mercado Común del Sur (Mercosur, the Southern Cone customs union): Argentina, Brazil, Paraguay, Uruguay and Venezuela (pending ratification)

Comunidad Andina (CAN, the Andean Community): Bolivia, Colombia, Ecuador and Peru

Central America: Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama

Rising military spending in South America

By Janie Hulse, a Latin America research analyst based in Buenos Aires, Argentina, www.researchfromthefield.com

Introduction

South America remains one of the lowest military spending sub-regions in the world in terms of absolute spending, but there are signs that this is beginning to change. Military spending by South American governments has surged over the last few years. Rising government revenue fuelled by high prices for oil and other commodities is largely responsible for the military build-up, but there are strategic factors at play as well. Venezuela's president, Hugo Chávez, led the region's return to the arms market by purchasing US\$4.4bn in weapons between 2003 and 2006. Over the past decade, neighbouring Colombia, which is contending with a decades-long guerrilla insurgency, has steadily built up its weaponry with the help of more than US\$5bn in US counter-narcotics and military aid. Further south, Chile's arsenal has undergone a decade of steady modernisation paid for by the country's booming copper sales. Brazil has followed suit and is now at the forefront, spending over US\$1bn on weaponry in 2006 alone and exponentially increasing its military budget over the last few years. In fact, the region's largest economy, Brazil, was ranked amongst the world's top 15 spending countries in 2007 by the Stockholm International Peace Research Institute (SIPRI). With military expenditure of US\$15.3bn in 2007, Brazil now ranks 12th after South Korea (US\$22.6bn) and ahead of Canada (US\$15.2bn). Although Brazil's military spending makes up only 1.1% of the world's total, its share is likely to climb as it aims to build a military worthy of its projected stature as one of the world's biggest economies by 2050—military spending in Russia accounted for 2.6% of global defence spending in 2007 and in India it accounted for 1.8%.

Increased military spending by Brazil and other key South American nations (Venezuela, Colombia and Chile) is driven by various factors and has significant implications. The governments' rationale for the purchase of new and different equipment includes years of economic growth combined with revised foreign policy objectives based on real and perceived threats and stepped-up military involvement in multilateral peacekeeping operations. A clear trend toward increased equipment purchases has significant implications for governments and businesses in the region. There is growing international competition from non-traditional supplier countries such as Russia and China and increased opportunities for small and medium size businesses within the region. This article will put South America's military spending and priorities into historical and geopolitical context, with a particular emphasis on the largest spending countries: Brazil, Colombia, Venezuela and Chile. It will consider the resulting prospects for a strengthening of South America's defence industry.

Global military spending, 2007

(US\$ bn unless otherwise indicated)

	Country	Spending	Spending as % of GDP	World market share (%)
1	US	546.8	4.0	40.8
2	UK	59.7	2.8	4.5
3	China	58.3	0.8	4.4
4	France	53.6	2.6	4.0
5	Japan	43.6	1.0	3.3
6	Germany	36.9	1.3	2.8
7	Russia	35.4	1.7	2.6
8	Saudi Arabia	33.8	6.1	2.5
9	Italy	33.1	1.9	2.5
10	India	24.2	0.8	1.8
11	South Korea	22.6	1.9	1.7
12	Brazil	15.3	0.8	1.1
13	Canada	15.2	1.2	1.1
14	Australia	15.1	2.0	1.1
15	Spain	14.6	1.1	1.1
	Total (incl other countries)	1,339.0	2.9	100.0

Source: Stockholm International Peace Research Institute; Economist Intelligence Unit.

Military spending suffered following the 1980s democratisation wave

South American countries have weathered major economic and political storms over the past four decades but have emerged better positioned to integrate themselves into the global economy. Most countries, with the notable exception of Colombia, the South American region's longest-standing democracy, were ruled by military dictatorships starting in the early 1970s and lasting until the mid-to-late 1980s. It was a time of high military spending mostly geared toward sustaining the large government bureaucracies and counter-insurgency efforts. This expenditure proved unsustainable in the face of protracted macroeconomic crises and a collapse in growth rates beginning in the early 1980s. The return to democracy led to all but the dismantling of the countries' military organisations—Chile was an exception with laws in place protecting the military institutions. This was mainly because, unlike in neighbouring countries, the economy flourished under military rule in Chile, so the armed forces relinquished power with considerable prestige. Throughout the late 1980s and the 1990s, most militaries lost credibility and suffered from years of political and financial neglect, reducing their missions to mere survival and leaving equipment to deteriorate.

More detached relations with US has led to diversification of military suppliers

Although the motivation was largely political, the adherence of many governments to the economic policies of the “Washington Consensus”, which was strongly promoted by the US Treasury and Washington-based financial institutions, namely the IMF and the World Bank, also contributed to a slashing of military budgets as the governments actively rolled the state back through privatisations and downsizing. Moreover, the US, then South America's biggest military equipment supplier, banned the sale of advanced weaponry to the region from 1978 to 1997. Government mismanagement, economic downturns and several major set-backs such as the Brazilian 1998-99 currency crisis and Argentina's debt default and economic collapse in 2001/02 revealed the weaknesses of the one-size-fits-all approach to development. As a result, the US

Recent commodity boom has helped governments step up military spending

government and international financial institutions lost credibility in the region, and defiance and disassociation from US foreign policy became the norm at the beginning of this decade. It also led some regional governments to court non-traditional military suppliers to the detriment of US-based defense contractors.

After faltering in the late 1990s and early 2000s, many countries in South America have again experienced healthy growth rates since 2004 thanks to a combination of policy improvements (which have reduced external vulnerabilities), surging commodity prices and robust Asian demand. Awash with cash and with a newfound sense of independence, South America has looked to countries such as Russia and China to re-equip their militaries after more than 30 years of neglect. Brazil, one of the world's four largest emerging market countries along with Russia, India and China (collectively known as the BRICs) feels it requires a more respectable military organisation to accompany (and in part allow for) its ascent on the world stage. Colombia, which may be in the last throes of an internal, decades-long guerrilla war has continuously invested in its military, but even there spending is increasing owing to a more hardline approach toward insurgents taken by the president, Álvaro Uribe, along with generous financial assistance from the US. Venezuela, flush with oil revenue, is bolstering its military, supposedly to protect itself from a potential US invasion but also as a means to secure military support for Mr Chávez, its leftist-populist president. Chile's spending spree is a by-product of a law left over from the period of military rule (1973-90) that requires it to use 10% of copper export revenue on military equipment purchases. Argentina is the major exception. Despite five years of annual average GDP growth in excess of 8%, and a desire to recover a greater role on the world stage, increasing military spending has not been on the agenda, not least because reconciliation between the armed forces and political parties remains distant. One of the most popular initiatives of the president Cristina Fernández de Kirchner, and her husband and predecessor, Néstor Kirchner, has been the priority they have accorded to efforts to bring military personnel involved in abuses during the military dictatorship to justice.

South American arms purchases have traditionally largely consisted of acquiring used equipment left-over from the great power conflicts. What is new about the current spending spree is that countries are buying more new, state-of-the-art aircraft and vehicles, some of which are produced in Latin America. Although they continue to buy used equipment, the region's major military establishments can now afford significant quantities of new equipment. A country-by-country overview of military priorities and recent purchases by some of the region's biggest spenders follows. These are by no means exhaustive lists but provide a general idea of what countries are buying, from where and for how much.

Military spending

	GDP (2007, US\$ bn)	Military spending (as a % of GDP)
Colombia	172	3.4
Chile	164	2.7
Brazil	1,314	2.6
Venezuela	228	1.2

Sources: Economist Intelligence Unit; The Central Intelligence Agency, *CIA World Fact Book*.

Brazil's military budget has risen sharply in recent years

As by far the largest country in South America, Brazil aims to create a proportional military power. Brazil's armed forces are respected internationally for their professionalism and they are relatively well-equipped thanks to a large national arms industry. However, until the current minister of defence, Nelson Jobim, took office, the defence budget was relatively small and the leadership of the Ministry of Defence was weak. Indeed, before 1999, Brazil didn't have a defence ministry that integrated the armed forces under unified strategic leadership. Prior to the 1990s, Brazil capped annual military spending at around 1.8% of GDP.

Brazilian army's focus extends to urban crime and protecting the Amazon

Starting in 2004 the importance of Brazil's military started to rise thanks to campaign promises made by the president, Luiz Inácio Lula da Silva. One specialist claims that Lula's promises to support and re-equip the military eased tensions amongst the armed forces and enhanced his electability as a left-leaning Partido dos Trabalhadores (PT, Workers Party) leader. Brazil's defence spending accounted for 2.6% of GDP in 2007, according to the US's Central Intelligence Agency (CIA). For 2008 the government budgeted US\$5.6bn in military spending, a 53% year-on-year increase. Moreover, in late 2007, Mr Jobim announced a major increase in Brazil's defence procurement budget (which covers military hardware purchases unlike military spending which covers all expenses including personnel, maintenance and energy costs, among other expenses) from an official US\$3.6bn for 2008 to US\$5.6bn for 2009.

Brazil has oriented most of its military efforts of late toward protecting the Amazon basin, supporting the police in fighting criminal activity in urban areas and lawlessness at its borders, as well as contributing to international peacekeeping missions. Its military forces rely heavily on aircraft and radar systems to control and protect the vast Amazon region with its valuable natural resources from eventualities from illegal, environmentally destructive activities to the more remote possibility of a foreign invasion. Moreover, Brazil is preoccupied with policing domestic criminal activities within its infamous *favelas* (shantytowns) as well as in the tri-border area that it shares with Argentina and Paraguay, where cross-border smuggling is rife. The value of smuggled goods in the tri-border area, including weapons and narcotics, is estimated to be between US\$2bn and US\$3bn per year. The Brazilian military uses many of the same strategies and tactics involved in controlling these lawless areas in its international peacekeeping operations. Brazil, along with Argentina and Chile, has consistently supported UN-sponsored peacekeeping and peace-observing missions, mostly in Africa but also in Central America and the Caribbean. The Brazilian armed forces, for example, have been in command of the military component of the Mission des Nations Unies pour la Stabilisation en Haïti (Minustah, the UN Stabilisation Mission in Haiti) since it was established by the UN Security Council in 2004. There are currently about 1,200 Brazilian troops stationed in Haiti.

Brazil is also focusing on new, regional and international threats

However, Brazil is also focusing on new, more traditional regional and international threats. A March 2008 raid against insurgents by Colombia's armed forces within Ecuadorean territory led to the deployment of Venezuela's military and acted as a wake-up call to Brazil and its neighbours that regional peace cannot be taken for granted. Moreover, the US has just reactivated its

Brazil has its own domestic aircraft manufacturing industry

navy's IV Fleet, which had been out of commission for nearly half a century. Despite reassurances from the US to regional governments that the fleet has no military operational capacity but only an administrative role to play, the local press indicates that the Brazilian government perceives it as a threat—according to the press Brazil does not consider it a coincidence that the US reactivated its fleet shortly after Brazil discovered some of the world's largest underwater crude oil reserves. Not surprisingly, an important part of Brazil's recent military rearmament strategy is aimed at protecting these offshore oil reserves.

Brazil's military sources a substantial share of its equipment from Embraer, formerly a state-owned company and now the third-largest aircraft manufacturer in the world. Brazil is the only country in the region with a state-of-the-art defense capability, in Embraer. Most South American countries have some defense manufacturing capabilities including light weapons, and others, such as Argentina, used to have serious manufacturing capabilities which, owing to years of under-funding, were privatised and bought by international companies, such as US-based Lockheed Martin's aircraft plant in Cordoba.

Embraer is one of Brazil's top exporters, employing 23,855 people, 88% of whom are based in Brazil. A large part of Embraer's business comes from sales of small aircraft (fewer than 120 seats) for civil aviation, but it also produces various defence products which are increasingly sold to other Latin American countries. Embraer's best known military plane is the Super Tucano, a state-of-the-art military turboprop used for training and light attack. The company has already received orders for 120 Super Tucanos from the armed forces of Brazil and Colombia—50 of the planes are already in operation. The first international order was placed by Colombia in December 2005 and the first aircraft were delivered at end-2007. In early 2007 Embraer took the Super Tucano on a tour of countries in Africa, Asia and the Middle East, including some Arab countries.

Beyond domestic production, Brazil is looking to technology co-operation to modernise its military. It has traditionally maintained close military ties with France and is now working more closely with Russia. It recently purchased a decommissioned aircraft carrier from France and is planning to produce Latin America's first nuclear submarine with French and Argentinian assistance. Brazil plans on using a French Scorpene class diesel submarine as the model and will work with Argentina on the sub's motor, a technology that Brazil does not possess. Brazil has also agreed to co-operate with Russia to develop jointly a jet fighter plane, satellite launch vehicles and civilian nuclear reactors, as well as communications and remote sensing satellites.

In February 2008 Brazil proposed the idea of creating a regional defence council referred to as the Consejo de Defensa Sudamericano (South American Defence Council) to resolve regional crises and foment a regional military industry. The defence council would not have operational capabilities but would promote joint military training and defense bases, co-ordinate military technology and resources, and promote military industrial integration. The council idea was quickly embraced by Argentina and Venezuela, with Colombia recently deciding to join after an early refusal. Within the defense council framework, Venezuela and Colombia have already agreed to ten accords to create a joint military industry, develop a heavy cargo plane and combat arms-trafficking

together. The regional council's objective dovetails with Brazil's national interest in boosting its domestic defense through local technology and manufacturing.

Colombia spends the region's largest share of GDP on the military

Colombia, the fourth-largest country in South America, has been ravaged by a decades-long violent conflict involving guerrilla groups and drug cartels. An improved security situation, which has boosted domestic demand and encouraged foreign direct investment (FDI), together with a favourable external backdrop leading to strong export growth, has resulted in a strong economic rebound since 2004. Colombia's military spending in 2007 was estimated to be around 3.4% of GDP according to the CIA, but one Argentinian defence scholar argues that its spending is closer to 7% of GDP.

Colombia needs a large helicopter fleet to fight remote jungle wars

Most of Colombia's military equipment purchases are geared toward fighting insurgents domestically. The combination of strong economic growth since 2004 and high levels of US aid has allowed Colombia to create and maintain one of the most admired armed forces in South America. In 2002, Mr Uribe's first year in office, US military and police assistance totalled US\$387m. In 2008 it had reached US\$434m. However, total military spending has risen at a much sharper pace given a doubling of Colombia's own defence spending. A good portion of the funds has gone toward modernising Colombia's fleet of transport helicopters needed to fight mostly in remote jungle terrain. Colombia also owns 106 aircraft, including many Russian Mi-17 and about a dozen UH-60 Black Hawks from the US. In 2005 the Colombian government made its biggest purchase in a decade with 25 of Embraer's Super Tucanos. Colombia has already taken delivery of 16 aircraft which are said to have been used during its March 2008 raid in Ecuador against the forces of the Fuerzas Armadas Revolucionarias de Colombia (FARC, the main guerrilla organisation).

