

GLOBAL MACRO SHIFTS

with Michael Hasenstab, Ph.D.
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LATIN AMERICA: THE RISE AND FALL OF POPULISM



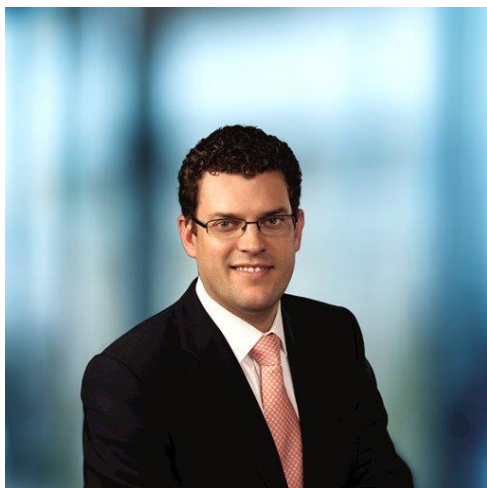
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Global Macro Shifts

Latin America: The Rise and Fall of Populism

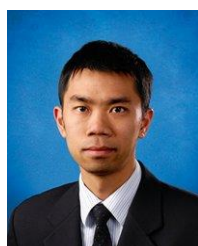


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Global Macro Shifts is a research-based briefing on global economies featuring the analysis and views of Dr. Michael Hasenstab and senior members of Templeton Global Macro. Dr. Hasenstab and his team manage Templeton's global bond strategies, including unconstrained fixed income, currency and global macro. This economic team, trained in some of the leading universities in the world, integrates global macroeconomic analysis with in-depth country research to help identify long-term imbalances that translate to investment opportunities.



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Overview

The result of the recent US presidential election has taken most analysts and observers by surprise; it has also generated an unusually high degree of uncertainty over the future course of policies. President-elect Donald Trump has been in the process of selecting his cabinet, and over the course of the next few weeks we should have more clarity over the future policy outlook.

Some parameters have already emerged, and they reinforce our long-standing view on the outlook for US economic growth, inflation and asset prices. The policies of the new administration will in all likelihood include a boost to public infrastructure spending, as well as a reduction in corporate income taxes. This combination would support economic growth, at least in the short term. A more robust growth outlook with an economy already at full employment (the unemployment rate dropped to a nine-year low of 4.6% in November), together with the stabilization of commodity prices, strengthens the case for a rise in inflation that we already anticipated in our first Global Macro Shifts (GMS) of 2016. The campaign rhetoric in the recent election pointed toward additional tailwinds to inflation coming from potential tariffs and expansionary fiscal policy. Indeed, the prevailing narrative in financial markets has now shifted from deflation or “low-flation” to reflation, converging to our long-held view. US Treasury yields have responded, with the yield on the 10-year Treasury note rising by 0.6 percentage points (pp) within two weeks of the election to a level 1.0 pp higher than last July.

Our next GMS of 2017 will include a detailed analysis of the US policy outlook and its global implications, incorporating the information that will become available as the new administration takes office. At this time, however, we believe it is especially relevant to focus on a trend that has gained prominence over the past 12 months, namely the rise of populist pressures.

Populism has been on the rise across a wide range of countries in recent years. While populism can mean different things to different people, we use the term to describe policies that promise rapid solutions to problems, often economic in nature, without the pain that typically accompanies more orthodox prescriptions. Traditional policy advice has been to address macroeconomic imbalances using a macroeconomic toolkit consisting, but not restricted to, prudent fiscal and monetary policies, openness to trade, deregulation and a movement toward greater global economic integration.

In the aftermath of the various global crises of the past decade, these traditional remedies are becoming dangerously unfashionable. This has been especially striking in some advanced economies. It contributed to the Brexit vote, where a

majority of UK voters opted to take the country out of the European Union (EU) to limit immigration and re-establish a stronger degree of national control over policies and regulations. Populist and nationalist parties have gained popularity in several other EU countries, raising uncertainty for upcoming elections in 2017. And populist elements have been strong and vocal in the recent US presidential election on both the Republican and Democratic sides; they have advocated a more inward-looking and interventionist economic focus as well as a more isolationist approach to global trade, with proposals to impose high import tariffs, scrap or renegotiate trade treaties, and curb immigration. Sharp criticism of the North American Free Trade Agreement and of immigration from Mexico signaled a temptation for the US to turn its back on Latin America. This would be damaging to the US economy, and especially ironic at a time when key Latin American economies are moving in the opposite direction, turning away from populist economic policies to embrace free-market and pro-business reforms.

In this paper, we analyze the experience of Latin American countries over the last several years. We focus mainly on three countries that had embraced populist economic policies: Argentina, Brazil and Venezuela. The former two have recently reversed course, whereas the latter has not. We think comparing their experiences holds some valuable lessons for any policymakers currently at risk of being seduced by the sirens’ song of populism. Of course, advanced economies are in a much stronger position than the countries covered in this paper, in terms of both macroeconomic fundamentals and institutions. However, we believe that the economic consequences of misguided policies would be qualitatively similar. In a situation where the temptation of protectionist policies, in particular, is strong, we believe therefore that this analysis can offer some useful guidance. In addition, this paper underscores the potential attractiveness of investment opportunities in Argentina and Brazil and, more generally, of countries with solid, orthodox macroeconomic policies.

The rest of the paper is structured as follows: Section 1 details how some Latin American countries drifted toward populist policies, a move that was exacerbated when they were hit by the commodity shock. Section 2 assesses the damage inflicted by these policies, comparing it to the experience of countries that instead maintained sound policies, notably Colombia. Section 3 describes, in our view, how the failure of populism has already led Argentina and Brazil to reverse course, while Venezuela continues to head in the wrong direction. Section 4 shows the benefits already generated by the improvement in policies in Argentina and Brazil and highlights the importance of staying the course.

1. The Sirens of Populism

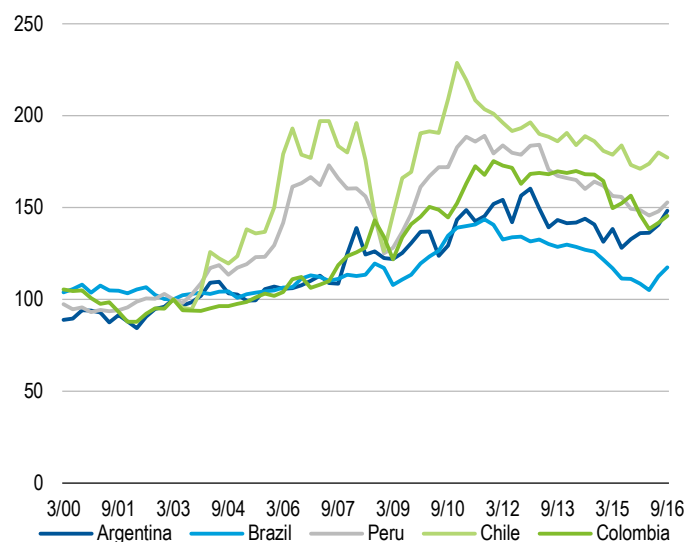
The recent experience of Latin America holds valuable lessons for policymakers tempted by the sirens of populism. We look at four countries, three of which succumbed to populist policies to varying degrees, while the fourth, Colombia, stayed resolutely orthodox. Argentina systematically moved away from orthodox policies in the aftermath of its sovereign debt default in 2001,

External Shock: Commodity Price Drop

Exhibit 1: South America Terms of Trade

March 2000–September 2016

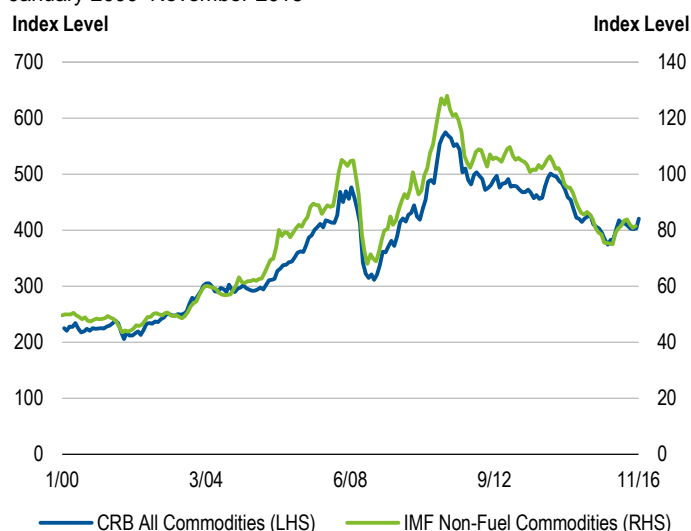
Index Level (2003 Q1 = 100)



Source: Calculations by Templeton Global Macro using data sourced from the National Administrative Department of Statistics (Colombia), Central Bank of Chile, Central Reserve Bank of Peru, Foundation Center for the Study of Foreign Trade (Brazil) and National Institute of Statistics and Censuses (Argentina).

Exhibit 2: Commodity Price Indexes

January 2000–November 2016



Source: Bloomberg; Commodity Research Bureau (CRB), US Bureau of Labor Statistics; International Monetary Fund (IMF). IMF non-fuel data through 10/16.

eventually gutting most of the institutions in the country. Brazil drifted toward increasingly statist and interventionist policies over the course of President Dilma Rousseff's first term in power. Venezuela's experiment is the longest standing in nature, having commenced with the ascent of Hugo Chavez to power in 1999. All four countries are, to varying degrees, commodity exporters. In Argentina, Brazil and Venezuela, the damage done to the respective economies and institutions was disguised to some extent by the rise in commodity prices, but all suffered from the sharp drop in commodity prices that marked the end of the commodity supercycle (see Exhibits 1 and 2). The drop in commodity prices exposed the unsustainability of the underlying policies. Colombia stands out as a remarkable case as it has not been swayed by populist economics.

The commodity price drop hit export and fiscal revenues, leaving governments facing weaker economic growth with fewer fiscal resources to deploy. At the same time, slower economic growth increased the popular pressure for supportive government measures—similar to the pressure that built up in the US and Europe after a prolonged weak recovery started in 2010.