Moreover, Colombia has recently purchased 13 Kfir jets from Israel, which will start to arrive in the second half of 2009. The air force will also receive a Super King 250 aircraft and three C-295 transport planes. It is expected that the army will take delivery of five more Russian-made Mi-17 helicopters and eight more US-made Black Hawks. The army will also receive 8,000 Israeli-made Galil assault rifles and other specialist infantry equipment, as well as 187 armoured trucks for transporting troops. The navy, meanwhile, will receive three high-speed patrol boats and two boats for intercepting drug-traffickers.

Russia and China are now Venezuela's main suppliers instead of the US

Boosted by surging oil revenue, Venezuela has increased arms purchases from an average of US\$71m between 2002 and 2004 to US\$4bn between 2005 and 2007. Its overall military expenditure is estimated at 1.2% of GDP in 2007, according to the CIA. Mr Chávez argues that he is equipping the military with state-of-the-art weapons to protect Venezuela from a potential US incursion. In 2006 the US cut off arms sales to Venezuela, refusing to sell it F-16 jet replacement parts. It has also used third-party transfer agreements to prevent Venezuela from purchasing equipment containing US technology from Brazil's Embraer. As a result, Russia and China have become important defence suppliers, filling the gap left by US contractors.

Venezuela's preferred supplier today is Russia, from which it has acquired more than US\$4bn in arms since 2003. In July 2008 Mr Chávez visited Russia where he signed a number of agreements to purchase more arms and bolster ties with

the Russian government. The purchases vary depending on the source, but according to the Russian press, Venezuela is considering spending US\$2bn on diesel submarines, air defence systems, and combat helicopters. Venezuela is also working with Russia to build two factories in Venezuela to produce AK-103 assault rifles and their ammunition. The Venezuelan government is looking to China for technical assistance and military equipment. Venezuela plans to install a radar system with the help of China and has begun negotiating the purchase of Chinese-made K-8 military planes, which are mainly for training but can be used for combat and surveillance.

Chile's military is largely focused on conflict prevention and peacekeeping

Chile's solid macroeconomic performance over the last two decades has allowed it to maintain its military spending at a high level—in 2007 it spent 2.7% of GDP according to the CIA. Since a 2002 defence white paper relegated potential local conflicts to second place, the Chilean military has been largely interested in conflict prevention and has focused on overseas force deployment, mainly in peacekeeping operations. It also prioritises disaster relief as Chile is prone to earthquakes. Instability and conflict of interests with neighbouring countries, however, deter it from ruling out more traditional foreign threats. Chile's armed forces remain well-equipped thanks to the decades-old “copper law”, last amended in 1990 by the former dictator, general Augusto Pinochet, which directs 10% of annual copper export earnings to the purchase or renewal of military equipment. As a result, the Chilean military has become one of the most technologically advanced and professional in Latin America. Some of Chile's more recent, significant purchases include 200 Leopard II tanks, ten F16s from the US, 18 F16s and four frigates from the Netherlands, three frigates from the UK, and two diesel submarines from a French-Spanish consortium.

Russian and Chinese suppliers are also replacing US contractors elsewhere

The rise in military spending by South American governments is beginning to attract the attention of big manufacturing countries. In particular, Russia and China are making significant inroads in a region that historically purchased weaponry from the US and Western European countries, including France, Germany and the Netherlands. Although US and European suppliers remain formidable competitors with a reputation for quality, sophistication and reliability, the Russian and Chinese suppliers are increasing their share of South American purchases thanks to shifting political alliances, cost savings and swifter business transactions. With many designs copied from the US and Europe, these suppliers can offer competitive prices as they forgo expensive research and development. For the most part, they make good replicas with significant cost savings for the buyers. Buyers, however, may experience problems when it comes to the upkeep and maintenance of the copycat equipment. Moreover, replicating copyrighted designs is illegal and creates political complications. Argentina, for example, was recently considering a purchase of economical Chinese helicopters to modernise its old Vietnam-era fleet, but its interest created an international debacle as the machines' design had been stolen from Eurocopter, a French company. The company denied that it had provided manufacturing rights and refused to provide repair parts for the Chinese helicopters. Argentina did not complete the purchase.

Acquisition of US equipment can be bureaucratic

The US is known for producing some of the world's most sophisticated military equipment and providing end-to-end solutions for buying countries. Its sales

often include a “kit” replete with training manuals and services, repair parts, maintenance systems and, if purchased through US Foreign Military Sales (FMS), a US government-backed guarantee. When it comes to expensive purchases, this is no small matter as training and repair are essential for durability. Yet its very strength is also the US government's competitive disadvantage. Purchasing through the US government means the transaction will be transparent but often slow as it is weighed down by heavy bureaucracy. Countries have also been put off by potential, future US congressional interference, as was seen recently with Venezuela. Purchase negotiations with countries like Russia and China, on the other hand, tend to be more lax with officials much more willing to accept kick-backs and keep dealings undercover. Seeing its regional market share slipping to second behind Russia, the US government is contemplating a revised acquisition process in order to streamline future transactions.

Growing military spending will help foment regional industries

The growing attention of the world's defence industry to the prospects of increased sales to South America will help strengthen regional know-how through technology transfers. It is no coincidence that Chile's capital, Santiago, was chosen for the 2008 International Air and Space Show. International and regional defence industry executives visiting the show also took advantage of the event to do business. The most important traditional military sales included aircraft. There were increasing displays, however, of defence products suitable for peace missions and community assistance, which now compete with high-tech aviation and missiles and asymmetrical warfare (conflicts in which the resources of the two actors differ in essence and in the struggle); such conflicts often involve strategies and tactics of unconventional warfare with the “weaker” combatants attempting to use strategy to offset deficiencies in quantity or quality. Improved local know-how through increased international links between defence industries is expected to result in production of more sophisticated machinery in South America. Such is the case for Brazil as it works with Russia on the aforementioned satellites and satellite-launch vehicles. Furthermore, regional buyers' increasing demand for low-tech gear, used in less-traditional conflicts (which are conflicts between a state and non-state actors including guerrillas, terrorists and drug-traffickers), will continue to open up space for small and medium-sized businesses from within the region.

Regional political efforts toward integration, including the South American Defence Council spearheaded by Brazil, will also help to strengthen regional and local industries. Brazil, with its strong industrial capacity, could positively impact on the industries in neighbouring countries. There are already signs that Brazil may become a catalyst in boosting Argentina's weakened defence industry. The two countries have recently co-designed a Humvee-type vehicle called the “Gaucho”, which is composed of used auto parts, helping create significant cost savings. With the prototype complete, production and commercialisation of the all-terrain vehicle is expected to start in 2009. This will be the first time that the two historic rivals manufacture defence equipment together. At present, the vehicle is intended for use by the Rio de Janeiro police force, but future regional and international military commercialisation remains a possibility. There is also talk between Brazil and

Argentina that Embraer may take over the military aircraft production facilities in Córdoba once Lockheed Martin's contract expires later this year.

Conclusion The recent revival of South America's military purchases is taking place in a context in which the US's influence in the region has diminished and new players are becoming increasingly important. Most of the big military suppliers of aviation and high-tech equipment in the region remain US and European companies, but Russian and Chinese companies are competing successfully in these areas. South America's own world-class manufacturer, Embraer, is also beginning to take business from international suppliers. Increased interest in low-tech weaponry appropriate for less-traditional conflicts is opening up space for small- and medium-size businesses in Latin America to compete for market share in the growing regional defence industry. The region's increasing capacity and newfound autonomy bolstered by improved economic fundamentals has led to new strategic partnerships and increased local confidence. Given this favourable context, a rise in military spending coupled with increased technology co-operation could lead to significant strengthening of the regional defence industry and have positive implications for South America's economy as a whole.

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Corruption and the cost of doing business in Latin America and the Caribbean

By Sebastian Freille, assistant professor in the Economics Faculty of the National University of Córdoba, Argentina

Introduction

Corruption in Latin America and the Caribbean is perceived to be among the worst in world. Only in Africa is corruption more widespread and pervasive, according to Transparency International. According to the organisation, corruption is considered a serious problem in 24 out of 32 Latin American and Caribbean countries included in its survey. It ranks among the biggest business concerns and has been singled out as the greatest single obstacle to economic development. It restricts long-term investment and growth because it introduces distortions in the allocation of resources. Corruption increases the cost of investment when kick-back payments are needed to obtain a license or a contract. It can be viewed as an additional tax and many firms are reluctant to consider investing in regions where such additional taxes are high. It also causes uncertainty since it undermines the institutional and legal framework. Finally, corruption may affect the composition of investment spending by encouraging activities with high potential for the exploitation of rents. This article examines the state of corruption in Latin America and the Caribbean. First, it discusses some of the reasons for corruption and the forms it may take. It then goes on to evaluate the impact corruption has on business costs and the investment climate. Finally, it provides a brief account of recent anti-corruption strategies undertaken in the region.

Corruption appears to have worsened, but there are a few salient exceptions

Corruption ratings have worsened for the vast majority of countries in the Latin America and Caribbean region. Although hard data on the incidence of corruption are in practice difficult to obtain, a number of subjective indicators that measure perceptions of corruption across countries provide a useful basis for analysis and comparison. According to Transparency International, Venezuela's corruption score worsened to less than 2 points (with ten the best and zero the worst score) in 2008, from 2.8 in 2001, its lowest rating since 1995 and the worst score after Haiti. Although Argentina and Brazil have seen their scores stabilise in the last two years, the long-term trend appears to have been downward. Mexico's rating has improved in recent years. For Caribbean countries, scores diverge widely. Saint Lucia is the top-rated country in the region, followed by Barbados, whereas Haiti ranks at the bottom. Some countries in the region have made important improvements in their corruption ratings. Colombia, granted highly corrupt status in 1998, has improved its rating significantly largely thanks to the success of its anti-corruption policies. El Salvador is another case where, despite a fall in 2008, corruption standards have improved in the last four years, bringing the country into the regional top 10 of countries with the lowest corruption ratings. Uruguay stands out as the most notable example since it has seen its score improve, ranking just below Chile and Barbados with a score comparable to those of rich countries. Costa

Rica has improved its rating since 2005, partly owing to an improved performance of the judiciary in dealing with corruption cases.

Corruption ratings for Latin America and the Caribbean

	2001	2002	2003	2004	2005	2006	2007	2008	2008 global rank ^a
Barbados	-	-	-	7.3	6.9	6.7	6.9	7.0	22
Chile	7.5	7.5	7.4	7.4	7.3	7.3	7.0	6.9	23
Uruguay	5.1	5.1	5.5	6.2	5.9	6.4	6.7	6.9	23
Costa Rica	4.5	4.5	4.3	4.9	4.2	4.1	5.0	5.1	47
Cuba	-	-	4.6	3.7	3.8	3.5	4.2	4.3	65
El Salvador	3.6	3.4	3.7	4.2	4.2	4.0	4.0	3.9	67
Colombia	3.8	3.6	3.7	3.8	4.0	3.9	3.8	3.8	70
Mexico	3.7	3.6	3.6	3.6	3.5	3.3	3.5	3.6	72
Peru	4.1	4.0	3.7	3.5	3.5	3.3	3.5	3.6	72
Trinidad and Tobago	5.3	4.9	4.6	4.2	3.8	3.2	3.4	3.6	72
Brazil	4.0	4.0	3.9	3.9	3.7	3.3	3.5	3.5	80
Panama	3.7	3.0	3.4	3.7	3.5	3.1	3.2	3.4	85
Jamaica	-	4.0	3.8	3.3	3.6	3.7	3.3	3.1	96
Guatemala	2.9	2.5	2.4	2.2	2.5	2.6	2.8	3.1	96
Dominican Republic	3.1	3.5	3.3	2.9	3.0	2.8	3.0	3.0	102
Bolivia	2.0	2.2	2.3	2.2	2.5	2.7	2.9	3.0	102
Argentina	3.5	2.8	2.5	2.5	2.8	2.9	2.9	2.9	109
Honduras	2.7	2.7	2.3	2.3	2.6	2.5	2.5	2.6	126
Nicaragua	2.4	2.5	2.6	2.7	2.6	2.6	2.6	2.5	134
Paraguay	-	1.7	1.6	1.9	2.1	2.6	2.4	2.4	138
Ecuador	2.3	2.2	2.2	2.4	2.5	2.3	2.1	2.0	151
Venezuela	2.8	2.5	2.4	2.3	2.3	2.3	2.0	1.9	158
Haiti	-	2.2	1.5	1.5	1.8	1.8	1.6	1.4	177

^a Out of a total of 180 countries.

Source: Transparency International, Corruption Perceptions Index. Available at <http://www.transparency.org>

Worse democratic conditions and low income levels contribute to poor scores

The reasons for the persistence of poor corruption ratings in the region are varied. First, despite sustained economic growth in recent years, the levels of GDP per head are still well below those of countries with low corruption ratings. On average, rich countries tend to have low levels of perceived corruption. In other words, most countries in Latin America and the Caribbean do not seem to have reached the development thresholds beyond which the incidence of corruption appears to decline. Additionally, the fact that a significant proportion of the GDP in those countries is generated by activities with a strong potential for rent extraction, as is the case for mining and oil production, is another reason for the existence of high corruption levels.

Although differences in GDP per head appear to be one of the most important determinants of the differences in corruption across countries, other reasons are clearly important as there are rich countries where perceived corruption is high and several poor countries where perceived corruption is low. Several countries in the region have suffered a weakening of democratic institutions during the past decade. The persistence of political instability in some countries is an important determinant of the high levels of perceived corruption. If the extent of political instability is high, public officials are likely to behave more

opportunistically as they consider that there is a possibility that they may lose their office at any time. Political instability has been a regular feature of Latin America and the Caribbean since the turn of the century. One major event was the regime change that took place in Haiti after the president, René Préval, dissolved the legislature in 1999. Another well documented case was the political upheaval following the events in December 2001 in Argentina. Political instability has also been significant in the Andean countries. In Bolivia, Gonzalo Sánchez de Lozada was forced to resign as president in response to fierce streets protests in 2003. In Ecuador, three presidents have been forced to resign in the last 12 years and Congress was disbanded and replaced by a constituent assembly in 2007. Political instability and crises have also been a regular feature of Venezuelan politics during the past 15 years.

Stable and effective institutions are needed to check corruption

The existence of stable and effective democratic institutions constitutes an essential check on bureaucratic and political corruption. Some of the region's institutions have been seriously compromised, reducing their efficiency in checking government corruption. In particular, judicial systems are hampered by their lack of independence and efficiency. Restrictions to press freedom increased during the term of the former president, Néstor Kirchner, in Argentina (2003-07) and since 2007 tensions between the media and the government in Honduras have increased after journalists exposed corruption scandals. Venezuela has suffered a steady decline in press freedom under the administration of Hugo Chávez (1999-present). This was highlighted when Mr Chávez refused to renew the broadcasting license of a popular television station aligned with the opposition in 2007. In Bolivia, there has been an increasing polarisation in party politics while Haiti has experienced declines in civil and political liberties through much of the past decade.

Decentralisation has created a lack of accountability and performance

Although a gradual move away from centralised systems towards decentralisation in many parts of Latin America and the Caribbean in the last two decades has helped to meet the electorate's demands for more effective local administrations, in many cases it has created new possibilities for corruption to flourish. In order to be successful, decentralisation must be accompanied by structural changes addressing the reform of the civil service and the streamlining of the tax administration. Several countries, including Chile, Argentina, Bolivia and Colombia, took clear steps towards decentralisation of public services in the early 1990s when they transferred a significant part of their education and health expenditure to sub-national institutions. The transfer was intended to improve service standards and accommodate regional differences. Although there were improvements in several health and education indicators, decentralisation gave rise to new problems, including escalating provincial and municipal indebtedness and a plethora of opportunities for local revenue capture and rent-seeking activity.

The existence of a strong tradition of patronage politics is often mentioned as another reason for the high levels of perceived corruption in the region. Within the patronage system, when an incumbent wins an election, he or she usually appoints a number of assistants to the non-elective positions. Combined with a high degree of political volatility, patronage encourages most bureaucrats to try to take as much as they can, causing corruption levels to soar. Some analysts

The existence of a large informal economy encourages corruption

have stressed the point that in countries where the civil service is based on merit rather than on patronage, as is the case of several European countries, corruption levels tend to be lower. In other words, a meritocratic form of recruitment of civil servants is an important ingredient to improving bureaucratic performance and lowering corruption levels. Some of the region's most institutionalised examples of party patronage are the Partido Revolucionario Institucional (PRI) in Mexico, which held power for over 70 years, and the Partido Justicialista (PJ, the Peronists) which currently governs Argentina.

The existence of a large informal economy also encourages corruption. In most cases, corruption proceeds find their way through informal channels. Black markets, money-laundering and foreign accounts are all likely destinations of the illegal proceeds. Weak money-laundering policies and a lack of tough procedures to recover assets diverted through corrupt practices sustain the informal economy. It has been suggested that the size of the informal economy in Latin America and the Caribbean region ranks among the highest in the world. According to a study by the IMF, the average size of the informal economy in a sample of 32 Latin American countries is 34% of GDP. Informality is pervasive in Paraguay and Nicaragua where it reaches over 60% of GDP while it is quite significant in countries such as Argentina, Peru, Costa Rica and Venezuela, where it averages between 30% and 40% of GDP.

Trust levels among citizens of selected countries

(% of respondents)

	Year of survey	Most people can be trusted	Can't be too careful	Don't know
Argentina	1999	15.0	82.6	2.4
Brazil	1997	2.8	96.5	0.7
Chile	2000	22.2	75.2	2.6
Colombia	1998	11.2	88.5	0.3
Dominican Republic	1996	25.2	70.0	4.8
El Salvador	1999	14.1	82.4	3.5
Mexico	2000	20.8	76.6	2.6
Peru	2001	10.6	88.7	0.7
Uruguay	1996	21.6	76.2	2.2
Venezuela	2000	15.8	83.6	0.6
China	2001	52.5	43.8	3.7
India	2001	38.9	55.9	5.2
Saudi Arabia	2003	50.5	44.7	4.7
Denmark	1999	64.1	32.3	3.6
Netherlands	1999	59.4	39.9	0.7
US	1999	35.5	63.6	0.9

Source: World Values Survey, various years. Available at <http://www.worldvaluessurvey.org>

A number of historical and cultural factors may also be relevant in explaining the region's high levels of corruption. Although these factors are not directly identifiable and therefore are difficult to be targeted by policy, they may be related to what is known as "culture of corruption". In many cases, these aspects are embedded in the legal system and tradition or are manifested in the way people relate to each other. The latter is often associated with indicators of social capital, and particularly with the levels of trust among citizens. According to the World Values Survey, less than 20% of the population felt that most

people can be trusted in Argentina, Brazil, Venezuela and Peru and only just over 20% in Mexico and Chile. These trust levels are far from those prevailing in Europe, North America and Asia, where they range from 30-70%. Only Africa and the Commonwealth of Independent States (CIS) countries have trust levels as low as those of Latin American countries. The findings are confirmed by Latinobarómetro data which include a larger sample of Latin American countries. In this survey, the average level of social trust in Latin America is approximately 20%.

Petty bribery is endemic and burdens smaller businesses most heavily

The most generalised form of public corruption in the region is the payment of bribes. According to Transparency International's *Global Corruption Barometer*, one in three people who have had dealings with the police admitted to paying bribes in 2006. A survey for Colombia in 2001 found that around one in four people offered a bribe to the police when falsely accused of an infringement. Bribery is also pervasive in the area of registry and permit services, with almost one in five people in Latin America and the Caribbean forced to pay a bribe in exchange for such a service. Bribery is also a considerable problem in the judiciary and healthcare services.

In most of these areas, corruption is a form of extortion which forces citizens and investors to pay a higher price than if corruption did not exist. The implications of this type of corruption are varied. On the one hand, by increasing investment costs it reduces savings. On the other hand, it pits officials against the public and raises the incentive to expose the corrupt act. But given that most of this kind of corruption is "petty", with the basic services thus obtained often necessary to expedite other activities, extortive corruption is likely to remain high. This is particularly true when the mechanisms available to combat corruption are deficient. A study by Transparency International found that micro-enterprises and small businesses are more heavily affected as they spend a larger share of their revenue on bribes.

"Collusive" corruption is more difficult to detect

"Collusive" corruption is more difficult to detect since both the bureaucrat and the investor benefit from the transaction. It can involve both bribery and embezzlement. The public official benefits as he charges a price including the bribe lower than the official price but gives nothing to the government, while the investor benefits by paying a price including bribe lower than the official price. However, the transaction entails a large cost to the economy given the waste of public resources and the distortion in the allocation of investment spending. This type of corruption generally takes place at the decision-making end of politics and is usually large-scale. Examples include a Senate bribe-for-votes scandal in Argentina (when senators were trying to pass the labour reform bill in 2000) and the *mensalão* vote-buying scandal that first broke in Brazil in 2005. This type of corruption is more likely to appear in cases where a strong administration faces a weak opposition (the case in both Argentina and Brazil) and when Congress's role vis-à-vis the executive is very weak (the case in Argentina). The most efficient safeguards against this type of corruption are the existence of a free and independent investigative press and the presence of non-governmental organisations (NGOs).

Red tape provides increased scope for corruption

Corruption adds to the already high cost of doing business in the region. According to the World Bank's *Doing Business* report, while more than 15 European countries rank in the top 30 on the ease of doing business, among Latin American countries only Chile makes this shortlist. Starting a business in certain regions of Brazil, for instance, requires the involvement of nine different municipal, state and federal authorities. In Colombia, it takes 14 procedures to start a business, four more than the regional average. Registering a property in Mexico can take more than two months and cost as much as 6% of the property value. Cumbersome entry and registration procedures increase opportunities for corruption given the number of contacts needed between officials and the public. These institutional barriers represent a considerable burden on small entrepreneurs and businesses which, unlike big corporations and multinational firms, may not be able to afford the high entry costs, let alone any potential bribes. Latin America seems to be lagging when it comes to introducing reforms to alleviate burdensome regulations. Although there has been progress in some countries, the region remains plagued by heavy and cumbersome regulations.

Colombia eases trade regulations to lower corruption potential

Only one-third of the countries made at least one positive reform in this direction in 2006-07, placing the region at the bottom of the *Doing Business* report list. Colombia led the way in the region with other countries also taking important steps towards easing trade regulations by introducing electronic registration procedures and establishing one-stop shops for certain activities. The introduction of a one-stop shop at the Commercial Registry in El Salvador dramatically simplified the procedures for the establishment of new businesses and reduced the time taken to start a business from 115 to 26 days. The only country where the situation has actually worsened is Venezuela, which saw the introduction of several hurdles at the border.

It is important to note that several initiatives have been implemented to raise awareness and gather information to improve anti-corruption policies. Colombia is a good example with the development of two complementary sets of indicators, the *Indice de Integridad de Entidades Públicas* (the public entities' probity index) and the *Indice de Integridad de los Gobiernos, Asambleas y Contralorías Departamentales* (the local government probity index). Also, both Colombia and El Salvador are leading the way in the reform of their bureaucracies by introducing leaner and quicker procedures that should lower firms' incentive to offer bribes.

The Porto Alegre municipal budgeting is deemed a triumph over corruption

One case that is often hailed as a major triumph against corruption is the participatory municipal budgeting scheme of Porto Alegre in Brazil, which was started in 1989. Conceived as a means of strengthening democracy at the local level by encouraging citizenship participation, it nearly eradicated corruption and enhanced the quality of public administration. It assured effective accountability through social audits and monitoring and improved local development standards in health, education, and other public services. The pilot projects, administered by the UN Development Programme (UNDP), namely *Transparent Municipalities* in Ecuador, Peru and Venezuela, are other examples of participatory budgeting aimed at improving local governance and accountability. The main achievements of these projects are an increase in the

The role of the private sector in corruption fight is important

number of audited city halls, improvements in transparency levels in public acts and the strengthening of control and accountability systems.

An ambitious form of addressing the fight against corruption is through the establishment of collective action frameworks. The number of such arrangements is rising fast as a consequence of both increased awareness and the availability of international funding. One success story at this level is the action plan put forward by a multi-faceted private initiative headed by the Confederación Colombiana de Cámaras de Comercio (Confecámaras, the Colombian confederation of commerce chambers) to promote business ethics and develop a transparent business culture in Colombia. Supported by the Centre for International Private Enterprise (CIPE), Confecámaras's efforts were aimed at restructuring the procurement process in Colombia. The result of several opinion surveys led to the development of Transparency Pacts and an Ethical Code of Conduct in 2003. The major goal of the work undertaken by Confecámaras finally came to fruition in 2007 with a substantial reform of Colombia's Procurement Law. Undoubtedly, the most far-reaching impact of this process has been the success in involving the private sector in the fight against public corruption. Similarly, Paraguay saw the creation of the Pacto Ético Comercial (PEC, business ethics pact), a coalition between businesses, government and civil society which has developed evaluation, certification and investigation processes. The coalition has also agreed to a fast clearing service for PEC customers dealing with Paraguayan customs. More than 150 of its members have signed the pact already.

Conclusion Corruption has been singled out as one of the greatest single obstacles to economic development as it negatively affects the allocation of resources. Low levels of GDP per head, high levels of political instability and the politics of patronage, the sheer size of the informal economy, the ill-considered attempts at decentralisation and an underlying weakness of democratic institutions are considered important reasons for the high level of corruption in the region. The most generalised form of corruption, bribery, is often accompanied by embezzlement thus making it especially difficult to detect considering the deficiencies in the system of checks and balances. In this context, the presence of cumbersome regulations and large amounts of red tape makes opening a new business not only a lengthy and costly affair, but also vulnerable to corruption. The introduction of reforms leading to a reduction in the number of procedures and waiting times in some countries is a therefore positive development. In many countries, a growing awareness and increased citizen participation have raised collective action and created a number of successful initiatives. Nevertheless, despite the progress made, episodes of grand corruption are still common in the region. Moreover, less favourable economic conditions going forward combined with centralisation of power in Venezuela and other countries could herald a deterioration in corruption in the region. With only Barbados, Chile and Uruguay ranked among the 30 least-corrupt countries in the world in 2007 according to Transparency International, it is clear that the fight against corruption will require a major effort from the private and public sector as well as the international community if the regional situation is to improve over the next decade.

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Political outlook

Political environment

After a relatively quiet electoral year thus far in Latin America, the most important election for the region will take place in the US on November 4th. Its outcome will set the tone for US-Latin American relations until 2012, and possibly until 2016. After seven years of benign neglect under the current president, George W Bush, Latin America and the Caribbean will be watching the US election to see how bilateral relations will shape up under the next president. Although it is highly likely that the balance of power in Congress will shift further to the Democrats, the final result of the presidential election is far from certain with both candidates tied in a statistical dead-heat in mid-September. A win for the Democratic candidate, Barack Obama, would give the new president a free hand to legislate and deal with outstanding regional issues, particularly during the first half of his term. A victory for the Republican candidate, John McCain, would also be positive for the region given the candidate's extensive foreign policy experience, particularly in Latin America. The next US administration will be forced to focus on important issues, including the ongoing domestic crises in the financial and housing sectors, and rising international tensions with Russia as well as the wars in Afghanistan and Iraq. This means that initially at least Latin America can expect little attention from the new administration. Nevertheless, Mr Bush's unfinished Latin American agenda will need to be addressed.

An increasingly assertive Venezuela will present the biggest challenge for the US

In the short term it is likely that—regardless of who wins the presidential election—the US Congress will approve the free-trade agreement (FTA) with Panama while the trade preferences for Colombia and Ecuador will be extended (they expire at the end of 2008) even though that will probably involve approval and backdating during the first half of 2009. Bolivia's trade preferences status, in light of the country's expulsion of the US ambassador in early September, is less certain. In the medium term, a migration reform, to which both candidates claim to aspire, will also be proposed. The issue's lack of campaign prominence will provide the next president with some leeway, particularly in light of US domestic economic difficulties and rising insecurity over globalisation. The Mérida Initiative (a three-year US\$1.4bn US proposal to equip and train security forces in Mexico, Central America and the Caribbean to combat drug-trafficking) will need to be extended, while its predecessor and counterpart, Plan Colombia, will need winding down.

The next US administration may also be called upon to deal with the growing economic problems in Central America and the Caribbean as a result of the impact of the US recession and the fiscal cost of high food and oil prices. Relations with a post-Fidel Cuba could be reassessed during an Obama presidency but it is less likely that much would change under Mr McCain. The growing risk of political instability in Bolivia, Ecuador, Argentina and Paraguay will challenge the next government, but the biggest challenge will come from dealing with Venezuela's president, Hugo Chávez, who, as his domestic woes mount, becomes increasingly assertive on the regional and international front.

A busier electoral year in 2009

From 2009 the election pace in the region will pick up with eight major elections, including six presidential polls, taking place. None of these elections—with the exception of Ecuador where we expect the incumbent, Rafael Correa, to win—threatens to add another country to the alliance of radical left-wing governments spearheaded by Venezuela's Hugo Chávez. Rather, the Economist Intelligence Unit continues to expect broad policy continuity across these countries—including Panama, Chile, Uruguay and Honduras (presidential contests) and Mexico (congressional elections), as their governments espouse moderately pro-business policies. Argentina, with its less heterodox policies and closer links with Mr Chávez will also organise legislative elections. Even in El Salvador, where a victory for the moderate presidential candidate of the radically left-wing opposition Frente Farabundo Martí para la Liberación Nacional (FMLN), Mauricio Funes, is a possibility, we currently still expect Rodrigo Ávila, the candidate for the ruling Alianza Republicana Nacionalista (Arena), to emerge victorious.

Ecuador will organise presidential and legislative elections in early 2009, assuming that the new constitution is approved in a referendum on September 26th. Although in Panama the incumbent president, Martín Torrijos, cannot stand for re-election, and despite growing dissatisfaction with rising inflation and crime, his party currently seems the favourite to remain in power, partly owing to a fragmentation of the opposition. Similarly, in Uruguay, Honduras and Chile, parties are preparing to organise their primaries and campaigns for elections in the latter half of 2009. Furthermore, Mexico and Argentina will organise legislative elections in 2009. While we expect that no party will win a majority in Mexico, forcing the government to continue to build alliances, deteriorating economic conditions could cause the legislative majority of Argentina's Peronist government to be reduced.