Governments in Argentina, Brazil and Venezuela began to intervene in their economies with a variety of measures. Colombia, instead, allowed its foreign exchange (FX) rate to depreciate to offset the adverse external shock, but at the same time maintained largely prudent fiscal and monetary policies. Exhibit 3 below provides a snapshot of the kinds of measures deployed by the more interventionist governments.

A Summary of Interventionist Policies

Exhibit 3: Failed Policy Measures Employed by Country

As at 5 December 2016

	Argentina	Brazil	Colombia	Venezuela
Price Controls	X	X		X
FX Controls and Manipulation	X			X
Over-Ambitious Social Programs	X	X		X
Fiscal Dominance	X	X		X
Meddling in Private Sector	X	X		X

Source: Templeton Global Macro. As at 2016 for Argentina, 2015–2016 for Brazil, and the present for Venezuela and Colombia.

Argentina

One of the stranger consequences of Argentina's debt default and the subsequent deep economic crisis was the government's decision to start falsifying statistics and eventually, in some cases, simply to suspend their publication.¹ In particular, as very loose policies led to ever higher inflation, INDEC, the national statistics institute, ceased publishing inflation data. To control the capital outflows that would result from high inflation, the government moved to limit its reserve losses.

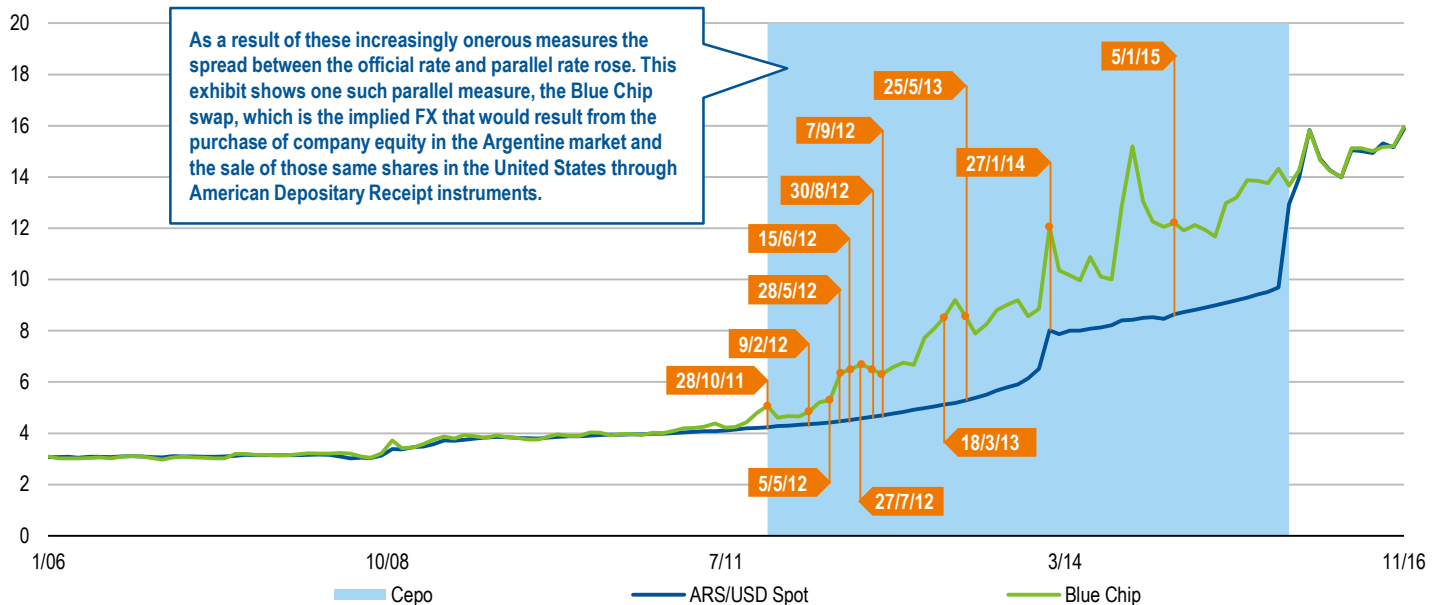
As illustrated below, Argentina decided to maintain strict control of the exchange rate, causing a large and widening gap between the official and parallel exchange rates, as well as the inevitable foreign currency shortages hitting importers (Exhibit 4). The accompanying box shows a timeline of tightening capital controls.

Argentina's Exchange Rate Controls Caused Distortions

Exhibit 4: Argentine Exchange Rates

January 2006–November 2016

ARS/USD



- 28/10/11:** Tax agency AFIP authorizes FX purchases only to those individuals or businesses that have taxable income to do so.
- 9/2/12:** Businesses purchasing FX to send abroad (e.g., for payment of imports) have to get prior central bank approval.
- 5/5/12:** AFIP establishes controls for those making FX purchases to travel abroad.
- 28/5/12:** FX controls extended to all real estate transactions. AFIP approval needed to purchase FX to settle real estate.
- 15/6/12:** "Saving" no longer a valid reason to purchase FX for private individuals according to AFIP.
- 27/7/12:** AFIP sends notices to those who buy FX for travel purposes but did not subsequently travel.
- 30/8/12:** A 15% surcharge is imposed on credit or debit card charges abroad as a tax withholding.
- 7/9/12:** The government prohibits private banks or bureaus de change from operating in ports and airports.
- 18/3/13:** The credit card surcharge rises to 20%. The surcharge (dubbed the tourism FX) is extended to the purchase of airline tickets, tour packages and other travel-related expenditures.
- 25/5/13:** Credit card companies announce new limits on cash withdrawals (US\$50 per month per account for countries bordering Argentina and US\$800 elsewhere.)
- 27/1/14:** Introduction of a separate FX rate for saving. A 20% retention is made for individuals seeking to purchase dollars for savings purposes.
- 5/1/15:** To slow the FX outflows, the government restricts the use of FX for purchasing stocks and bonds.

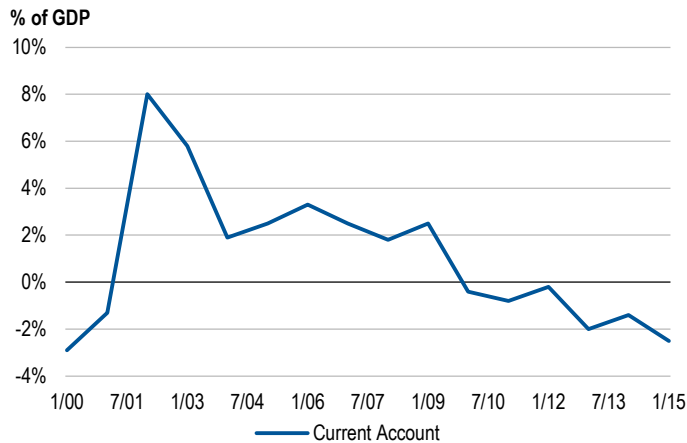
Source: Bloomberg. Shaded area corresponds to October 2011–December 2015 highlighted in text. Cepo refers to Cepo Cambiario (currency control period).

1. In 2007, the Kirchner government seized control of the statistical agency, INDEC, and replaced its technical director and suspended the Consumer Price Index (CPI) methodology. There was a widespread perception that the government would begin to under-report the inflation rate. Private economic consultancies began to publish their own estimates but received threats and fines from the government. In response, in June 2011, a group of opposition members of Congress began to publish its own inflation figures, labeled the "IPC Congreso" or "Opposition CPI," and they were partially shielded from official harassment by parliamentary immunity. In 2013, the IMF's executive board decided to censure Argentina for failing to abide by its commitments to provide data of quality. It was the first country censured on this basis. Around the same time, local provinces and the city of Buenos Aires began to compile their own official estimates of CPI inflation. The mayor of Buenos Aires at the time was Mauricio Macri, the country's current president.

A Decade of Populist Policies Took a Toll

Exhibit 5: Argentina: Current Account (as a % of GDP)

January 2000–January 2015



Source: Calculations by Templeton Global Macro using data sourced from Ministry of Finance and Public Finance (Argentina) and IMF, World Economic Outlook, October 2016.

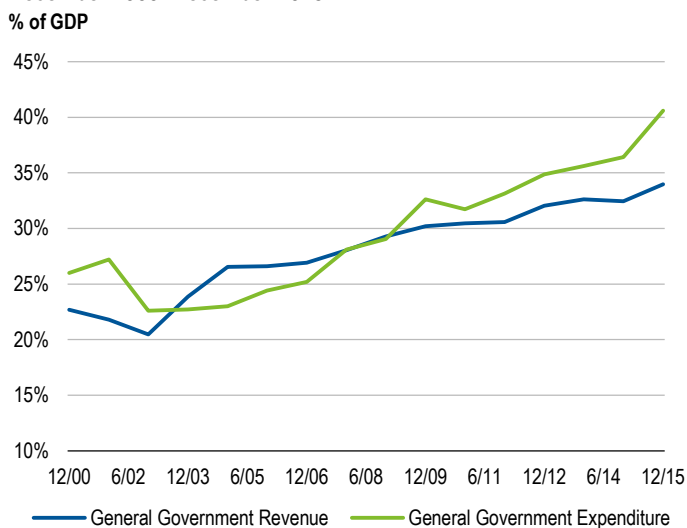
Argentina's government embarked on a massive inward push, trying to become self-reliant on domestic production and penalizing both exporters and importers. In 2008, soy export tariffs reached 50% and terminally crippled the crown jewel of Argentina's once thriving agricultural sector. In 2012, the government introduced a "non-automatic import licensing system" requiring companies to seek prior approval for all imports. The consequences were disastrous. Export restrictions also wreaked havoc on domestic meat, dairy, wheat and corn producers. Import restrictions triggered small-scale trade wars with neighboring countries ranging from pulp producers in Uruguay to car parts manufactures in Brazil.