Mr Chávez deflects attention away from his growing domestic problems

Mr Chávez's international policy actions appear increasingly reckless as demonstrated by the September expulsion of the US ambassador to Caracas (following similar action by Bolivia), his invitation to the Russian navy for joint exercises off the coast of **Venezuela** in November and his bellicose talk of supporting Bolivia's president, Evo Morales, with arms and troops if needed. Bolivia is a member of Mr Chávez's Alternativa Bolivariana para los Pueblos de Nuestra América (ALBA, the Bolivarian Alternative for the Americas) initiative. Although Mr Chávez's provocative actions will heighten tensions with the US and irritate many of his Latin American counterparts, they must be understood in the context of Venezuela's growing internal problems. Indeed, Mr Chávez's stepped up focus on perceived external threats seems largely aimed at uniting the population—and the military—behind his weakening presidency and deflecting attention away from the rapidly deteriorating domestic economy. Mr Chávez's defeat in the December 2007 referendum has been confirmed as a major turning point in his administration in the past nine months as public support has fallen steadily owing to growing frustration with soaring inflation and food shortages. Although the opposition remains divided and lacks clear leadership, it is likely that the new movements that emerged in 2007 will perform well in the regional elections scheduled for November 23rd. Apart from Mr Chávez's falling popularity ratings and the rise of an opposition of sorts, the president also faces strife within his own alliance which is

increasingly divided over how to drive "21st-century socialism" forward. Even so, Mr Chávez retains complete control over the unicameral legislature and has a strong influence over weak and politicised institutions. It is the Economist Intelligence Unit's central forecast, therefore, that he will serve out the remainder of his term (which runs until 2013), while a gradual political realignment takes place. However, the onset of an economic crisis—provoked by the distortions of the current policy framework—could engender widespread social unrest, raising the possibility of a more radical political upheaval.

Political tension in Bolivia will be a concern for the US and South America

Besides seeking a more workable *modus vivendi* with Mr Chávez's Venezuela, improving bilateral relations with **Bolivia** will be one of the challenges facing the new US administration, while the deepening instability there will continue to be a source of concern for other South American countries. Despite an agreement between Mr Morales, of the leftist Movimiento al Socialismo (MAS), and opposition prefects (departmental governors) to negotiate a solution to Bolivia's spiralling political crisis, tensions will remain high. In referenda in May and June Mr Morales saw his mandate and national support reaffirmed but the positions of the four main opposition prefects of Beni, Pando, Tarija and Santa Cruz were also strengthened, allowing them to continue to rally their supporters around the issues of regional autonomy and regaining control of natural gas revenue. Mr Morales has issued a decree calling for a national referendum in the first quarter of 2009 to ratify a new constitution that would formalise, among other things, a greater centralisation of natural gas revenue to the detriment of the rich eastern departments that form the bedrock of opposition to Mr Morales's government. Based on Mr Morales's continued high popularity among the country's indigenous majority, as confirmed by recent poll successes, we expect the constitution to be approved, despite widespread protests. Fresh general elections could be held as early as December 2009. Although we do not expect that the country will disintegrate in the outlook period, there is a risk that increasing civil disorder could lead to wider conflict and have a serious negative impact on our central economic assumptions for Bolivia.

More broadly, although relatively small (a US\$17bn economy with a population of 9.7m), Bolivia is likely increasingly to become a focus of international attention. Rising crime and drug-trafficking is likely to be high on the US's agenda for the region, and in mid-September the US State Department blacklisted Bolivia for shortcomings in efforts to eradicate the illegal drugs trade. Moreover, Bolivia is an important supplier of natural gas to neighbouring Argentina and Brazil, so instability that continues to impair gas supplies (as occurred in September 2008) will have a direct impact on those countries' economies. Finally, given Mr Chávez's overt involvement in radicalising tensions, the way in which other countries in the region co-operate to try and defuse Bolivia's conflict will be an important test of the extent to which a more moderate and constructive approach to resolving regional frictions can be developed. The summit of the Unión de Naciones Suramericanas (Unasur, the Union of South American countries, founded in 2007) convened by Chile's president, Michelle Bachelet, in September is a first step in this direction.

Rising inflation and numerous undecided voters pose a risk in Ecuador

There is less risk of unrest in **Ecuador**, where a new constitution is expected to be approved on September 26th, but the impact of rising inflation and a large

share of undecided voters (with electoral rules stating that abstentions and annulled ballots be counted as "no" votes) pose a risk to our forecast. If the president, Rafael Correa, were to be defeated, his standing would be weakened and he might struggle to complete his term in office, particularly if the economy continues to deteriorate. We currently believe that Mr Correa will see his constitution approved and that he and his Alianza País (AP) party will win fresh elections in early 2009. Mr Correa remains very popular while the opposition is still divided and unpopular and a viable leader has yet to emerge.

A victory for the right in local elections will redefine Nicaragua's politics

In **Nicaragua**, the smallest and poorest of the four (five if Honduras's legislature ratifies ALBA membership) participant countries in Mr Chávez's ALBA, legislative activity will be on hold until after the November 2008 municipal elections. The growing likelihood that the ruling left-wing Frente Sandinista de Liberación Nacional (FSLN, the Sandinistas) of the president Daniel Ortega, which currently dominates at the local level, will lose many municipalities, including the capital, Managua, to a united right-wing opposition, will alter the balance of political power in the next few years. If Eduardo Montealegre, who lost to Mr Ortega in the presidential race in 2006, wins the mayorship of Managua, his position as *de facto* leader of the united right-wing alliance will be reinforced. This will diminish the ability of Arnoldo Alemán, the leader of the rightwing Partido Liberal Constitucionalista (PLC, part of the right-wing alliance), to strike a deal with the Sandinistas over the extension of their controversial joint pact (which shared out positions in the country's main institutions between the two parties and which could help overturn Mr Alemán's corruption conviction in the Supreme Court), complicating policymaking for Mr Ortega's administration during the remainder of his term.

Ms Fernández's political capital has shrunk

In **Argentina**, not an ALBA partner, but politically sympathetic to Mr Chávez's regime and increasingly dependent upon his financial largesse given that it remains cut-off from the international capital markets, the president, Cristina Fernández de Kirchner, has seen her political capital shrink as serious cracks have opened in the broad political alliance that she and her husband and predecessor, Néstor Kirchner, have built over the past five years. Unless the Kirchners can rebuild their political capital and their popularity, they are likely to face increasing opposition from congressmen and state governors who were formerly their allies. Our central forecast is based on the assumption that pressure from the Partido Justicialista (PJ, the Peronists) and Ms Fernández de Kirchner's own will to survive politically (she faces mid-term congressional elections in October 2009), will force her to adopt more consistent economic policies from late 2008—to date she has stayed with Mr Kirchner's loose monetary and fiscal policy framework, an approach that has become increasingly unsustainable and is raising the risk of an inflationary spiral and a hard landing during the forecast period. However, the new economic policies are unlikely to increase her popularity, given that the necessary reforms will be painful, especially for the poor. It would reduce, nonetheless, the growing risk that the economy suffers a much sharper than currently expected slowdown, which would have serious political consequences and could cost the president her mandate.

Excessive expectations could quickly undermine Mr Lugo's popularity

Fernando Lugo, a former priest and political outsider who was sworn in as **Paraguay's** president on August 15th, faces significant challenges. Mr Lugo's plans to implement politically difficult policies to reduce poverty and social exclusion, including a land reform programme, carry significant downside risk given the high expectations of change created by his election campaign. Although the legislative position of Mr Lugo's broad governing coalition has been eased to a degree by the declared support of Lino Oviedo, a former general who leads Paraguay's third-largest political party (the Partido Unión Nacional de Ciudadanos Éticos, or UNACE), Mr Lugo's lack of experience in public office will further compound the challenges he faces.

Municipal elections in Brazil and Chile preview forthcoming general elections

Although Brazil, the region's largest country, and Chile, one of its most stable, do not face general elections this year, the outcome of forthcoming congressional contests will provide important indicators of political parties' prospects in the next presidential contests. In **Brazil**, municipal elections are due on October 5th and the parties' performances will be important for positioning them ahead of the 2010 presidential election, which is wide open because the president, Luiz Inácio Lula da Silva, is constitutionally ineligible to stand for a third term. We expect the ruling Partido dos Trabalhadores (PT) to increase its share of mayorships on the back of Lula's popularity—which has recently risen to a new high, extending to the richer and more educated segments of society on the back of strong economic growth. A good performance for the PT in October, coupled with Lula's high popularity, would boost the ruling party's prospects of retaining power in 2010.

Likewise in **Chile**, which has municipal elections scheduled for October 26th, their outcome will provide a preview of the December 2009 presidential and congressional elections. The outcome of the municipal elections, where the ruling Concertación Democrática (Concertación) coalition is presenting two separate lists of candidates, and a new alliance, Por un Chile Limpio (for a clean Chile), is competing for the first time, will be important. The divisions in the ruling party portend difficult negotiations in 2009 over agreement on a common list for the presidential and congressional elections. A good electoral performance by Por un Chile Limpio may provide it with the political weight to make a further impact in 2009. Divisions within the Concertación, which have increased in recent years as the government has been blamed for falling economic growth, rising inflation and unemployment, potentially signal a realignment of Chilean politics.

Tough economic conditions for Central American and Caribbean politicians

Although our central forecast assumes that no other **Central American** or **Caribbean** governments will join Mr Chávez's ALBA alliance, the growing risk of a sharp economic decline (owing to recessionary conditions in the US and a further tightening of global liquidity) and high inflation could test allegiances by making the region more vulnerable to Venezuelan handouts. The issue of rising insecurity is also worrying voters as drug violence is displaced from Mexico, where the government is cracking down heavily on the cartels, to neighbouring countries. Most of these have much weaker and smaller security forces that are already struggling to cope with existing levels of violent crime. Popular dissatisfaction over declining purchasing power and rising crime, may raise the risk of social unrest, which would compound governability problems

facing the sub-region's governments. It could also increase the temptation for voters to elect radically left-leaning parties, as could happen in El Salvador in March 2009 but is less likely elsewhere. Venezuela already has a significant influence in the region as spiralling oil prices and the rising cost of subsidising energy prices have driven most countries to sign up to its PetroCaribe initiative which provides preferential financing on oil purchases. One country, Honduras, has recently gone as far as to sign up to ALBA, but it is far from certain that its legislature will ratify the treaty, not least as doing so would compromise relations with the US, its main trading partner and source of most of its foreign direct investment (FDI) and workers' remittances. For now, we assume that the 2009 elections scheduled in Central America will see incumbent parties (El Salvador and Panama) return to power or a shift to the right (in the case of Honduras). In Costa Rica, the ruling Partido Liberación Nacional (PLN) looks set to start the campaign for 2010 as a favourite, while judging from current developments in Nicaragua where Mr Ortega's popularity has plummeted, the right, if it stays united, has a good chance of returning to power in 2011. However, if economies deteriorate substantially, electoral pressure to deal with poverty and wide income inequalities will grow.

Election watch

Elections

	Presidential	Legislative
In 2009		
Ecuador	Feb 2009	Feb 2009
El Salvador	Mar 2009	Jan 2009
Panama	May 2009	May 2009
Mexico	-	Jul 2009
Argentina	-	Oct 2009
Uruguay	Oct 2009	Oct 2009
Honduras	Nov 2009	Nov 2009
Chile	Dec 2009	Dec 2009
In 2010-13		
Costa Rica	Feb 2010	Feb 2010
Colombia	May-2010	Mar 2010
Dominican Republic	-	May 2010
Brazil	Oct 2010	Oct 2010
Bolivia	Dec 2010	Dec 2010
Peru	Apr 2011	Apr 2011
Nicaragua	Nov 2011	Nov 2011
Mexico	Jul 2012	Jul 2012
Venezuela	Dec 2012	Dec 2011
Paraguay	Apr 2013	Apr 2013

2009 elections unlikely to result in spread of regional radicalism

In Panama, which does not hold elections until May 2009, Balbina Herrera, the candidate for the ruling Partido Revolucionario Democrático (PRD), will be favoured by a strong economic performance and a divided opposition. A win for Mr Funes of the left-wing opposition Frente Farabundo Martí para la Liberación Nacional (FMLN) in El Salvador would require that the party steps away from its radical doctrine and embraces a more business-oriented agenda. Currently this still seems a remote prospect, as the party's radical wing remains dominant. Our baseline assumption is that the incumbent Alianza Republicana Nacionalista (Arena) secures re-election with its candidate, Rodrigo Ávila. In El Salvador a defeat for the incumbent would shake up the political landscape,

Crime and inflation will dominate the campaigns

if only because the former guerrillas of the FMLN came in from the cold just over 15 years ago.

The elections in all these countries will be dominated by popular worries over slowing growth, rising food and oil prices, and high crime rates. Aside from an inflationary spiral, which would erode real incomes and hit private consumption hard, the combination of higher prices and interest rates and their negative impact on consumer spending could sway voters to support opposition parties. This does not augur well for sitting presidents and governments and as a result policy implementation is set to become even more complicated in some of these countries. In El Salvador, regardless of the final result, coalition-building will remain key to implementing the government's policy agenda—both the FMLN and the ruling Arena will remain in minority positions.

In Mexico, the outcome of the July 2009 congressional election will be important in determining whether the president, Felipe Calderón of the centre-right Partido Acción Nacional (PAN), can maintain momentum behind his government's structural reform agenda in the second half of his term. His government faces a much more difficult environment in the remainder of 2008 and in 2009. A slowing economy, which will preclude fulfilment of Mr Calderón's electoral pledge to reduce unemployment, and the difficulties he will face in reversing a recent worsening of violent crime, will threaten public confidence in his government. An expected strong performance for the opposition Partido Revolucionario Institucional (PRI) could potentially galvanise reform. This will be particularly so if the leftist Partido de la Revolución Democrática (PRD) performs poorly, as currently seems likely, as it has been the most obstructive force in Congress. Although a significant number in the PRI's ranks remain resistant to supporting the PAN government, many are increasingly concerned about the threat to long-term prospects posed by sluggish reform and regard constructive support for reform as the best route to recapturing the presidency in 2012.

Economic forecast

Global outlook

	2007	2008	2009	2010	2011	2012
Real GDP growth (%)						
US	2.0	1.8	0.6	1.7	2.5	2.7
Japan	2.1	0.8	0.8	1.6	1.1	1.3
OECD	2.7	1.7	1.1	2.0	2.4	2.5
World (market exchange rates)	3.7	2.7	2.0	2.9	3.3	3.3
World (PPP exchange rate)	4.8	3.8	3.2	4.0	4.3	4.4
World trade growth (%)						
Goods	7.4	5.3	4.4	5.8	6.4	6.7
Consumer price inflation (%)						
US	2.9	4.4	2.6	2.2	2.5	2.4
Japan	0.1	1.8	1.4	1.2	1.2	1.1
OECD	2.1	3.6	2.3	1.9	2.0	1.9
Export price inflation (%)						
Manufactures (US\$)	4.4	9.1	0.6	0.5	0.6	0.7
Commodities (%)						
World oil price (Brent; US\$/b)	72.7	110.0	91.0	100.0	115.0	120.0
Non-oil commodities (measured in US\$)	20.8	20.8	-4.9	3.1	-1.5	2.4
Food, feedstuffs, beverages	30.9	36.7	-1.5	4.0	1.2	5.9
Industrial raw materials	11.2	3.2	-9.8	1.7	-6.0	-3.7

Policymakers face challenging global conditions in 2009

- The recent turmoil in US financial markets, its continuing housing crisis and the fallout of global inflationary pressures, confirms the Economist Intelligence Unit's expectation of a sharply weakening global economy in the remainder of 2008-09. We expect global growth (measured using purchasing power parity—PPP—weights) to slow to 3.2% in 2009 from 4.8% in 2007. The greater weight in the global economy of rapidly growing emerging economies, particularly China and India, and the greater resilience of emerging market economies will mitigate the negative impact of US trends on global growth. Nevertheless, emerging markets will also face challenging conditions in 2009 as external conditions deteriorate and their policymakers struggle to control inflation. Our assumption that commodity-induced inflationary pressures will ease in 2009 combined with the recent turmoil in US markets, underlines our expectation of at least one rate cut (to 1.5%) by the Federal Reserve (Fed, the US Central Bank) before end-2008 as authorities work to restore financial market stability and support growth.