By 2015, Argentina had entered into trade conflicts with over 40 different countries. This left the domestic agricultural and

Massive Fiscal Expansion Also Proved Detrimental

Exhibit 7: Argentina: Government Revenue and Expenditure

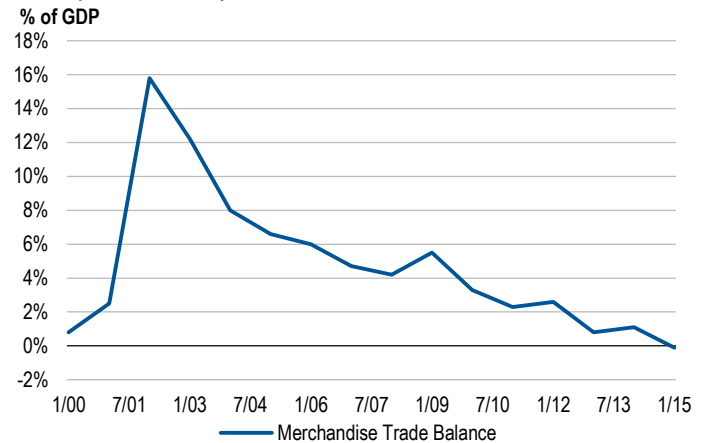
December 2000–December 2015



Source: IMF, World Economic Outlook, October 2016.

Exhibit 6: Argentina: Merchandise Trade Balance

January 2000–January 2015



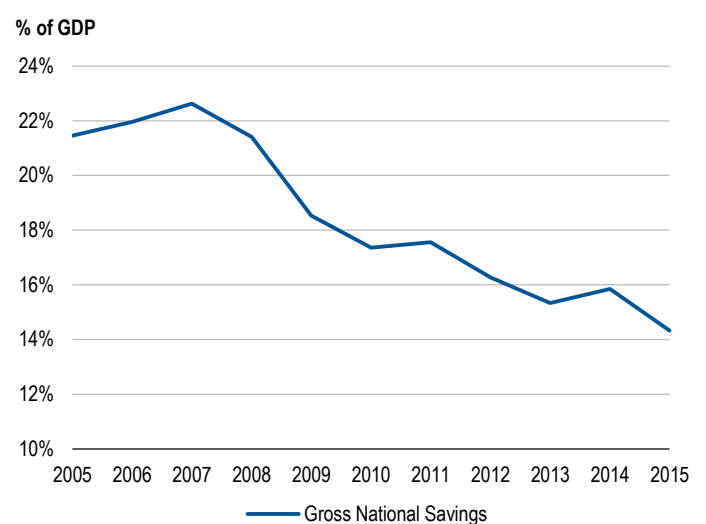
Source: Calculations by Templeton Global Macro using data sourced from Ministry of Finance and Public Finance (Argentina) and IMF, World Economic Outlook, October 2016.

manufacturing sectors in disarray. As recently as 2002 Argentina boasted a trade surplus of 16% of gross domestic product (GDP), as illustrated in Exhibit 6 above. After more than a decade of protectionism the entire surplus was erased and 2015 ended in a deficit, largely due to populist and heavy-handed government policies, though lower commodity prices also contributed.

At the same time, the government drove a massive fiscal expansion in order to support growth, including through a massive expansion of social programs. Moreover, it micro-managed utilities and transport tariffs by raising subsidies to as much as 5% of GDP. Government expenditures quickly outpaced revenues, expanding the fiscal deficit and driving down gross national savings (Exhibits 7 and 8).

Exhibit 8: Argentina: Gross National Savings (as a % of GDP)

December 2005–December 2015



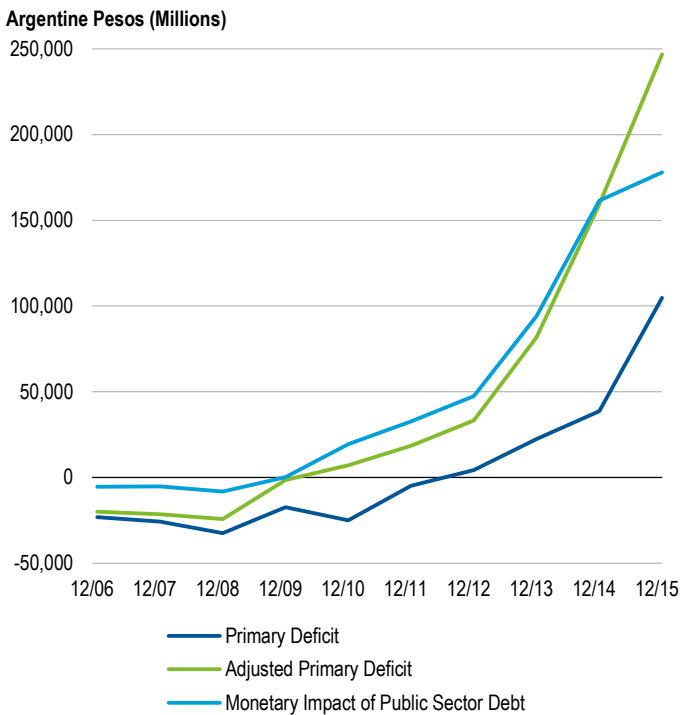
Source: IMF, World Economic Outlook, October 2016.

This high degree of fiscal dominance in turn drove a massive growth in money creation, which boosted inflation to extremely high rates. Indeed Argentina is an excellent object lesson for advocates of central banks embarking on a program of monetary debt. Such a program consists of a central bank explicitly printing money to directly finance increased fiscal deficits—as shown in Exhibit 9, this is de facto what Argentina’s central bank was doing. After the country defaulted on its external debt in 2001, it was locked out of international debt markets. Prior to the end of the commodity supercycle, the lack of access to financing was less of an issue, but as commodity

prices collapsed the central bank became the government’s first source of financing an ever-increasing deficit. The government was unwilling to cut its deficit through either higher taxes or lower expenditures and turned to the central bank, in effect printing money to finance itself. The money printing had the effect that economic theory would predict—inflation soared. As Exhibit 10 shows, the precise amount by which inflation increased is hard to judge—as noted at the outset of this section, the previous president, Cristina Kirchner, suspended the publication of official inflation statistics after a period of time when they were manipulated.¹

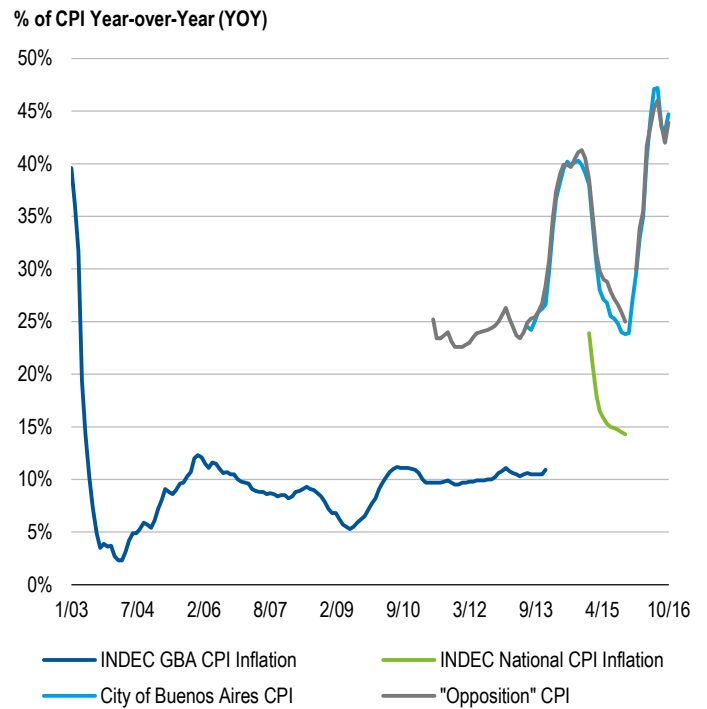
Argentina’s Experiment with Monetary Debt Financing Caused Inflation To Soar

Exhibit 9: Argentina: Primary Deficit and Money Creation
December 2006–December 2015



Source: Calculations by Templeton Global Macro using data sourced from Ministry of Finance and Public Finance (Argentina) and Central Bank of Argentina.

Exhibit 10: Argentina: Consumer Prices
January 2003–October 2016



Source: National Institute of Statistics and Censuses (Argentina); General Directorate of Statistics and Censuses, City of Buenos Aires; "Opposition" CPI collected from Bloomberg. INDEC GBA CPI Inflation data end 12/13. INDEC National CPI Inflation data begin 12/14 and end 10/15. City of Buenos Aires CPI data begin 7/13. "Opposition" CPI data begin 5/11.

Brazil

In Brazil, high commodity prices in the early part of the millennium allowed the country's then president, Luiz Inácio Lula da Silva, to follow expansionary social programs, even as his administration maintained relatively orthodox monetary, fiscal and foreign direct investment policies. The first Lula term, which began in 2002, was marked by enormous optimism for the outlook for Brazil. However, by the time President Dilma Rousseff took office in 2011, economic policies had begun to deteriorate even before the collapse in commodity prices, with signs of a drift toward populism; eventually in response to the commodity shock the government intensified its micro-managing of the economy.

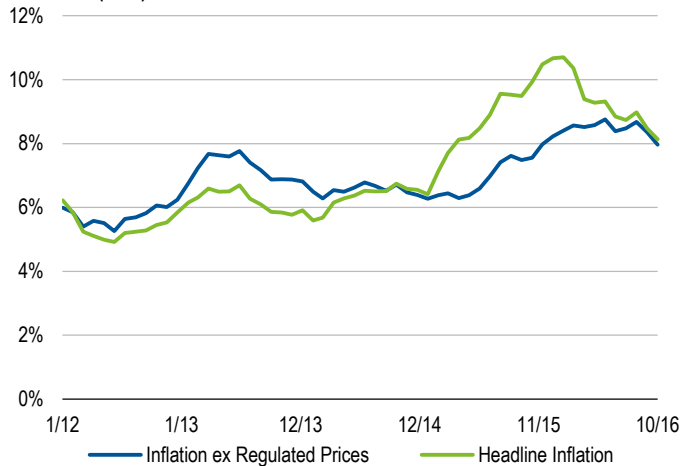
Contending with a drought, a slowing economy and high inflation, the government cut electricity prices and limited

Brazil Attempts To Slow Rising Prices

Exhibit 11: Brazil: Broad Inflation

January 2012–October 2016

% Inflation (YOY)



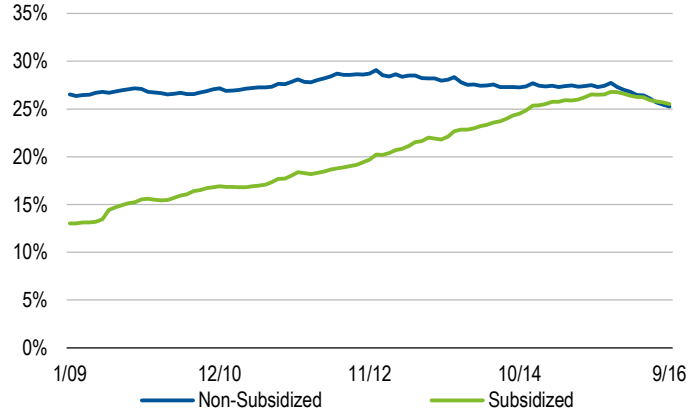
Source: Calculations by Templeton Global Macro using data sourced from Central Bank of Brazil.

Brazil Tightened Control of Credit

Exhibit 13: Brazil: Financial System Credit (as a % of GDP)

January 2009–September 2016

% of GDP



Source: Central Bank of Brazil.

2. Source: Bloomberg, as at July 2014.

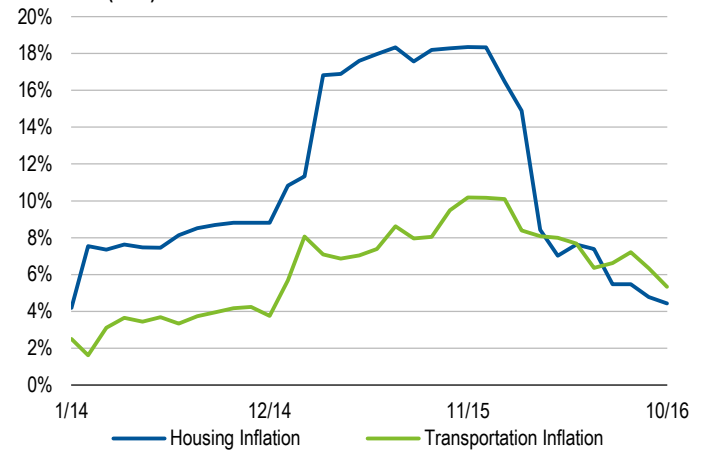
transport tariffs in 2013 in an effort to slow the rise in overall consumer prices (Exhibits 11 and 12). This put the power generation industry under pressure and resulted in a fall of power distribution to consumers by 18% and to industry by 32%.² At the same time, it created a substantial degree of repressed inflation, estimated at some 30% in electricity prices, 20% in urban bus fares and 15% in gasoline prices.² Headline inflation was brought down, but in an unsustainable way and with damage to industry—and it remained above the central bank's target.

Brazil also maintained tight control of credit flows: By the end of 2015, government subsidized lending accounted for a full half of total financial credit, up from about 30% in 2009 and accounting for most of total credit growth (Exhibit 13). Directed credit growth was tilted toward the household sector (Exhibit 14).

Exhibit 12: Brazil: Housing and Transport Inflation

January 2014–October 2016

% Inflation (YOY)

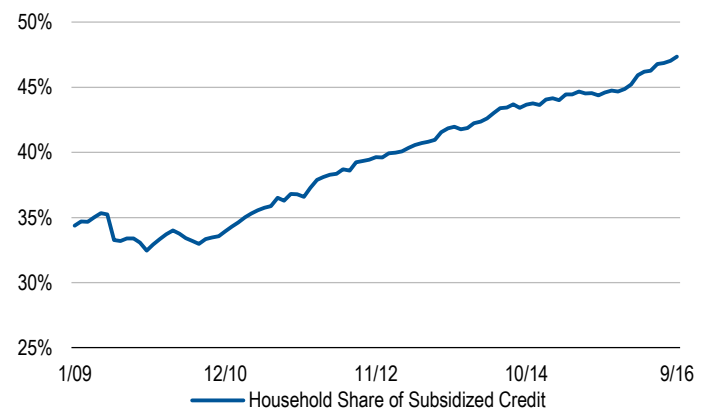


Source: Central Bank of Brazil.

Exhibit 14: Brazil: Household Share of Subsidized Credit

January 2009–September 2016

% of Subsidized Credit



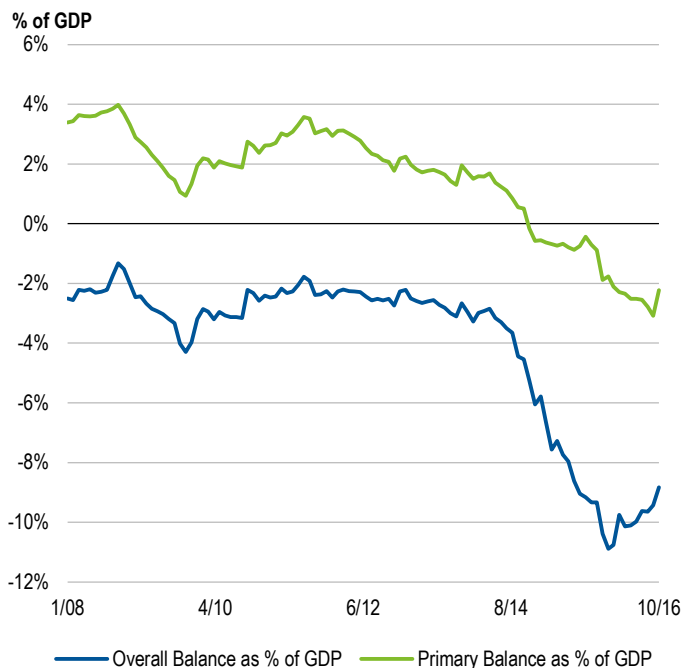
Source: Central Bank of Brazil.

Similar to Argentina, Brazil also pursued extremely loose fiscal policy to support social spending, driving the fiscal deficit into double digits (Exhibit 15). While campaigning for a second term, President Rousseff ran on an anti-market, statist platform. Between 2004 and 2013, government spending grew by almost 8% a year in real terms, or twice the average rate of GDP growth.

Brazil's Fiscal Deficit Reached Double Digits

Exhibit 15: Brazil: Overall Fiscal Balance and Primary Balance

January 2008–October 2016



Source: Central Bank of Brazil.

Venezuela

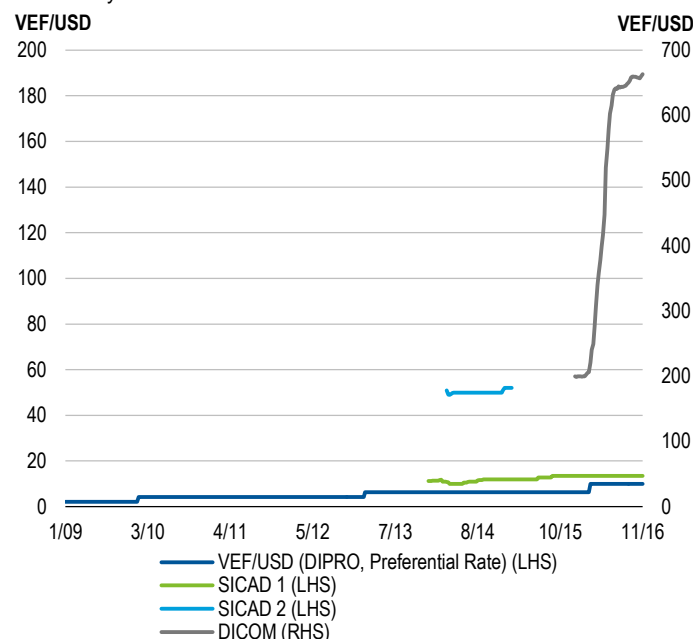
Observing Venezuela's economy today, it is hard to imagine that during the 1970s it was one of Latin America's wealthiest countries and seen as one of its most stable democracies. By the time Hugo Chavez took the helm in 1999, it had undergone three coup attempts and a presidential impeachment, and per capita growth had plunged.

Under Chavez, Venezuela pursued all the misguided policies described in the cases of Brazil and Argentina to an even greater extent. When he came into power he used petrodollars to massively subsidize a range of products from food to medicine. While very popular, the move disincentivized production, simultaneously creating dependency and a thriving black market.

Venezuela's Controlled Exchange Rate Constrained Foreign Exchange and Distorted Currency Valuations

Exhibit 16: Venezuela's Multiple Official Exchange Rates

16 January 2009–25 November 2016



Source: Bloomberg. SICAD = Venezuela's Complimentary System of Foreign Currency Acquisition; SIMADI = Venezuela's Marginal Currency System (individual market rate). SICAD 1 data begin 12/13. SICAD 2 data begin 3/14 and end 2/15. DICOM data begin 12/15.

These policies were rapidly becoming unsustainable even before oil prices collapsed in 2014. The exchange rate was heavily controlled, resulting in an extreme lack of foreign exchange, which eventually caused a shortage of even the most basic products. In Exhibit 16 above we show the variety of exchange rates that have been introduced in Venezuela over the last decade—and this chart does not even include the parallel market rate, for which we do not have a time series. Currently, most official transactions (mainly those of public institutions and those deemed essential) occur through official channels at a preferential rate of 10.0 Venezuelan bolivar (VEF) per US dollar (USD), called the DIPRO, while a few occur at different, more depreciated rates (SICAD 1 and, briefly, SICAD 2). Most recently, the government allowed some sales to specific private sector firms at the "DICOM" rate, which as at 5 December 2016 was quoted at 665.5 VEF/USD. To put these official rates in perspective, the illegal parallel market rate on the same day was quoted at 4138 VEF/USD. In the ultimate irony, in April 2016 there were reports that the government could not pay to print notes, as the soaring inflation required too many to be printed, and the country could not pay the currency maker.³

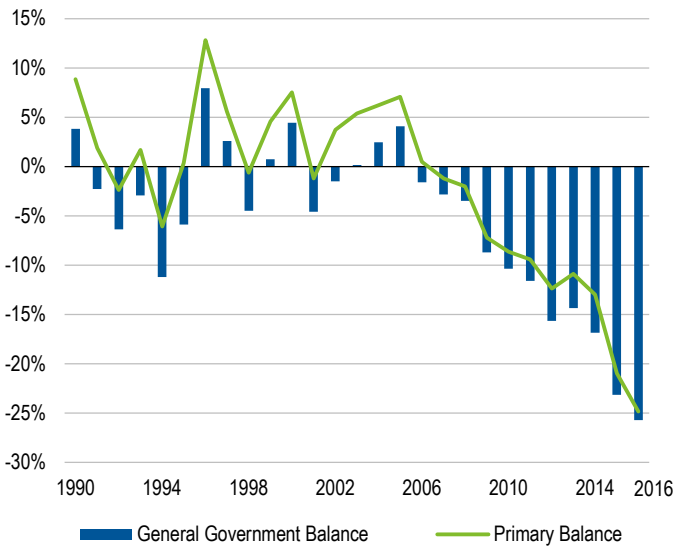
3. As noted above, currently the market operates via a multiple exchange rate system for official transactions and an illegal but active parallel exchange rate. Most official transactions (mainly those of public institutions and those deemed essential) occur through official channels at a preferential rate of 10.0 Venezuelan bolivar (VEF) per US dollar (USD) (devalued from 6.29 in March 2016). This rate is called the DIPRO rate. Since 2013, a number of other transactions occur at the SICAD rate (or SICAD 1), which as at 5 December 2016 was at 13.5 VEF/USD. The government also briefly experimented with another auction mechanism termed SICAD 2 that never really entered into practice. The illegal parallel rate noted in the text was quoted by a popular site, dollartoday.com, at 4138 VEF/USD as at 5 December 2016.