Deepening financial turmoil and rising inflation are the two main global risks

- There are a number of serious risks to our global baseline outlook. One of the most important is a further deterioration of the financial-market crisis which would cause serious disruptions to the global real economy. Although a good deal of the exposure to the sub-prime crisis has now been factored in, the tightening of global credit conditions in the wake of the Lehman Brothers collapse, the Merrill Lynch takeover and the quasi-nationalisation of AIG and Fannie Mae and Freddie Mac in August and September, will impair Latin America's prospects for financing and foreign direct investment (FDI) flows.
- Another important risk is inflation, which has risen globally since the start of 2008 but has recently shown tentative signs of easing. Although we expect consumer price inflation in the developed world to abate in 2009-10 amid weaker commodity prices and slowing domestic demand, in much of the

developing world, including many countries in Latin America, the loose monetary conditions and accelerating domestic demand of the past two years leave a backlog of inflationary pressure that will prove difficult to rein in swiftly. In some countries in Latin America, inflation could continue to rise as rising wage demands—as workers look to compensate for their reduced spending power—could create second-round inflationary pressures. The acceleration in inflation poses a dilemma for policymakers globally, with many countries unable to lower domestic interest rates to offset the impact of recessionary conditions in the US, and, worse, any policy tightening likely to restrict domestic demand and erode competitiveness as exchange rates appreciate against the US dollar. In Latin America, many governments face growing fiscal dilemmas as the cost of subsidies aimed at mitigating the inflationary impact of rising commodity prices becomes unsustainable.

- The correction in commodity prices under way since July, which is helping to ease inflationary pressures, will bring problems of its own as it will hit those commodity-dependent countries that have used recent record revenue to step up fiscal spending, increasing the threat of a pro-cyclical downturn. At the same time, lower commodity prices imply weaker exchange rates for these countries, potentially neutralising any benefits on the inflation side. There are growing worries about the sustainability of economic boom in China, although our central forecast is for a gradual slowdown. Risks related to geopolitical developments also remain important. These include an escalation of violence in the Middle East, terrorist attacks and rising trade protectionism.

Oil and soft commodity prices will weaken before recovering in 2010-12

- Many Latin American countries have been enjoying a boom in export earnings over the past two years, including the first half of 2008, owing to high commodity prices, buoyed by rapid economic growth in emerging Asia (especially China). Apart from oil and metals, Latin America is also an important exporter of foods, feedstuff and beverages (FFB). Despite a slowdown in global growth, we expect that food, feedstuff and beverages prices will be underpinned by rising biofuel demand, reduced plantings for food/feed crops (owing to competition for acreage from more lucrative crops) and increased demand for food as average incomes rise in China and India. Food, feedstuff and beverages prices will therefore decline by just 1.5% in 2009, before recovering their upward trend from 2010.

- Crude oil prices have plunged since peaking in July 2008 with Brent crude—which had fallen to US\$89/barrel on September 16th—reflecting weakening global growth and an unwinding of speculative investor interest. Even so, we see little downside risk to prices despite a recession in the US. Crude prices will ease slightly in 2009, with Brent crude averaging US\$91/barrel in 2009 (down from US\$110/b in 2008), before rising again in 2010-12 owing to increased supply constraints. Historically high prices will help to underpin the public finances and currencies of Latin America's crude exporters. However, in the long term this will build up problems, as securing political support for much-needed structural reform will become all the harder.

Latin America	Key indicators LatAm & Caribbean	2006	2007	2008	2009	2010	2011	2012
	GDP growth (%)	5.4	5.4	4.1	3.0	3.9	4.0	4.0
	Consumer prices (% av)	5.2	5.4	8.2	8.0	6.5	6.0	5.3
	Public-sector debt (% of GDP)	37.3	36.0	33.0	31.9	31.1	30.7	30.4
	Current-account balance (US\$ bn)	52.7	22.6	-4.6	-31.8	-48.4	-58.4	-65.7
	Current-account balance (% of GDP)	1.8	0.7	-0.1	-0.7	-1.0	-1.2	-1.3
	External financing requirement (US\$ bn)	-105.3	-94.0	-117.7	-141.7	-155.4	-168.1	-175.6
	FDI inflows (US\$ bn)	70.0	106.0	103.4	89.9	100.9	105.3	110.2
	FDI inflows (% of GDP)	2.4	3.1	2.4	2.0	2.2	2.2	2.2

US recession and continued inflationary pressures dampen regional prospects

Growth in Latin America will slow significantly in 2009 owing to recessionary conditions in the US, the region's largest trading and investment partner. Slower growth will diminish the ability of fiscal policy to spur growth in many countries across the region while inflation will mostly preclude any significant easing of monetary policy. Although commodity prices have begun to ease, inflationary pressures will remain high for part of 2009 owing to lagged effects of loose monetary policy in much of 2006-07 and the risk that higher wage demands, as workers attempt to restore their lost purchasing power, feed into second-round price pressures. This will also force policymakers to keep monetary conditions tight. Our forecast assumes that policymakers will be able to control rising inflation in 2009, which would otherwise threaten domestic demand (a key driver of growth) and damage confidence, reducing medium-term growth to below currently forecast levels.

The risk of a major financial crisis is low, because Latin America's external vulnerabilities have fallen sharply in the past decade. Part of the improvement has been cyclical, given favourable international conditions in 2004-07 and early 2008, but part has been structural, as most countries (except Argentina, Ecuador and Venezuela) have reduced public and external debt and have adopted a more flexible policy framework, enhancing confidence in macro-economic stability. Domestic demand has more solid foundations than in the past, providing support for growth. Fiscal policy is more disciplined and public and external solvency ratios have improved. Policymakers in many countries used the good years to switch public external debt into domestic debt and since 2004/05 the strongest-rated sovereigns have been able to issue local currency debt on the international markets. Risk appetite has hit new lows following the recent turmoil in the US financial sector and closed access to capital markets for Latin American issuers—we do not expect that demand for such paper will return any time soon. However, international reserves remain high and in many countries amply cover external liabilities. A gradual deepening of local capital markets has made parts of the region less reliant on foreign savings to finance growth.

Latin America's GDP growth will slow less sharply than in past US downturns

Real GDP growth in Latin America will slow by around 1 percentage point in each of 2008 and 2009. Although Brazil, which accounts for just over one-third of regional GDP will barely slow this year (we project 2008 growth of 5.3%, compared with 5.4% in 2007), elsewhere GDP is decelerating more markedly. Still very strong activity in Brazil in the second quarter (driven by household consumption and investments), has prompted us to revise up our growth forecast for 2008 from 4.6% to 5.3%. However, deteriorating external conditions



Argentina and Venezuela are the most exposed among the major economies

combined with weaker domestic demand on the back of higher interest rates will cause overall GDP growth in 2009 to slow to 3.4%.

In Mexico (which makes up one-quarter of regional GDP), the US slowdown has started to have a more marked impact. The Indicador Global de la Actividad Económica (IGAE, a close proxy for GDP growth) slowed from 2.9% in the first quarter to 1.8% in the second. For the first half as a whole, GDP growth slowed to 2.8%. The deceleration in the remainder of 2008-09 will be driven by a sharp weakening of the external balance in line with developments in the US, and weakening domestic demand as rising inflation and unemployment erode real household incomes. We anticipate that full-year growth will slow to 2.3% in 2008 and 1.6% in 2009, the lowest rate of growth among the four major economies. Even so, our forecast for Mexico implies that it will be more resilient in the face of US weakness than in the past, when it has tended to magnify US cycles. During the last US recession, in 2001-02, GDP in Mexico contracted more sharply than that the US and stayed weaker for longer.

In Argentina (the region's third-largest economy), the distortions in the policy environment represent a significant threat to our baseline forecast for a relatively orderly transition from the high rates of growth that have characterised the rebound from the 2001-02 crisis, to more sustainable rates of economic expansion. After growing by 8.7% in 2007, real GDP growth is forecast to decelerate to 6% in 2008 and 3.5% in 2009. Nevertheless, these numbers overstate the level of activity since the deflator is based on official inflation figures, which underestimate real inflation in the economy. Moreover, there is a growing risk of a hard landing in 2009-10 should policymakers fail to implement more consistent policies and address price misalignments and other distortions in the economy.

In Venezuela (the region's fourth-largest economy), which already suffers from extreme versions of some of the imbalances that threaten Argentina, fiscally fuelled domestic demand has underpinned GDP growth in recent years. However, the skewed structure of GDP growth in the first half of 2008 underscores the contradictions of the policy environment. Although real GDP growth picked up from 4.9% year on year in January-March to 7.1% in the second quarter, this was largely owing to an increased fiscal stimulus (which boosted domestic demand components) and a major statistical discrepancy; real exports contracted for the eleventh successive quarter. Rising inflation is eroding real incomes and hurting purchasing power, while the radicalisation of economic policy over the past year is producing a significant contraction in private investment. Although our forecast of continuing high energy prices will boost domestic demand through the fiscal injection, this effect will be largely offset by inflation and its negative impact on real incomes. These trends are expected to continue during the remainder of the forecast period, producing slower growth of 5.4% in 2008 and 2.7% in 2009.

Private consumption will underperform overall GDP growth in 2010-12

Latin American domestic demand has held up reasonably well in the first half of 2008 despite slowing US growth. However, it is set to weaken in the remainder of 2008-09 owing to the erosion of real disposable incomes by rising inflation, tighter credit conditions and rising unemployment as the deterioration of the external environment has a greater impact on the domestic

economy. In some of the smaller economies, domestic demand will also be hard hit by weakening inflows of workers remittances from the US and the EU. Even so, our projections reflect the greater resilience of the region in the face of US recession than was the case in 2001. This in turn reflects a strengthening of domestic supports in recent years on the back of improved policies, which have contributed to generally lower inflation (notwithstanding the recent commodity-price related upturn) and a deepening of credit markets.

However, from 2009 domestic demand growth is forecast to slow to below 5% (from 5.8% in 2008), given a slowdown in all its components to more sustainable rates. Although private consumption will be an important driver of growth in 2008, expanding by 4.9%, it will slow to 3.3% in 2009 owing to rising inflation. Assuming that policymakers are able to control inflation, we estimate that private consumption will grow by an average of 3.8% in 2010-12. However, this will be slower than average GDP growth of 4%. This is owing to the fact that, although real incomes will once again benefit from falling prices it will take time for them to regain their previous purchasing power levels. Government spending will ease from 2009 onwards as slowing growth curbs fiscal revenue. Other components of demand will slow, contributing to an overall deceleration of regional GDP. Following supply disruptions in 2007, export volumes will moderate further in 2008 and in 2009 as a result of the global slowdown.

Trade and remittances flows will slow due to recessionary conditions in the US

Besides being the region's most important trading partner, the US is home to nearly 15m legal and illegal migrant workers from Latin America. The US recession will not only dampen the Latin America's export growth, but also impair workers' remittances flows. Exports have played an important role in the region's strong economic performance of recent years (although with imports also surging, the contribution of net trade has been increasingly negative since 2004), with high prices for the region's agricultural and mineral commodity exports boosting investment and fiscal performance. Rising remittances and FDI flows to the region have also spurred domestic demand. Although Mexico has been the first to experience a contraction in remittance flows, there has been a deceleration in the growth pace of remittances to other countries. This not only reflects the slowdown in the US economy, but also the fading of reporting gains, and tighter immigration control in the US. We expect that workers' remittances from the US to countries other than Mexico will slow with a lagged effect. A longer and deeper US recession than currently forecast and a continued tightening of US immigration represent risks to remittances growth.

Many smaller open economies, such as those of Central America and the Caribbean, are much more dependent than Mexico on workers' remittance flows, as well as being heavily dependent on exports to the US market. Inflows will decelerate in 2008, owing in part to the high base of comparison and in part to an unravelling in the US housing market (which is damaging the job prospects of many Central Americans, legal and illegal). Despite falling in 2009, remittances will continue to play an important role in supporting consumption. Remittances to Central America peaked at 9.5% of sub-regional GDP in 2006-07; they are set to fall to around 8.2% in 2008 and 7.5% in 2009. In Costa Rica and Panama the contribution of remittances is relatively small, at 3.9% and 1.2% of GDP respectively in 2007, but in Honduras (33%), El Salvador (26%), Guatemala

The rising financing requirement is a major source of concern

(20%) and Nicaragua (18%) remittances will continue to provide major support to domestic economies.

The region would suffer if the US recession were to be prolonged. Despite a substantial improvement since the 1990s, the region's external financing requirement is set to remain very large and a major source of concern, particularly in view of the recent turmoil in US markets and a substantial deterioration in global borrowing conditions which will last well into 2009. A gradual deterioration in the current-account balance and a need to roll over still-substantial maturing foreign debt will result in Latin America's external financing requirement nearly doubling between 2007 and 2012. At US\$142bn in 2009 and an average of US\$166bn in 2010-12, the region could struggle to secure sufficient financing if credit availability does not improve. More than half of the external financing requirement will be accounted for by Brazil and Mexico. These two economies, which between them will need to roll over in excess of US\$70bn in 2009-10, are two of the region's most solid credits, with scope to absorb more onerous credit terms in 2009-10 than the exceptionally favourable rates of the past few years without creating serious strains. However, many Central America and Caribbean countries in particular will find it problematic to raise the funds to cover their external financing requirements (which will widen as export growth tails off) and this may signal painful adjustments in imports.

During the credit upswing in 2006-07, banks in Mexico, Central America, the Caribbean and some Andean countries borrowed from US banks to lend to consumers and companies, fuelling a mini credit boom. Banks in Brazil, Argentina and Chile are less exposed, as they have relied more on domestic sources to fund the credit expansion. Latin America's reduced external vulnerability and increasingly flexible policy frameworks will enable it to weather a sharp adjustment in US growth rates without suffering a financial crisis. However, the sharp decline in the region's financial markets since August illustrates the risks to some of the region's currencies of tightening global liquidity conditions. Although in the major markets (Brazil, Mexico and Chile) there has been a broadening and deepening of foreign investment in local assets. But a rising stock of foreign investment in local markets also represents an increased vulnerability to a more drastic deleveraging on the part of international investors.