The Impact of the Oil Revenue Collapse on Venezuela's Fiscal Balance

Exhibit 17: Venezuela: General Government Balance

June 1990–June 2016

% of GDP



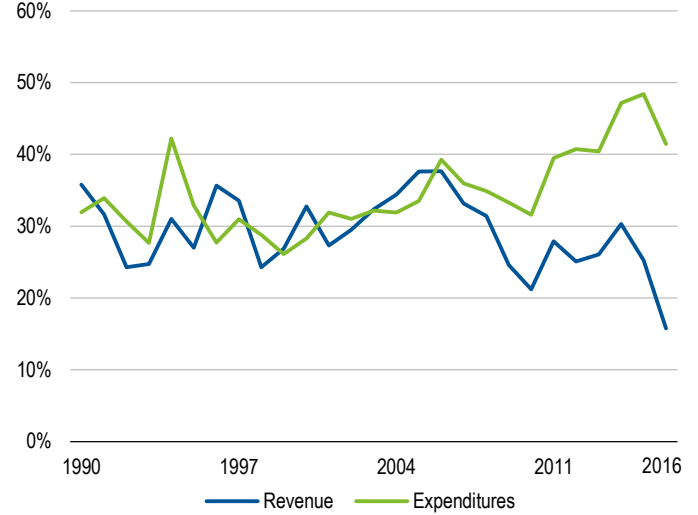
Source: IMF, World Economic Outlook, October 2016.

Exhibits 17 and 18 show a precipitous widening in the fiscal deficit that coincided with a collapse in oil revenues, and continued in the face of a more recent modest attempt to reduce spending. Financial repression was also pushed to an extreme degree, with extremely fast growth in monetary aggregates combined with artificially low deposit and loan rates. Venezuela's inflation fast outpaced inflation in most of its regional partners, as shown in Exhibit 19.

Exhibit 18: Venezuela: General Government Revenues and Expenditures

June 1990–June 2016

% of GDP



Source: IMF, World Economic Outlook, October 2016.

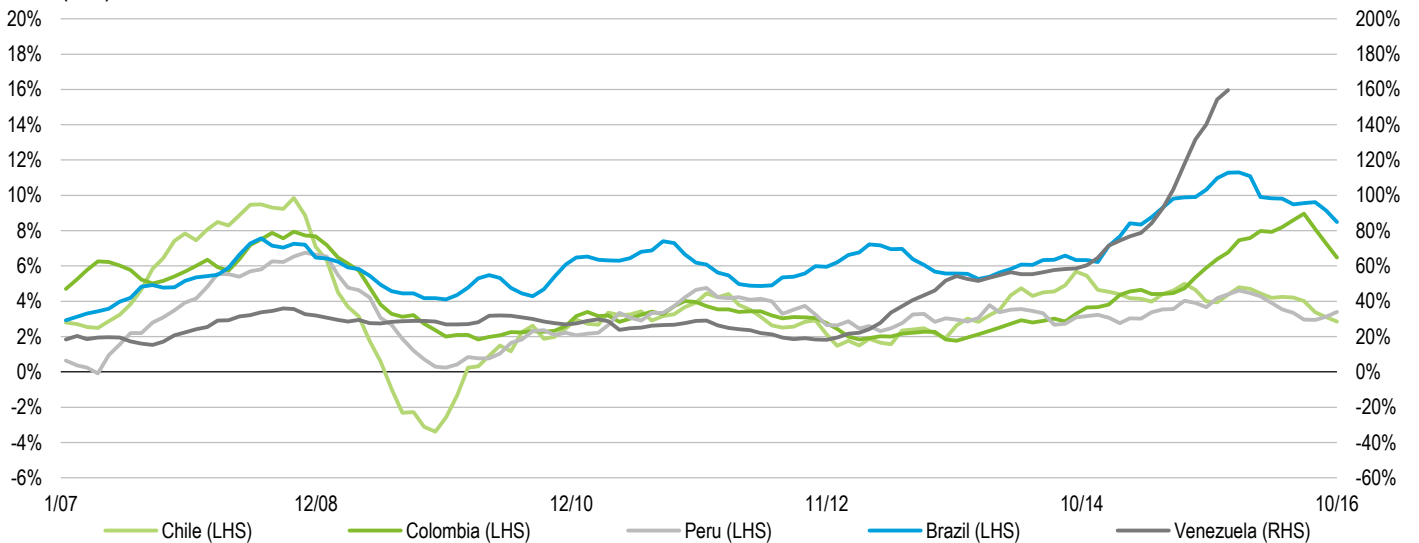
Venezuela's external position suffered an equally dramatic deterioration, as evidenced by Exhibits 20–22. Domestic oil production has been on a steady decline. According to the Organization of the Petroleum Exporting Countries (OPEC), oil production has declined by about a third, from around 3.0 million barrels per day (m bpd) in late 2000 to 2.1 m bpd in November 2016.

Venezuela's Inflation Far Surpasses Regional Inflation

Exhibit 19: Annual Inflation Rates in Select Latin American Countries

January 2007–October 2016

% CPI (YOY)



Source: National Institute of Statistics (Chile), National Administrative Department of Statistics (Colombia), National Institute of Statistics and Informatics (Peru), Central Bank of Venezuela, Brazilian Institute of Geography and Statistics. Venezuela data end 12/15.

Venezuela's External Position Has Deteriorated in the Wake of Falling Oil Production

Exhibit 20: Venezuela: Current Account

February 2005–August 2015

USD (Millions)

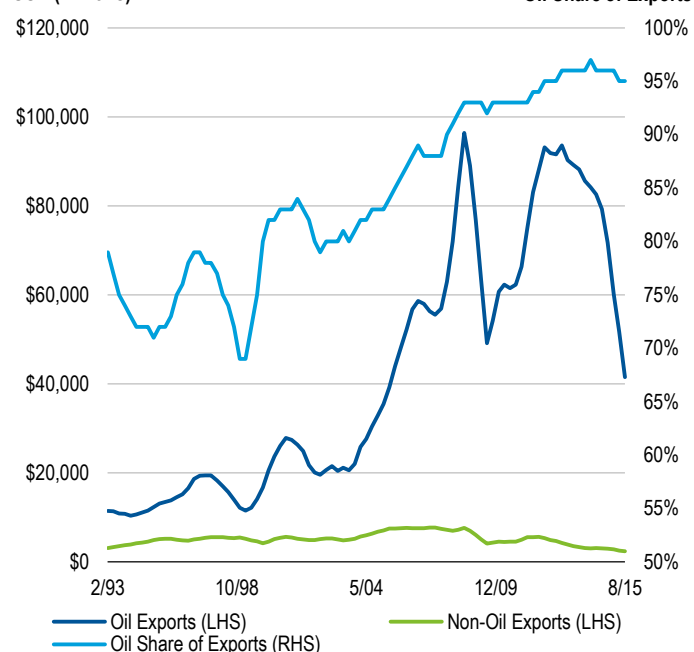


Source: Central Bank of Venezuela.

Exhibit 21: Venezuela: Balance of Payment Exports

February 1993–August 2015

USD (Millions)



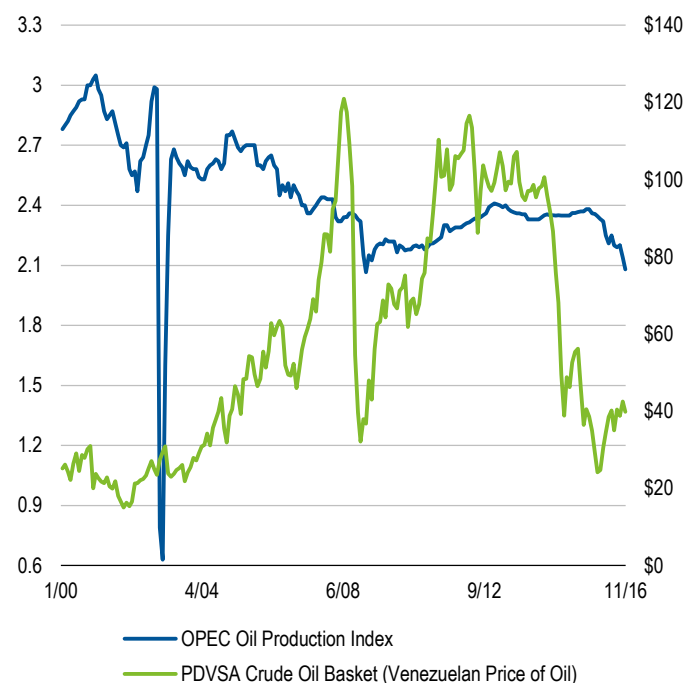
Source: Central Bank of Venezuela.

Exhibit 22: OPEC Production and Venezuelan Oil Prices

January 2000–November 2016

Millions of Barrels per Day (M BPD)

USD per Barrel



Source: Bloomberg. Petróleos de Venezuela, S.A (PDVSA) is Venezuela's state-owned oil and natural gas company.

Colombia

Before concluding this section, it is worth noting that through the period of soaring commodity prices, followed by their collapse, policies in Colombia stayed on an even keel. It is fair to say that Colombia has had essentially the same economic policies since the late 1960s. This is particularly impressive given that the government has been involved in an armed conflict with the guerilla group Revolutionary Armed Forces of Colombia—People's Army (FARC-EP) for almost the entire period. The FARC-EP was formed during the Cold War period as a Marxist-Leninist peasant force, promoting a political line of agrarianism and anti-imperialism. Over the years, FARC-EP evolved from kidnapping and terrorism to attacking energy infrastructure. The ongoing conflict has had little impact on the government's fiscal or monetary policy.

2. The Damage

In all three countries that followed populist policies, such policies have brought about significantly adverse consequences: Inflation rose to high levels, the economic system was severely distorted, productivity growth suffered, manipulation of the exchange rate combined with high inflation caused a significant appreciation of the real exchange rate (which undermined competitiveness), and in some cases public debt expanded rapidly. Exhibit 23 provides a snapshot of the damage suffered by the different countries. It is notable that

Colombia, having maintained prudent macro policies, only suffered from the increase in inflation brought about by the depreciation of the exchange rate.

In Brazil, the real effective exchange rate (REER) rose more than 32% between 2011 and 2014 (Exhibit 25); then in 2015, as the government relaxed price controls, the surge in inflation caused an additional 24% real appreciation.

The Consequences of Populism

Exhibit 23: Policy Consequences by Country

As at 5 December 2016

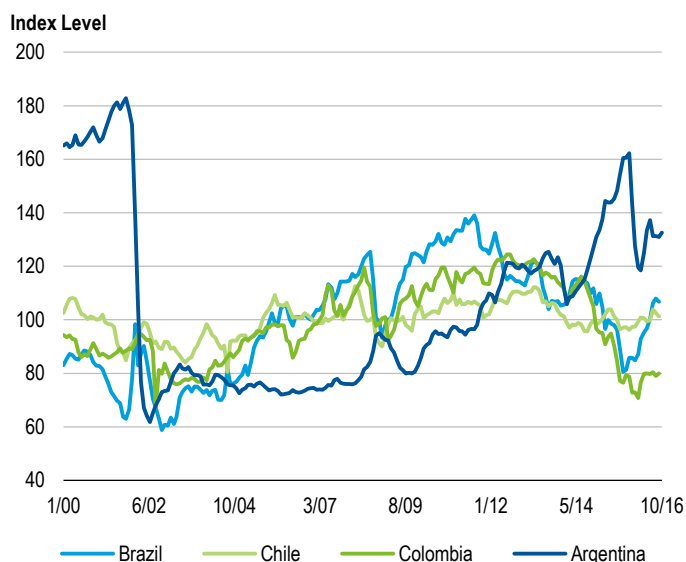
	Argentina	Brazil	Colombia	Venezuela
Rising Inflation	X	X	X	X
Expanding Debt	X	X		X
Real Exchange Rate Over-Appreciation	X	X		X
Low Productivity	X	X		X
Economic Distortions	X	X		X

Source: Templeton Global Macro.

Inflation Surges Caused Spikes in Real Exchange Rates

Exhibit 24: CPI-Based Multilateral Real Exchange Rates

January 2000–October 2016

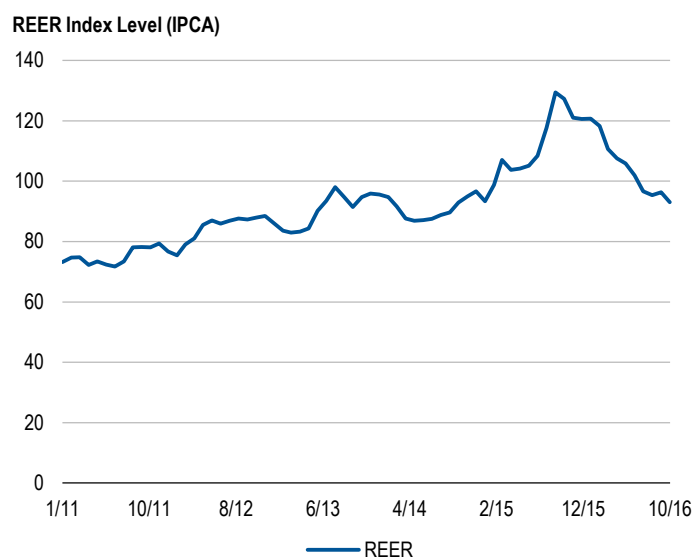


Source: Calculations by Templeton Global Macro using data sourced from IMF International Financial Statistics and Central Bank of Argentina. Brazil, Chile and Colombia data end 9/16.

Brazil's Real Effective Exchange Rate Spiked and Has Begun to Correct

Exhibit 25: Brazil: Real Effective Exchange Rate

January 2011–October 2016

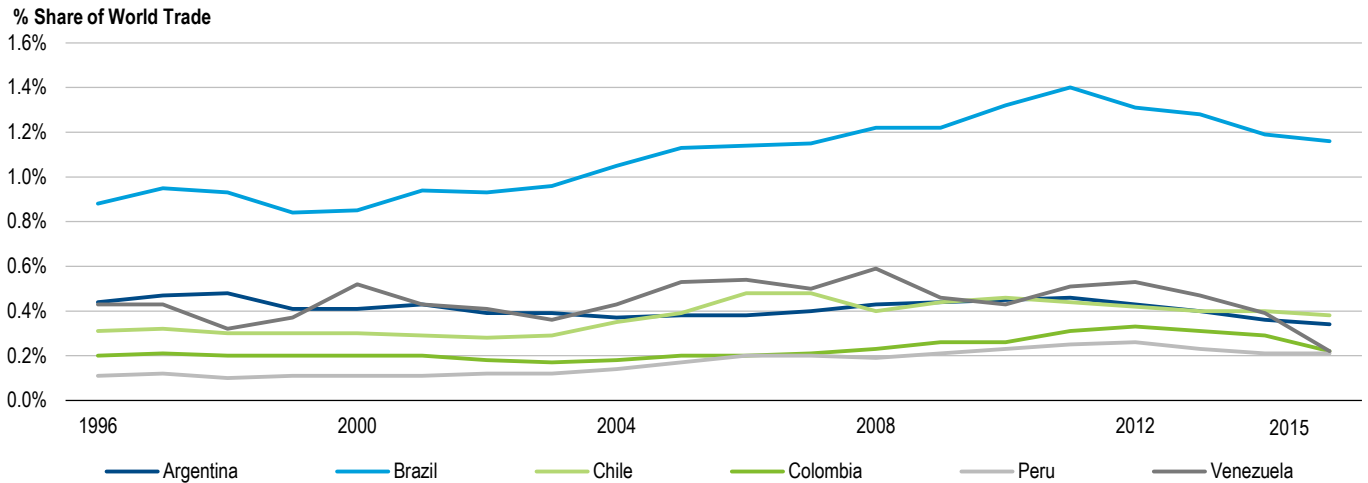


Source: Central Bank of Brazil. IPCA = Brazil's Consumer Price Index.

Populist Policies Led to a Decline in Competitiveness for Argentina, Brazil and Venezuela

Exhibit 26: Latin American Countries' Share of Merchandise World Trade

1996–2015



Source: Calculations by Templeton Global Macro using data sourced from World Trade Organization.

Losing competitiveness in recent years, Argentina, Brazil and Venezuela all saw a decline in their share of merchandise world trade to a greater extent than other regional peers, where the decline was only driven by the adverse commodity shock (Exhibit 26).

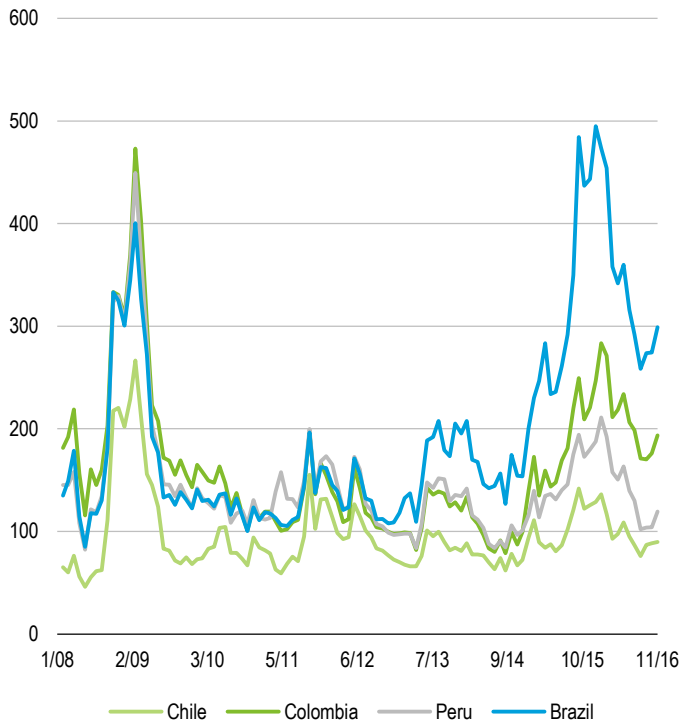
The rise in public debt was mirrored by a significantly higher probability of default in Argentina and Venezuela, relative to regional peers, with a recent reversal of these trends in the case of Argentina.