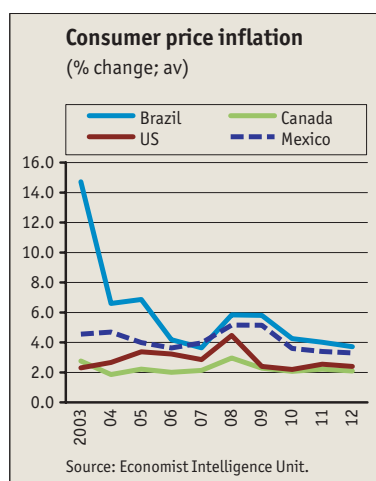
High public debt and low investment levels remain sources of weakness

There has been a sharp reduction in the external debt stock across most of the region in recent years, but improvements to public finances, although tangible, have been much less marked, leaving public-sector debt levels relatively high. The regional public-sector debt/GDP ratio has been falling since 2002, when it reached 49%, and this trend will continue in the forecast period. We expect it to ease to 33% in 2008 and 32% in 2009. However, thereafter the pace of improvement will slow markedly with the public debt/GDP ratio falling to just 30% in 2012. This is owing to the economic slowdown and the lack of growth in the tax base in most countries. Although efforts to increase formalisation are helping to lay the ground for stronger revenue bases (Brazil is a salient example in this regard), in most countries these will be consolidated only in the long term, while most governments also face a heavy backlog of public investment needs in healthcare, education and the physical infrastructure. Despite the

likelihood of rising financing costs, it is unlikely that other structural reforms to the public finances (which also tend to be marked by serious spending inefficiencies) will advance significantly. These are politically difficult reforms, and with few governments in the region commanding legislative majorities, it is unlikely that much progress will be made.

Investment rates will remain inadequate in the first half of the forecast period with the investment/GDP ratio (including the largest economies of Brazil, Mexico and Argentina) averaging just over 21%. It will rise to a more acceptable 23% in 2010-12, but this masks substantial divergences. Investment rates in Colombia and Peru are at the higher end of the spectrum, at over 25%. The improved security situation in Colombia, which has given foreign investors the confidence to return, has provided the main boost for investment. Rising populism and nationalism in a few countries will act to constrain private investment in those markets, such as Ecuador, where the investment rate will average around 18% in the forecast period. More broadly, deficiencies in the business environment, including cumbersome and complex procedures for opening new businesses, and highly protective labour codes, constrain investment in many countries. As with fiscal reform, addressing these deficiencies will be slow in the context of weak governability.

Continued inflationary pressures are the chief threat to economic recovery



A weaker trade surplus will drive the current account into deficit from 2008

We project an easing of inflation in most countries in 2009 in line with our commodity price forecasts, slowing domestic demand and our expectation of continued adherence to inflation-targeting regimes across most of the region. However, some governments could struggle to rein in lagged pressures from relatively loose monetary policy in 2005-7 and possible second-round price pressures from increased wage demands. In Central America in particular, inflation has risen to double-digit levels in recent months—in the dollarised economies of Panama and El Salvador it has moved close to 10%. This is not only hurting consumer spending but also the fiscal accounts, which are suffering under the pressure of the rising cost of energy and food subsidies. Across the board higher inflation means that regional inflation will rise to 8.2% in 2008, before starting on a downward trend in 2009-12 (with the exception of Argentina and Venezuela). However, with risks to our oil and soft commodity price forecasts mostly on the upside, and worsening external financing conditions posing risks to some currencies in the region, monetary authorities may be forced to raise rates anew to meet inflation targets. This would curb domestic demand and could hit confidence and export competitiveness.

Very strong export growth in the first half of 2008, in spite of recessionary conditions in the US, will not be sufficient to prevent Latin America's current-account surplus of the last five years from reverting to a small deficit in 2008. The main driver of this deterioration is Brazil's reversal of its current-account surplus into a deficit combined with sharp deteriorations in Mexico's and Central America's current-account deficits. In the early part of the forecast period the current-account deficit will average 0.4% of GDP. It is projected to grow to 1.2% in 2010-12, still a low level by historical standards, but leading to a relatively high external financing requirement in absolute terms, which will be a particular concern in the early part of the forecast period, as discussed above.

FDI inflows will fall but remain above levels reached in the 1999-2000 boom

After four successive years of decline, FDI inflows into the region recovered in 2004 and reached US\$106bn in 2007 (3% of GDP). The recovery can be ascribed to high US growth in the first three-quarters of 2007, robust demand for commodities (encouraging resource-seeking investors) and better policy support for manufacturing investment in the region, including the implementation of free-trade agreements (FTAs), such as the Dominican Republic-Central American Free-Trade Agreement (DR-CAFTA). Although FDI inflows will fall slightly in 2008 and more sharply in 2009, to US\$90bn, they are set to remain above the peak of US\$84bn reached in 1999-2000 (boosted by the one-off effects of market opening, privatisation and a global investment boom) as investment opportunities continue to widen and deepen. Despite a recovery in the second half of the forecast period FDI inflows are set to erode slightly on a share-of-GDP basis. Latin America's full potential to attract FDI will be constrained by structural weaknesses and the high cost of doing business, including excessive bureaucracy, a deficient infrastructure and skills shortages. Large domestic markets will ensure that Brazil and Mexico continue to receive more than half of the region's FDI inflows throughout the forecast period. Chile is expected to account for nearly 17% in 2008-12, followed by Colombia with 7% and Central America with 6%.

Mercosur	Key indicators Mercosur	2006	2007	2008	2009	2010	2011	2012
	GDP growth (%)	5.3	6.3	4.9	3.4	3.8	3.9	4.0
	Consumer prices (% av)	6.5	6.3	9.3	9.7	8.1	7.3	6.2
	Current-account balance (US\$ bn)	48.2	29.1	21.9	4.9	1.8	-1.7	-5.1
	Current-account balance (% of GDP)	3.2	1.6	0.9	0.2	0.1	-0.1	-0.2
	External financing requirement (US\$ bn)	-34.4	-22.7	-27.9	-41.9	-43.5	-47.5	-50.2
	FDI inflows (US\$ bn)	24.8	42.1	40.5	35.6	38.4	39.4	41.0
	FDI inflows (% of GDP)	1.7	2.3	1.7	1.4	1.5	1.5	1.5

Inflation will remain stubbornly high in Venezuela and Argentina

The Mercado Común del Sur (Mercosur, which includes Argentina, Brazil, Paraguay, Uruguay and Venezuela, pending ratification by the Brazilian and Paraguayan legislatures) is the largest trading bloc in Latin America. Two specific trends—the higher than average inflation rate and the strength of its current account—will continue to differentiate it from the rest of the region and impact Latin America's overall performance.

Average annual inflation in Mercosur will remain above our regional forecast average of 8.1% (2008-09) and 5.9% (2010-12) because of stubbornly high inflation in Venezuela and in Argentina—Mercosur inflation is forecast to decline from 9.5% in 2008-09 to 7.2% in 2010-12. Venezuela's 12-month inflation rate reached 33% in July and we expect it to end 2008 at around 36% owing to fiscal laxity which is fuelling strong domestic demand, while policy uncertainty is deterring investment in domestic capacity. There is likely to be little inflation relief until 2010 at the earliest, even if domestic demand growth slows as expected. We expect that Venezuelan inflation will remain in double-digits throughout the forecast period. Argentina has the second-highest level of inflation in the sub-region; it reached 9.1% in July according to official sources but the government's manipulation of inflation data to give a favourable reading contrasts with private measures of inflation, which are close to 25%. Price pressures are being driven by strong domestic demand and booming domestic liquidity, fuelled by very low real interest rates. Our forecast that

inflation will average just below 10% in 2008-09, and ease to 8% in 2010-12, assumes that there will be a realignment of energy and transport prices under the government of Cristina Fernández de Kirchner in the coming months.

The Mercosur current account will drive the region's good external performance

Despite a reversal of Brazil's current-account surplus to a deficit in 2008, Mercosur is the only sub-region in Latin America that is expected to maintain a current-account surplus for most of the forecast period and as such will stem the deterioration in Latin America's current account. Nonetheless, it will continue to shrink, owing to a declining, albeit large, trade surplus. Mercosur has been the main beneficiary of China's growing import demand for commodities, demonstrated by the strong export earnings growth that has benefited the trade account. The trade surpluses of Brazil, Argentina and Venezuela—the latter is Latin America's leading oil exporter—are largely responsible for the positive performance. Indeed, with the risks to our oil price forecast still weighted on the upside, Venezuela's (and therefore the sub-region's) surplus could turn out stronger than currently forecast. In the long term, although not within our five-year forecast horizon, Brazil is expected to become a significant oil exporter.

Andean Community

Key indicators Andean Community	2006	2007	2008	2009	2010	2011	2012
GDP growth (%)	6.6	7.1	5.3	4.6	4.5	4.5	4.3
Consumer prices (av)	3.3	4.0	7.2	5.8	5.1	4.7	4.5
Current-account balance (US\$ bn)	2.4	-1.4	-1.7	-7.8	-9.5	-9.5	-7.9
Current-account balance (% of GDP)	0.9	-0.4	-0.4	-1.8	-2.2	-2.1	-1.6
External financing requirement (US\$ bn)	-11.0	-17.6	-16.5	-21.7	-23.5	-24.0	-22.8
FDI inflows (US\$ bn)	9.4	14.4	15.4	12.6	11.2	11.1	10.4
FDI inflows (% of GDP)	3.3	4.2	3.6	2.9	2.6	2.4	2.1

Andean fixed investment rates are the highest in Latin America

The Comunidad Andina (CAN, the Andean Community) countries—namely Bolivia, Colombia, Peru and Ecuador—stand out in the regional context for their above-average growth rates, driven to a large extent by a high level of fixed investment and FDI by Latin American standards. Bolivia, Peru and Ecuador attract mainly resource-seeking investment, but security improvements in Colombia have enabled it to broaden inflows of FDI in recent years. Although GDP growth will slow progressively in the Andean Community, prospects are among the strongest in the region throughout the forecast period. In 2008-09 GDP is expected to reach 4.9% (down from 5.7% in 2003-07), before easing to a still strong 4.5% in the second half of the forecast period. In 2008-09 growth in these countries will continue to be driven by domestic demand, which, albeit slowing, will remain more than robust at 6.3% in this period. Most of the deceleration in domestic demand will stem from investment growth moving towards more sustainable levels after expanding by 14% per year on average in 2003-07. A particularly strong surge in 2006-07 (up by 21%), was boosted by investment growth in Colombia and major extractive projects in Peru.

Central America

Key indicators Central America	2005	2006	2007	2008	2009
GDP growth (%)	4.6	6.4	6.6	4.4	3.5
Consumer prices (av)	8.3	6.2	6.9	12.7	12.8
Current-account balance (US\$ bn)	-4.7	-5.1	-8.1	-14.7	-14.2
Current-account balance (% of GDP)	-4.8	-4.6	-6.4	-9.9	-8.5
External financing requirement (US\$ bn)	-7.5	-9.3	-10.1	-17.0	-16.3
FDI inflows (US\$bn)	2.8	4.8	6.8	6.4	6.0
FDI inflows (% of GDP)	2.9	4.4	5.3	4.3	3.6

Central America is one of the most exposed sub-regions

Central America (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama) has experienced a remarkable turnaround since 2004, with GDP expanding by an average of 5.1% between 2004 and 2007. These were the highest growth rates since the early 1990s, the end of civil wars in Guatemala and El Salvador, and the defeat at the poll of the marxist Sandinistas in Nicaragua. In terms of GDP, Central American FDI has been the highest in Latin America, averaging 3.7% in 2003-07 and 4.7% in 2006-07. Although we expect that the benefits of DR-CAFTA with the US will continue to support exports and investment in the remainder of 2008-09, the sub-region will be one of the most vulnerable to a severe deterioration in economic conditions. Although moderate in absolute terms, external financing requirements are very onerous relative to GDP. The sub-region's dependence on imported fuel has contributed to it suffering some of the worst inflation rates in the region in the past year and this is expected to exact a heavy toll on private consumption in the forecast period. In many of these economies credit has been growing rapidly and banking systems and supervisory arrangements are in many countries less robust than in the Latin America region's more developed economies. In addition, public finances are mostly weak and have been weakened further in the past year by initiatives to cushion the impact of rising inflation.

Barring a deep and long US recession, we expect that FDI will fall to US\$6.4bn in 2008 and US\$6bn in 2009, with around 40% going to Panama (related to the expansion of the canal). Recent renewed turmoil in the US markets may well force us to revise our FDI forecasts for 2009 as companies delay their investment decisions because of lack of available financing or poor short term prospects. This would also affect our growth forecast for the region. In the long term, however, stable macroeconomic and political environments, especially in Panama, Costa Rica and El Salvador, combined with access to the US through DR-CAFTA (for all countries except Panama), a young workforce (and a skilled workforce in the case of Costa Rica), will attract FDI to the sub-region. Continued investment opportunities in utilities, industry, infrastructure (especially the Panama Canal expansion), and services (especially in tourism), will spur FDI.

Business environment rankings

The Economist Intelligence Unit's business environment rankings model seeks to measure the quality or attractiveness of the business environment and its key components in 82 of the world's largest economies. It is designed to reflect the main criteria used by companies to formulate their global business strategies and investment location decisions. The quantitative assessment of the business environment—based on the opportunities for, and hindrances to, the conduct of business—enables a country to be ranked on its overall position and in each of the categories, on both a global and a regional basis. The model ranks countries according to investment conditions over the past five years (2003-07), as well as according to our projections of how business conditions will evolve over the next five years (2008-12). This allows us to use the regularity, depth and detail of our forecasting work to generate a unique set of forward-looking business environment rankings on a regional and global basis. The table below gives our index scores and rankings for the 12 Latin American countries included in the rankings for the historical period (2003-07) and the forecast period (2008-12).

Latin American business environment rankings

	2003-07		2008-12		Change in total score ^a	Change in rank ^a	Qualitative assessment ^b	
	Total score (out of 12)	Global rank (out of 82)	Total score (out of 12)	Global rank (out of 82)			2003-07	2008-12
Argentina	5.83	57	6.08	63	0.25	-6.0	moderate	moderate
Brazil	6.52	42	6.79	43	0.27	-1.0	good	good
Chile	7.82	19	7.85	20	0.04	-1.0	good	good
Colombia	6.00	49	6.70	49	0.70	0.0	moderate	good
Costa Rica	6.36	44	6.74	48	0.38	-4.0	moderate	good
Cuba	4.13	80	4.59	80	0.46	0.0	very poor	very poor
Dominican Republic	5.18	65	5.71	66	0.53	-1.0	poor	moderate
Ecuador	5.08	68	4.77	76	-0.31	-8.0	poor	very poor
El Salvador	5.97	51	6.78	46	0.81	5.0	moderate	good
Mexico	6.92	32	7.24	32	0.33	0.0	good	good
Peru	5.98	50	6.54	52	0.57	-2.0	moderate	good
Venezuela	5.04	69	4.39	81	-0.65	-12.0	poor	very poor

^a From forecast period to historical period. ^b Qualitative grades are assigned according to the following scale: very good, score more than 8; good, 6.5-8; moderate: 5.5-6.4; poor, 5-5.4; very poor: less than 5.

Chile stays in the global top 20 of most attractive business environments

Broadly speaking, the investment environment in Latin American countries will lag that in their global competitors in 2008-12, with the exception of El Salvador, which manages to improve its position in the rankings. Chile leads the regional league in terms of its attractiveness as a business destination and ranks 20th in our global rankings of most attractive business environments. Although Chile is a much smaller market than Mexico and Brazil, it leads the region's rankings because of its proven commitment to economic liberalisation and structural reform since the 1970s.

Mexico and Brazil, helped by the large size of their markets, follow Chile in the regional rankings. Mexico's business environment attractiveness will improve in the forecast period, leaving it firmly in the top 40% of the rankings, owing to some progress on structural reform under its president, Felipe Calderón, as well

as the economy's growing integration with the US since the North American Free-Trade Agreement (NAFTA) came into force in 1994. This has made it an especially attractive location for foreign investors looking to export to the US. Brazil, which is ranked mid-way in our model, is attracting an increasingly diverse array of investors, who want to take advantage of its large market size and export potential. However, deficiencies in regulation, tax policy and the labour market will remain drawbacks in the business environment. It is followed by two Central American countries, El Salvador and Costa Rica, which despite their small size have made substantial progress in improving their business environment in recent years. Colombia, where an improving security situation and a stable economy have raised the country's attractiveness for investors, ranks in sixth place. It is followed closely by Peru. Argentina and the Dominican Republic are clustered in the bottom quarter of global rankings, together with, at a distance, Ecuador Cuba and Venezuela.

Greater uncertainty in Venezuela and Ecuador

Venezuela's business environment will remain extremely unattractive (Venezuela ranks 81st out of 82 countries in our model) owing to a high level of uncertainty for investors—the president, Hugo Chávez, has nationalised the telecommunications, electricity utilities, steel and cement industries and has also completed a forced acquisition of a stake of at least 60% in four heavy-crude joint ventures with the private sector. Likewise, in Ecuador, heightened political uncertainty since the election of the president, Rafael Correa, an ally of Mr Chávez, in late 2006 will undermine the already poor prospects for progress on the structural reform needed to make the economy more competitive. Legal insecurity will remain endemic and will deter most potential foreign investors.

Argentina and Dominican Republic will improve less than elsewhere

Business conditions in Argentina will improve less than elsewhere, reflecting the interventionist economic policy orientation of the government of the president, Cristina Fernández de Kirchner. This will prevent rapid progress in reforming institutions and restoring the confidence of investors. The Dominican Republic's global ranking will fall in the forecast period despite a stable macroeconomic environment and enhanced policies towards foreign investment as its attractiveness as an investment location is constrained by the small size of its market, its frail institutional capacity and political effectiveness, widespread skills shortages and a poor infrastructure.

Peru and Colombia's governments will maintain pro-business policies

Peru will maintain an investor-friendly policy environment and remain in the upper third of our rankings for macroeconomic stability. The president, Alan García, will continue to push for the formalisation of trade agreements with Peru's main trading partners, lowering business costs and improving competitiveness for investors. Political effectiveness will remain a weakness, but the political environment will improve slightly in terms of stability.

The progress made by Colombia's president, Álvaro Uribe, on improving the security environment and his success in maintaining economic stability, will help improve Colombia's investor attractiveness in the forecast period. Despite steady progress, the guerrilla conflict will continue to impair the operating environment for the foreseeable future.

Chile, Mexico and Brazil will remain the most attractive investment locations

In Chile more progress will be made in the forecast period on trade liberalisation, fiscal modernisation and infrastructure. In Mexico, after passing a

fiscal reform, the window of opportunity to pass further reform is quickly closing as the 2009 mid-term elections loom large. There is a growing risk that the oil and labour reform bills, both difficult areas to tackle, will see no progress until late 2009. In Brazil the centrist policies of the government of the president, Luiz Inácio Lula da Silva, mean that there is a broad commitment across the political spectrum to tight fiscal policies and inflation control. Structural constraints will continue to preclude a more dynamic performance. However, municipal elections in 2009 and a fragmented legislature will compound the challenges of consolidating economic policy orientation and implementing the structural reforms needed to underpin robust growth.

Small market size marks El Salvador and Costa Rica

El Salvador's attractiveness as the fourth investment location in Latin America in the forecast period is underpinned by its favourable access to the US market via the Dominican Republic-Central American Free-Trade Agreement (DR-CAFTA), a secure framework for foreign investors, its stable economic policies and the steady political environment since 1992. Costa Rica's investment conditions will also improve in 2008-12 as the government of Óscar Arias attempts to boost investment opportunities. The approval in October 2007 of a referendum on DR-CAFTA has reassured investors who were concerned that the country might remain excluded from the free-trade zone. The agreement is expected to come into effect by October 2008. However, continued slow pace of economic reform and the persistence of structural macroeconomic weaknesses will continue to worry investors. However, both countries have small domestic markets, a shallow financial system and large income inequalities. Moreover, in the case of Costa Rica, a large public deficit poses a risk to macroeconomic stability, while in El Salvador rising inflation in a dollarised economy could compromise competitiveness. Furthermore, El Salvador's deficient infrastructure and high crime rate will remain drawbacks.

Cuba's economy is set to remain tightly state-controlled, despite the succession

Unsurprisingly, Cuba has one of the world's least attractive foreign investment environments in the historical and forecast periods. The low overall ranking is largely a result of the high degree of state control and tight restrictions on the private sector owing to the government's ideological hostility to the development of private businesses. Foreign investment is closely controlled. The official succession of power from Fidel Castro, who spent nearly 50 years in power, to his brother, Raúl Castro (76), without political upheaval in February 2008, shows that change will be gradual, rather than sudden, supported by the country's well-established and effective institutions. The new president has indicated that there are no plans to reform the one-party political system.

Overall regional scores

(total score, out of 10)

	2003-07	2008-12
North America	8.58	8.57
Western Europe	7.77	7.97
Asia & Australasia	6.56	7.03
Eastern Europe	6.14	6.66
Latin America	5.90	6.18
Middle East & Africa	5.47	6.10
World average	6.74	7.08

Data summary

Latin America and the Caribbean

Latin America^a

	2003 ^b	2004 ^b	2005 ^b	2006 ^b	2007 ^c	2008 ^c	2009 ^c	2010 ^c	2011 ^c	2012 ^c
Economic growth (%)										
GDP	2.2	5.9	4.4	5.4	5.4	4.1	3.0	3.9	4.0	4.0
Private consumption	1.8	5.0	5.8	6.0	6.7	4.9	3.3	3.7	3.9	3.9
Government consumption	1.2	2.9	2.9	4.2	3.1	4.5	3.2	3.5	2.8	3.2
Gross investment	-3.5	13.1	5.3	12.1	12.9	9.0	6.7	7.2	6.9	6.9
Exports of goods & services ^d	4.2	12.5	7.6	6.9	5.5	3.5	2.9	5.6	6.0	6.2
Imports of goods & services ^d	1.1	15.1	11.4	14.0	13.8	10.4	6.4	7.2	7.0	7.4
Domestic demand	0.7	6.2	5.3	7.0	7.5	5.8	4.1	4.5	4.5	4.5
GDP growth per head	0.7	4.4	2.9	3.9	4.0	2.7	1.7	2.5	2.7	2.7
GDP (PPP weights)	1.9	6.1	4.6	5.5	5.7	4.2	3.1	0.0	0.0	0.0
Population, income and market size										
Population (m)	514.6	522.0	529.5	536.8	544.2	551.5	558.9	566.2	573.8	581.2
GDP (US\$ bn at market exchange rates)	1,795	2,070	2,527	2,944	3,435	4,224	4,463	4,641	4,825	5,073
GDP per head (US\$ at market exchange rates)	3,488	3,965	4,773	5,483	6,312	7,659	7,986	8,197	8,409	8,727
Private consumption (US\$ bn)	1,178	1,323	1,602	1,839	2,170	2,634	2,793	2,906	3,022	3,176
Private consumption per head (US\$)	2,290	2,534	3,026	3,425	3,988	4,775	4,997	5,133	5,266	5,465
GDP (US\$ bn at PPP)	3,898	4,239	4,561	4,961	5,381	5,730	6,042	6,433	6,879	7,341
GDP per head (US\$ at PPP)	7,574	8,121	8,614	9,241	9,888	10,390	10,811	11,362	11,989	12,630
Economic structure (% of GDP)										
Private consumption	65.7	63.9	63.4	62.5	63.2	62.3	62.6	62.6	62.6	62.6
Government consumption	14.6	14.3	14.6	14.8	14.9	15.1	15.3	15.3	15.2	15.1
Gross fixed investment	17.2	18.1	18.3	19.2	20.1	20.8	21.5	22.1	22.6	23.1
Exports of goods & services	24.5	26.0	25.6	26.1	25.2	25.6	24.9	25.6	26.7	27.7
Imports of goods & services	22.9	23.9	23.2	23.5	24.2	24.6	25.4	26.7	28.1	29.4
Price inflation (%)										
Consumer prices (av)	10.8	6.8	6.3	5.2	5.4	8.2	8.0	6.5	6.0	5.3
Current account (US\$ bn)										
Current-account balance	9.4	21.9	38.1	52.7	22.6	-4.6	-31.8	-48.4	-58.4	-65.7
Current-account balance (% of GDP)	0.5	1.1	1.5	1.8	0.7	-0.1	-0.7	-1.0	-1.2	-1.3
Trade balance	45.3	61.1	84.3	100.7	75.0	67.0	38.8	15.2	8.3	-2.5
Services balance	-12.2	-12.6	-17.0	-18.1	-23.4	-36.2	-40.5	-42.0	-42.3	-43.2
Income balance	-59.1	-68.5	-79.3	-89.9	-91.2	-98.2	-92.2	-86.4	-91.8	-90.8
Current transfers balance	35.4	42.0	50.1	60.0	62.3	62.7	62.1	64.8	67.4	70.8
Memorandum items										
Share of world population (%)	8.2	8.2	8.2	8.3	8.3	8.3	8.3	8.3	8.3	8.3
Share of world GDP (% at market exchange rates)	4.9	5.0	5.7	6.1	6.4	6.9	7.0	6.6	6.4	6.3
Share of world GDP (% at PPP)	8.1	8.1	8.2	8.2	8.3	8.3	8.3	7.7	7.7	7.7
External debt										
Total external debt (US\$ bn)	807.9	808.5	744.7	728.4	819.5	858.7	869.9	884.7	895.5	909.7
Total external debt (% of GDP)	45.0	39.1	29.5	24.7	23.9	20.3	19.5	19.1	18.6	17.9
Debt-service ratio, paid (%)	31.2	26.3	24.6	22.7	16.7	13.7	13.1	12.5	11.9	11.0

^a Comprises Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Trinidad and Tobago, Uruguay and Venezuela. ^b Economist Intelligence Unit estimates. ^c Economist Intelligence Unit forecasts. ^d Includes intra-regional trade.

Mercosur

Mercosur^a

	2003 ^b	2004 ^b	2005 ^b	2006 ^b	2007 ^b	2008 ^c	2009 ^c	2010 ^c	2011 ^c	2012 ^c
Economic growth (%)										
GDP	2.0	7.5	4.9	5.3	6.3	4.9	3.4	3.8	3.9	4.0
Private consumption	1.1	5.6	6.1	6.5	8.2	6.3	3.7	3.4	3.8	3.9
Government consumption	1.5	4.6	3.3	3.4	3.7	5.5	3.4	4.2	3.0	3.2
Gross investment	-5.4	20.6	6.5	15.1	15.8	10.7	7.2	7.4	6.4	7.3
Exports of goods & services ^d	4.6	13.7	8.8	3.2	4.6	2.7	2.1	4.8	5.5	5.7
Imports of goods & services ^d	0.6	22.9	14.6	19.8	22.5	16.5	7.5	7.6	7.0	8.1
Domestic demand	0.0	7.9	5.6	7.5	8.9	7.1	4.4	4.4	4.3	4.6
GDP growth per head	0.6	6.0	3.4	3.9	4.9	3.6	2.1	2.6	2.6	2.7
GDP (PPP weights)	1.5	7.6	5.0	5.4	6.4	4.9	3.4	3.8	4.0	4.0
Population, income and market size										
Population (m)	251	255	258	262	265	269	272	276	279	283
GDP (US\$ bn at market exchange rates)	782	949	1,235	1,499	1,839	2,380	2,565	2,640	2,693	2,782
GDP per head (US\$ at market exchange rates)	3,111	3,724	4,777	5,724	6,928	8,852	9,420	9,579	9,649	9,844
Private consumption (US\$ bn)	482	563	730	883	1,102	1,412	1,533	1,575	1,602	1,651
Private consumption per head (US\$)	1,918	2,209	2,823	3,372	4,153	5,252	5,632	5,713	5,738	5,840
GDP (US\$ bn at PPP)	1,962	2,158	2,322	2,525	2,758	2,958	3,126	3,328	3,557	3,797
GDP per head (US\$ at PPP)	7,806	8,467	8,986	9,638	10,392	11,002	11,483	12,074	12,743	13,435
Economic structure (% of GDP)										
Private consumption	61.6	59.3	59.1	58.9	59.9	59.3	59.8	59.6	59.5	59.3
Government consumption	17.2	16.9	17.5	17.6	17.6	17.7	17.8	18.0	18.1	18.0
Gross fixed investment	15.2	16.8	17.2	18.1	19.2	19.7	20.4	21.0	21.4	21.9
Exports of goods & services	19.2	20.7	19.9	19.2	18.0	18.7	17.4	17.9	18.9	19.8
Imports of goods & services	13.5	14.8	14.2	14.5	15.6	16.3	16.5	17.4	18.4	19.4
Price inflation (%)										
Consumer prices (av)	16.2	7.8	8.3	6.5	6.3	9.3	9.7	8.1	7.3	6.2
Current account (US\$ bn)										
Current-account balance	24.2	30.6	44.4	48.2	29.1	21.9	4.9	1.8	-1.7	-5.1
Current-account balance (% of GDP)	3.1	3.2	3.6	3.2	1.6	0.9	0.2	0.1	-0.1	-0.2
Trade balance	58.3	69.5	88.8	91.7	75.9	83.3	64.0	58.1	57.6	52.6
Services balance	-8.4	-8.7	-12.6	-13.8	-18.5	-28.7	-31.9	-33.8	-34.0	-34.4
Income balance	-29.4	-34.2	-36.1	-34.9	-32.7	-36.6	-31.3	-26.9	-29.5	-27.5
Current transfers balance	3.6	4.0	4.3	5.2	4.4	3.9	4.0	4.4	4.2	4.2
Memorandum items										
Share of world population (%)	4.0	4.0	4.0	4.0	4.0	4.0	4.1	4.1	4.1	4.1
Share of world GDP (% at market exchange rates)	2.1	2.3	2.8	3.1	3.4	3.9	4.0	3.9	3.8	3.7
Share of world GDP (% at PPP)	4.1	4.1	4.2	4.2	4.2	4.3	4.3	4.3	4.3	4.2
External debt										
Total external debt (US\$ bn)	450.5	444.1	384.0	370.5	423.5	442.0	448.5	452.2	451.5	452.8
Total external debt (% of GDP)	57.6	46.8	31.1	24.7	23.0	18.6	17.5	17.1	16.8	16.3
Debt-service ratio, paid (%)	50.5	35.9	36.8	31.0	20.4	15.5	14.7	14.0	13.4	12.2

^a Comprises Argentina, Brazil, Paraguay, Uruguay and Venezuela. ^b Economist Intelligence Unit estimates. ^c Economist Intelligence Unit forecasts. ^d Includes intra-regional trade.