Rising Public Debt Increased the Risks of Sovereign Defaults for Argentina and Venezuela

Exhibit 27: Five-Year Credit Default Swaps

January 2008–November 2016

Basis Points of Credit Spread

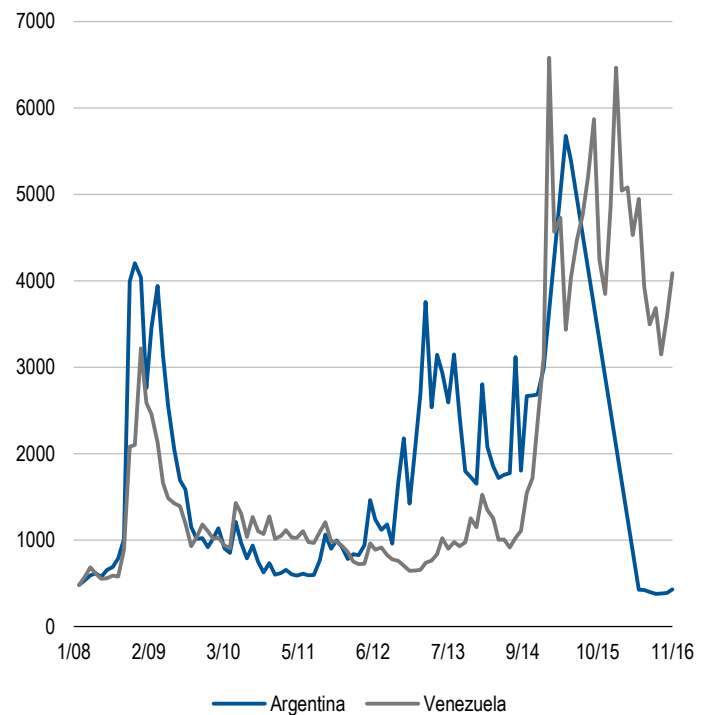


Source: Bloomberg.

Exhibit 28: Five-Year Credit Default Swaps

January 2008–November 2016

Basis Points of Credit Spread



Source: Bloomberg.

3. Reversing Course

In **Argentina**, the protracted deterioration in economic conditions eventually resulted in the ouster of Cristina Kirchner by Mauricio Macri in November 2015. President Macri was elected on a strong economic liberalization platform.

The new government swiftly launched a broad range of reforms:

Strengthening Institutions

- The new government re-established the independence of the central bank, essential to gain anti-inflation credibility.
- It also re-established a sounder system of checks and balances:
 - It appointed independent and qualified judges, including in the Supreme Court.
 - It revamped the INDEC and other institutions to increase transparency and improve efficiency in government expenditure.
 - It complied with judicial rulings even in cases where they complicated the ambitious fiscal reform effort, as in the case of the reimbursement of pension financing for provinces under co-participation rules.
- Equally important is the fact that the necessary legislative measures are being passed through a divided Congress where the Peronist opposition has a strong representation. This signals to us that there is broader recognition that the past policies had brought the country toward a dead end.

Monetary Tightening

- The newly independent central bank hiked interest rates aggressively from 29% at the end of November 2015 to 38% in December 2015; after a cut to 30.5% in February 2016, it brought the rate back to 38% in March in order to anchor inflation expectations.
- The new government began to reverse previous price distortions with a credible plan to raise gas and electricity tariffs, and allowed cities and provinces to increase transportation tariffs. It reduced soy taxes from 50% to 30%, and announced plans for further reductions as fiscal capacity allows.

Fiscal Consolidation and Normalization of FX Policy

- The new government embarked on a fiscal adjustment path, and the 2017 budget has been approved by Congress.

- One of the biggest steps was the immediate float of the Argentine peso. The subsequent large depreciation allowed the convergence of the official and parallel FX rates, and paved the way to eliminate the FX controls that had artificially restricted imports of key inputs.

Regularizing Argentina's International Relationships

- The new government took Argentina out of international isolation by successfully passing a law to negotiate an agreement with hold-out creditors.

This strong and broad-ranging reform effort represents a clear departure from the past, and sends a strong signal to international investors that the government is strongly committed to its new economic policy course—we think the willingness to immediately tackle many of the toughest challenges is the most convincing way of establishing credibility.

In **Brazil**, policy correction was forced upon the former president, Dilma Rousseff, as the market increasingly denied her the financing needed to continue on her unsustainable path. Her ability to execute a policy correction was severely hampered by her plummeting approval ratings, which hit 9% at the lowest point.⁴ This in turn was a result of a painful and protracted political crisis sparked by a massive corruption scandal, ultimately resulting in her impeachment for illegal fiscal spending during her first term.

The new Brazilian government, led by President Michel Temer, has pushed forward with the first steps toward fiscal consolidation, lowering the ceiling on public spending and readying a possible reform of social security. The government has also begun to reverse the previous micro-management of the economy so as to reduce policy-induced distortions. One of the biggest steps was to begin deregulating administered prices in 2015. As Exhibits 11 and 12 on page 7 show, administered prices had been used to artificially suppress inflation, so that the overall CPI was growing at a slower pace than non-regulated prices; in 2015 this relationship reversed as deregulation allowed regulated prices to recover. In 2015 this, of course, created a temporary surge in overall inflation, but this has faded in 2016 as base effects have become more favorable, allowing inflation to decline in a much more sustainable and less distortionary setting.

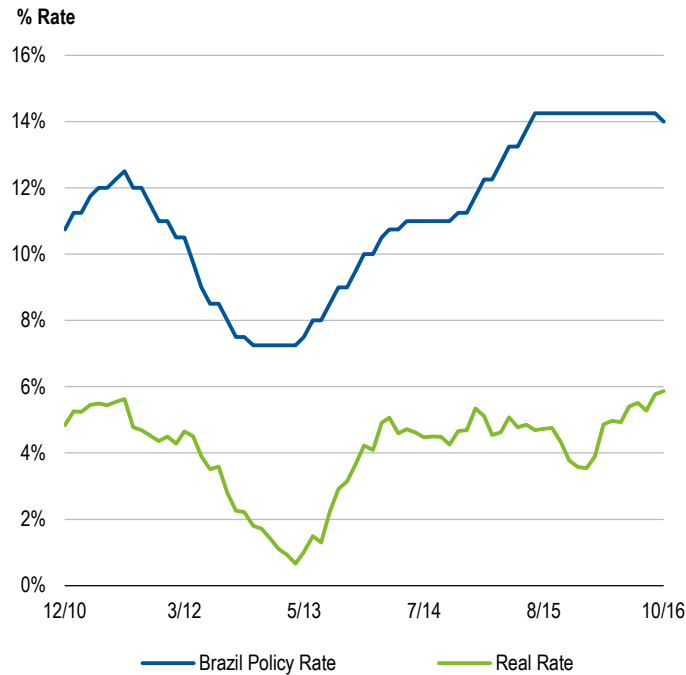
Faced with rising inflation and an economy still in recession, the central bank had to strike a difficult balance in 2015; after

4. Source: IBOPE Polling Agency, Brazil, July 2015.

Brazil Raised Its Policy Rate to Rein in Inflation

Exhibit 29: Brazil: Nominal Central Bank Policy Rate and Real Rate

December 2010–October 2016



Source: Calculations by Templeton Global Macro using data sourced from Central Bank of Brazil.

keeping the real interest rate stable through mid-2015, it allowed it to creep up (even while starting to reduce nominal rates) to secure a decline in inflation in 2016 (Exhibit 29).

A more prudent monetary policy was also manifested in a reversal of the previous credit expansion: For example, new operations on government subsidized directed credit have declined 20% yoy since early 2016 (Exhibits 30 and 31).

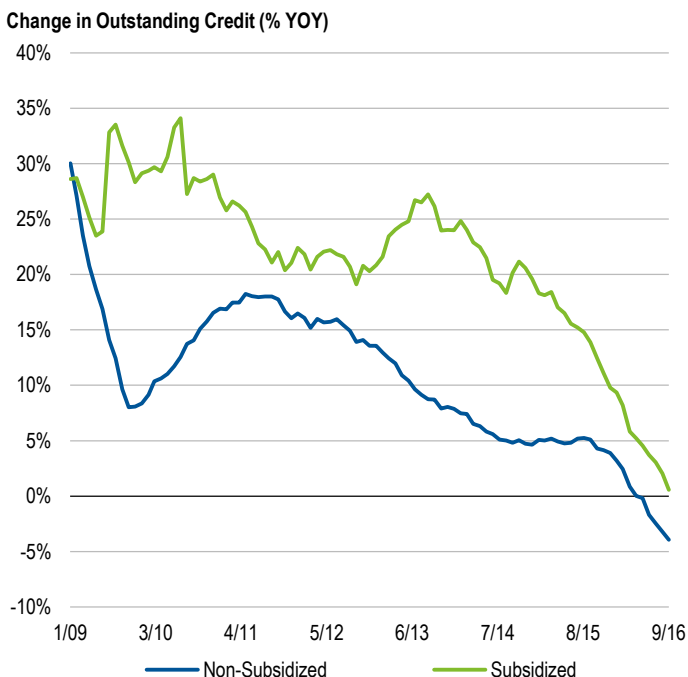
Meanwhile, a significant depreciation of the nominal exchange rate helped reverse the previous appreciation in real effective terms; together with the impact of the recession on imports, this helped narrow the current account deficit from 4.5% of GDP in mid-2015 to just 1.25% in late 2016; the narrow balance of payments moved to a strong +2.5% of GDP (Exhibit 32).

To briefly touch upon **Colombia**, despite the lack of any serious deterioration of policies, the government has actually taken steps to tackle the inflation that resulted from exchange rate depreciation. Monetary policy was tightened; steps have been taken to consolidate the fiscal accounts further to address any potential impact from lower revenues on the back of lower oil prices; and finally, in parallel, negotiations with FARC-EP were pursued to end the long conflict with the guerilla group, further strengthening and safeguarding the democratic institutions of the country.

Credit Expansion Has Slowed Sharply

Exhibit 30: Brazil: Change in Financial System Credit Outstanding

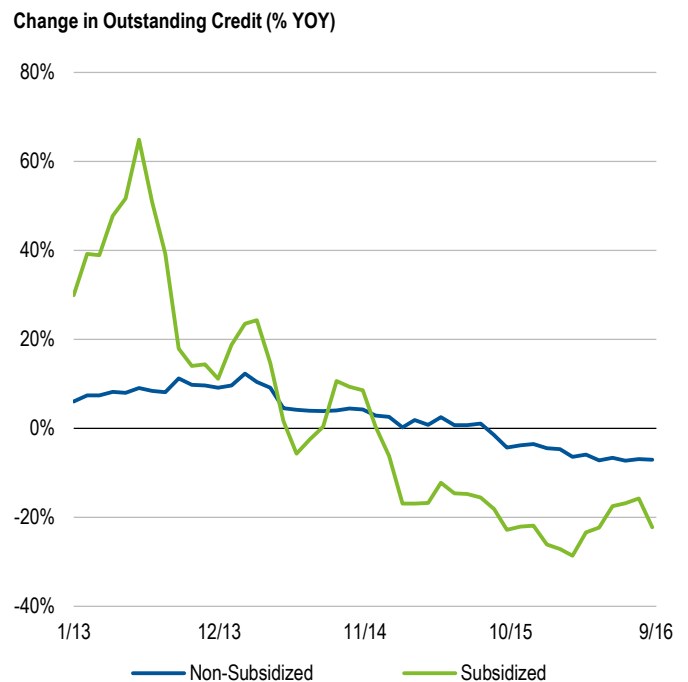
January 2009–September 2016



Source: Central Bank of Brazil.