Andean community

Andean community^a

	2003 ^b	2004 ^b	2005 ^b	2006 ^b	2007 ^c	2008 ^c	2009 ^c	2010 ^c	2011 ^c	2012 ^c
Economic growth (%)										
GDP	3.8	5.4	5.4	6.6	7.1	5.3	4.6	4.5	4.5	4.3
Private consumption	2.9	4.8	5.1	6.5	7.0	5.0	4.2	4.4	4.7	4.6
Government consumption	0.9	2.1	5.3	3.6	3.8	4.7	4.8	4.5	4.2	4.2
Gross investment	4.4	11.7	14.0	20.7	20.9	12.7	9.9	7.1	6.9	7.0
Exports of goods & services ^d	6.9	12.9	9.9	6.2	5.4	6.5	5.8	6.8	6.4	5.4
Imports of goods & services ^d	2.5	14.4	15.8	15.3	15.0	13.5	9.7	8.3	8.1	7.8
Domestic demand	2.8	5.7	6.8	9.0	9.7	6.9	5.8	5.2	5.2	5.2
GDP growth per head	2.2	3.8	3.8	5.0	5.5	3.7	3.0	3.0	3.0	2.9
GDP (PPP weights)	3.8	5.4	5.4	6.5	6.9	5.2	4.5	4.5	4.5	4.3
Population, income and market size										
Population (m)	93.1	94.5	96.0	97.4	98.9	100.4	101.9	103.3	104.8	106.4
GDP (US\$ bn at market exchange rates)	177	209	249	282	339	424	429	434	459	493
GDP per head (US\$ at market exchange rates)	1,907	2,214	2,596	2,893	3,428	4,227	4,212	4,196	4,381	4,638
Private consumption (US\$ bn)	120	137	159	175	210	256	262	267	282	303
Private consumption per head (US\$)	1,285	1,450	1,659	1,793	2,128	2,552	2,569	2,582	2,694	2,848
GDP (US\$ bn at PPP)	476	518	563	619	679	731	781	837	899	962
GDP per head (US\$ at PPP)	5,114	5,486	5,868	6,352	6,870	7,280	7,666	8,094	8,570	9,043
Economic structure (% of GDP)										
Private consumption	67.4	65.5	63.9	62.0	62.1	60.4	61.0	61.5	61.5	61.4
Government consumption	15.0	14.6	14.6	13.9	13.6	13.6	13.9	14.2	14.2	14.3
Gross fixed investment	17.5	18.2	19.5	20.8	22.2	23.5	25.0	25.7	26.1	26.5
Exports of goods & services	21.0	22.8	24.6	27.0	25.7	27.9	29.0	30.7	31.7	32.4
Imports of goods & services	21.4	22.0	23.1	24.7	25.1	26.6	30.2	33.2	34.7	35.6
Price inflation (%)										
Consumer prices (av)	5.5	4.6	3.5	3.3	4.0	7.2	5.8	5.1	4.7	4.5
Current account (US\$ bn)										
Current-account balance	-2.3	-1.1	0.2	2.4	-1.4	-1.7	-7.8	-9.5	-9.5	-7.9
Current-account balance (% of GDP)	-1.3	-0.5	0.1	0.9	-0.4	-0.4	-1.8	-2.2	-2.1	-1.6
Trade balance	1.6	5.1	8.2	12.2	10.6	11.4	5.5	2.2	2.3	2.1
Services balance	-3.3	-3.6	-4.3	-4.7	-5.3	-6.5	-7.4	-7.8	-8.4	-9.2
Income balance	-7.4	-10.3	-12.8	-15.9	-18.8	-20.5	-19.9	-18.0	-18.2	-16.4
Current transfers balance	6.8	7.7	9.1	10.8	12.2	13.8	14.0	14.1	14.8	15.6
Memorandum items										
Share of world population (%)	1.48	1.49	1.49	1.50	1.51	1.51	1.52	1.52	1.53	1.54
Share of world GDP (% at market exchange rates)	0.49	0.51	0.56	0.59	0.63	0.70	0.67	0.65	0.65	0.66
Share of world GDP (% at PPP)	0.98	1.00	1.01	1.02	1.04	1.06	1.07	1.07	1.07	1.07
External debt										
Total external debt (US\$ bn)	89.1	92.4	90.4	89.7	95.8	100.8	100.6	99.6	99.1	101.2
Total external debt (% of GDP)	50.2	44.2	36.3	31.8	28.3	23.8	23.4	23.0	21.6	20.5
Debt-service ratio, paid (%)	32.9	27.5	30.0	22.5	21.5	15.8	14.3	13.7	13.1	12.4

^a Comprises Bolivia, Colombia, Ecuador, and Peru. ^b Economist Intelligence Unit estimates. ^c Economist Intelligence Unit forecasts. ^d Includes intra-regional trade.

Central America

Central America^a

	2003 ^b	2004 ^b	2005 ^b	2006 ^b	2007 ^b	2008 ^c	2009 ^c
Economic growth (%)							
GDP	3.8	4.2	4.6	6.4	6.6	4.4	3.5
Private consumption	3.9	3.6	4.6	5.2	6.1	4.0	3.2
Government consumption	0.5	0.6	2.8	4.2	4.5	4.2	4.9
Gross investment	2.9	7.5	3.5	11.4	8.1	10.0	7.1
Exports of goods & services ^d	2.4	11.9	7.2	8.1	10.1	3.2	3.3
Imports of goods & services ^d	1.7	9.6	6.0	7.4	9.0	5.1	4.7
Domestic demand	3.4	4.0	4.3	6.2	6.4	5.2	4.2
GDP growth per head	1.7	2.0	2.5	4.2	4.4	2.3	1.4
GDP (PPP weights)	3.7	4.4	4.8	6.4	6.7	4.5	3.6
Population, income and market size							
Population (m)	38	39	40	40	41	42	43
GDP (US\$ bn at market exchange rates)	83	89	99	111	127	149	167
GDP per head (US\$ at market exchange rates)	2,181	2,303	2,503	2,749	3,072	3,531	3,890
Private consumption (US\$ bn)	64	70	79	89	101	118	134
Private consumption per head (US\$)	1,698	1,815	1,992	2,194	2,445	2,807	3,117
GDP (US\$ bn at PPP)	175	187	202	220	241	257	273
GDP per head (US\$ at PPP)	4,617	4,834	5,112	5,447	5,846	6,114	6,346
Economic structure (% of GDP)							
Private consumption	77.9	78.8	79.6	79.8	79.6	79.5	80.1
Government consumption	11.3	10.8	10.5	10.3	10.2	10.2	10.3
Gross fixed investment	17.6	17.8	17.8	19.2	20.3	21.0	21.8
Exports of goods & services	36.4	37.6	38.4	38.5	38.9	39.0	38.6
Imports of goods & services	45.4	48.4	49.5	50.4	51.0	51.4	52.2
Price inflation (%)							
Consumer prices (av)	5.3	6.8	8.3	6.2	6.9	12.7	12.8
Current account (US\$ bn)							
Current-account balance	-4.4	-5.0	-4.7	-5.1	-8.1	-14.7	-14.2
Current-account balance (% of GDP)	-5.3	-5.6	-4.8	-4.6	-6.4	-9.9	-8.5
Trade balance	-9.7	-11.8	-13.6	-16.6	-20.8	-28.8	-28.9
Services balance	1.5	1.7	1.8	2.8	3.5	4.3	4.6
Income balance	-2.9	-2.9	-2.8	-2.9	-3.8	-3.5	-3.7
Current transfers balance	6.6	8.1	9.8	11.6	13.0	13.2	13.7
Memorandum items							
Share of world population (%)	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Share of world GDP (% at market exchange rates)	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Share of world GDP (% at PPP)	0.4	0.4	0.4	0.3	0.3	0.4	0.3
External debt							
Total external debt (US\$ bn)	39.7	40.2	40.1	39.9	40.1	41.9	43.5
Total external debt (% of GDP)	48.0	45.1	40.5	36.0	31.7	28.2	26.0
Debt-service ratio, paid (%)	9.9	9.8	9.0	10.7	6.4	6.0	5.7

^a Comprises Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama. ^b Economist Intelligence Unit estimates. ^c Economist Intelligence Unit forecasts. ^d Includes intra-regional trade.

Guide to the business rankings model

Outline of the model

The business rankings model measures the quality or attractiveness of the business environment in the 82 countries covered by *Country Forecasts* using a standard analytical framework. It is designed to reflect the main criteria used by companies to formulate their global business strategies, and is based not only on historical conditions but also on expectations about conditions prevailing over the next five years. This allows the Economist Intelligence Unit to utilise the regularity, depth and detail of its forecasting work to generate a unique set of forward-looking business environment rankings on a regional and global basis.

The business rankings model examines ten separate criteria or categories, covering the political environment, the macroeconomic environment, market opportunities, policy towards free enterprise and competition, policy towards foreign investment, foreign trade and exchange controls, taxes, financing, the labour market and infrastructure. Each category contains a number of indicators that are assessed by the Economist Intelligence Unit for the last five years and the next five years. The number of indicators in each category varies from five (foreign trade and exchange regimes) to 16 (infrastructure), and there are 91 indicators in total.

Almost half of the indicators are based on quantitative data (eg, GDP growth), and are mostly drawn from national and international statistical sources for the historical period (2003-07) and from Economist Intelligence Unit assessments for the forecast period (2008-12). The other indicators are qualitative in nature (eg, quality of the financial regulatory system), and are drawn from a range of data sources and business surveys adjusted by the Economist Intelligence Unit, for 2003-07. All forecasts for the qualitative indicators covering 2008-12 are based on Economist Intelligence Unit assessments.

The main sources used in the business rankings model include CIA, *World Factbook*; Economist Intelligence Unit, *Country Risk Service*, *Country Finance*, *Country Commerce*; Freedom House, *Annual Survey of Political Rights and Civil Liberties*; Heritage Foundation, *Index of Economic Freedom*; IMF, *Annual Report on Foreign Exchange Restrictions*; International Institute for Management Development, *World Competitiveness Yearbook*; International Labour Organisation, *International Labour Statistics Yearbook*; UN, *Human Development Report*; US Social Security Administration, *Social Security Programs Throughout the World*; World Bank, *World Development Report*; World Development Indicators; World Economic Forum, *Global Competitiveness Report*.

Calculating the rankings

The rankings are calculated in several stages. First, each of the 91 indicators is scored on a scale from 1 (very bad for business) to 5 (very good for business). The aggregate category scores are derived on the basis of simple or weighted averages of the indicator scores within a given category. These are then adjusted, on the basis of a linear transformation, to produce index values on a 1-10 scale. An arithmetic average of the ten category index values is then calculated to yield the aggregate business environment score for each country, again on a 1-10 scale.

The use of equal weights for the categories to derive the overall score reflects in part the theoretical uncertainty about the relative importance of the primary determinants of investment. Surveys of foreign direct investors' intentions yield widely differing results on the relative importance of different factors. Weighted scores for individual categories based on correlation coefficients of recent foreign direct investment inflows do not in any case produce overall results that are significantly different to those derived from a system based on equal weights.

For most quantitative indicators the data are arrayed in ascending or descending order and split into five bands (quintiles). The countries falling in the first quintile are assigned scores of 5, those falling in the second quintile score 4 and so on. The cut-off points between bands are based on the average of the raw indicator values for the top and bottom countries in adjacent quintiles. The 2003-07 ranges are then used to derive 2008-12 scores. This allows for intertemporal as well as cross-country comparisons of the indicator and category scores.

Measurement and grading issues

The indices and rankings attempt to measure the average quality of the business environment over the entire historical or forecast period, not simply at the start or at the end of the period. Thus in the forecast we assign an average grade to elements of the business environment over 2008-12, not to the likely situation in 2012 only.

The scores based on quantitative data are usually calculated on the basis of the numeric average for an indicator over the period. In some cases, the "average" is represented, as an approximation, by the recorded value at the mid-point of the period (2005 or 2010). In only a few cases is the relevant variable appropriately measured by the value at the start of the period (eg, educational attainments). For one indicator (the natural resources endowment), the score remains constant for both the historical and forecast periods.

List of indicators in the business rankings model

Political environment

1. Risk of armed conflict
2. Risk of social unrest
3. Constitutional mechanisms for the orderly transfer of power
4. Threat of politically motivated violence
5. International disputes or tensions
6. Government policy towards business
7. Effectiveness of political system in policy formulation and execution
8. Quality of the bureaucracy
9. Transparency and fairness of political system
10. Corruption
11. Impact of crime

Macroeconomic environment

- *1. Inflation
- *2. Budget balance as % of GDP
- *3. Government debt as % of GDP
- *4. Exchange-rate volatility
- *5. Current-account balance as % of GDP

Market opportunities

- *1. GDP, US\$ bn at PPP
- *2. GDP per head, US\$ at PPP
- *3. Real GDP growth
- *4. Share of world merchandise trade
- *5. Average annual rate of growth of exports
- *6. Average annual rate of growth of imports
- *7. The natural resource endowment
- *8. Profitability

Policy towards private enterprise and competition

1. Degree to which private property rights are protected
2. Government regulation on setting up new private businesses
3. Freedom of existing businesses to compete
4. Promotion of competition
5. Protection of intellectual property
6. Price controls
7. Distortions arising from lobbying by special interest groups
8. Distortions arising from state ownership/control

Policy towards foreign investment

1. Government policy towards foreign capital
2. Openness of national culture to foreign influences
3. Risk of expropriation of foreign assets
4. Availability of investment protection schemes

Foreign trade and exchange controls

1. Capital-account liberalisation
- **2. Tariff and non-tariff protection
- *3. Openness of trade
4. Restrictions on the current account

Taxes

- **1. The corporate tax burden
- *2. The top marginal personal income tax
- *3. Value-added tax
- *4. Employers' social security contributions
5. Degree to which fiscal regime encourages new investment
6. Consistency and fairness of the tax system

Financing

1. Openness of banking sector
2. Stockmarket capitalisation
- **3. Distortions in financial markets
4. Quality of the financial regulatory system
5. Access of foreigners to local capital market
6. Access to medium-term finance for investment

The labour market

- **1. Incidence of strikes
- *2. Labour costs adjusted for productivity
- *3. Availability of skilled labour
4. Quality of workforce
5. Restrictiveness of labour laws
6. Extent of wage regulation
7. Hiring of foreign nationals
- *8. Cost of living

Infrastructure

- *1. Telephone density
- **2. Reliability of telecoms network
- **3. Extent and quality of road network
- *4. Production of electricity per head
- **5. The infrastructure for retail and wholesale distribution
- **6. Extent and quality of the rail network
7. Quality of ports infrastructure
- *8. Stock of personal computers
- *9. R&D expenditure as % of GDP
- *10. Rents of office space

Note. A single asterisk (*) denotes a purely quantitative indicator. Indicators with a double asterisk (**) are partly based on data. All other indicators are qualitative in nature.