Exhibit 31: Brazil: Financial System Credit Expansion: New Operations

January 2013–September 2016

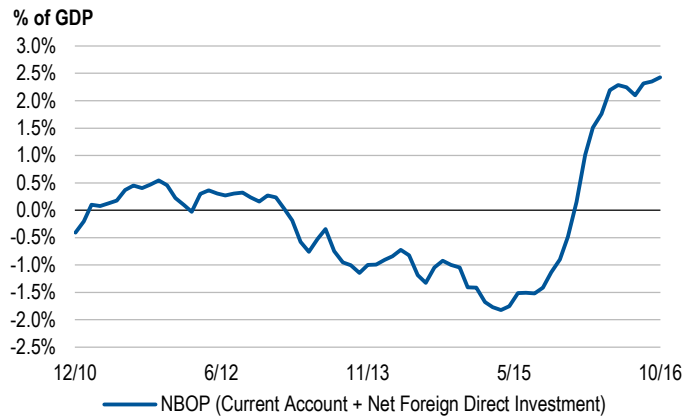


Source: Calculations by Templeton Global Macro using data sourced from Central Bank of Brazil.

Rapid Improvement in the External Balance Is Underway

Exhibit 32: Brazil: Narrow Balance of Payments (NBOP = Current Account + Net Foreign Direct Investment)

December 2010–October 2016

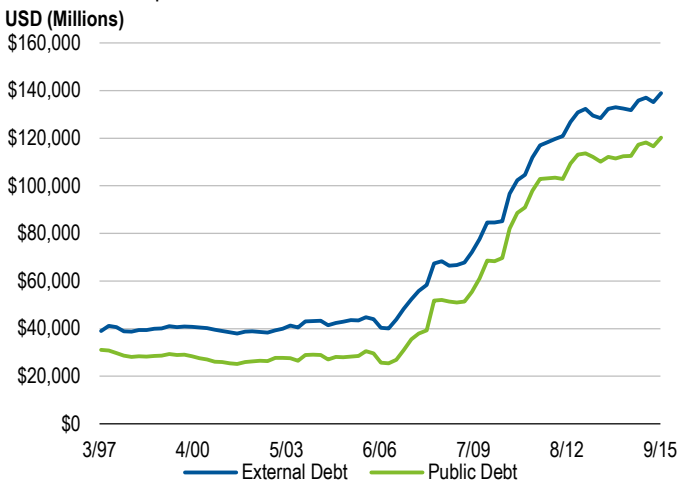


Source: Calculations by Templeton Global Macro using data sourced from Central Bank of Brazil.

Venezuela's Debt Has Risen Sharply While International Reserves Have Rapidly Declined

Exhibit 33: Venezuela: External Debt

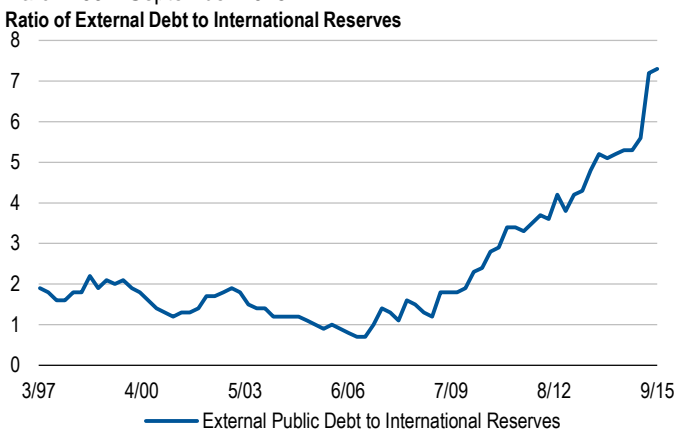
March 1997–September 2015



Source: Central Bank of Venezuela.

Exhibit 35: Venezuela: External Debt to International Reserves

March 1997–September 2015



Source: Calculations by Templeton Global Macro using data sourced from Central Bank of Venezuela.

5. Source: Bloomberg. Data as at 30/11/16.

At the time of this writing, **Venezuela's** populist policies are still in full swing. On the exchange rate front, the black market rate reached around 4300 VEF,³ while the primary rate remains at 9.99 VEF.⁵ The population now faces extremely harsh conditions, with high unemployment and a severe lack of food and other basic necessities. This has triggered protests and increased the risk to social stability but has not yet resulted in political change, much less in a policy correction.

Nominal debt in Venezuela continues to rise. The FX distortions make it difficult to estimate GDP in US-dollar terms and calculate a ratio, but we can see that reserves are depleting at a fast pace, and the ratio of debt to reserves is skyrocketing. In November 2016, PDVSA had problems making coupon payments on its bonds maturing in 2021, 2024 and 2035. The payments were eventually made, but delays seem likely to recur.

Exhibit 34: Venezuela: International Reserves

January 2005–November 2016



Source: Central Bank of Venezuela.

We can summarize this section in the following table:

A Summary of Policy Adjustments

Exhibit 36: Policy Adjustments by Country

As at 5 December 2016

	Argentina	Brazil	Colombia	Venezuela
Price Deregulation	+	+		
FX Deregulation	+			
Fiscal Consolidation	+	+	+	
Strengthening Institutions	+	+	+	

Source: Templeton Global Macro.

4. Forging into the Decade Ahead

Looking forward to the next decade, it is hard for us to feel anything but pessimistic about the outlook for **Venezuela**. It simultaneously has greater oil reserves than Saudi Arabia and the world's fastest contracting economy, inflation that is estimated to be heading toward 1000%,⁶ and shortages of food and medicine that are pushing the country toward a humanitarian crisis.

In both **Argentina** and **Brazil**, there are reasons to be far more optimistic, although the policy correction has just begun. While it will be crucial to maintain the momentum in the coming years, in both countries the most important factor—political commitment—appears to be in place, and if the new policies are maintained the benefits will be substantial. We see encouraging signs and discuss some of them below.

In **Brazil**, as highlighted in the previous sections, it had become critical to address structural problems to support fiscal consolidation and to enhance long-term potential growth. The political transition that culminated in the August Senate impeachment trial of the former president has clarified the outlook. There is renewed hope that the new administration will be able to deliver the clear regime shift toward more orthodox policymaking. Looking forward, we will be monitoring the progress of the Temer administration to continue to accelerate and deepen the fiscal adjustment and other structural reforms that are needed to enhance productivity and the flexibility of the economy.

We have early indications of the government's commitment toward both short-term measures and longer-term structural reforms to address the deterioration in the fiscal picture. In a key development, a constitutional amendment was approved that caps the growth of nominal primary fiscal spending at the previous year's inflation rate (in other words, with no increase in real terms). To illustrate the impact of this new policy on debt dynamics, we have carried out a simple simulation.

If current policies remain in place, we believe that over the medium term inflation will stabilize at the central bank's target of 4.5%. For the purpose of this exercise, we assume real GDP growth recovers to 3% (a conservative estimate for Brazil's potential growth rate), government revenues remain constant as a share of GDP, and the 2017 primary deficit is at the government's target of 2% of GDP (Exhibit 37 and 38).

Under these assumptions, we estimate that revenues will exceed expenditures by 2022, ensuring that the debt-to-GDP ratio would stabilize at just under 100% (Exhibits 39 and 40). In other words, sustaining the current fiscal consolidation effort would be sufficient to ensure debt sustainability within the next five years.

By comparison, a continuation of the old policies resulting in a sustained primary fiscal deficit of 2% of GDP would cause the debt-to-GDP ratio to continue to rise, as shown in Exhibit 40. In other words, without a policy correction debt dynamics would soon have become unsustainable.

This may be the most important reform so far, but there are indications that more are in the pipeline, including importantly a reform of Brazil's social security system, which should further enhance the structural soundness of public finances. The government has also indicated that there are a number of other structural reforms, including in the labor market, that will be addressed after the key fiscal reforms are secured. While Brazil will not return to strong growth next year, its trajectory should improve as we see the results of the economy returning to a more promising path supported by an orthodox policy framework and the strong structural reform agenda.

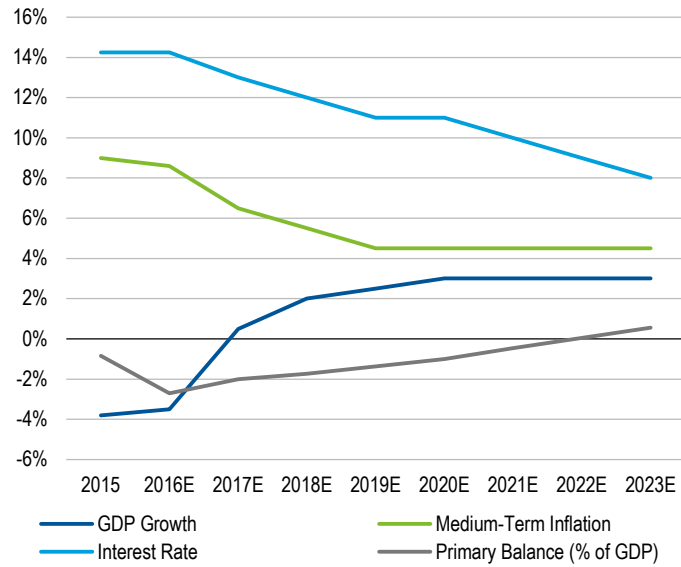
In **Argentina**, the government has set out a path to recovery based on market-based policies, monetary restraint and a slow fiscal adjustment. One of the consequences of Argentina's 2001 default was that the country was effectively locked out of capital markets in the aftermath until the current administration took office and regularized relations with creditors. An unintended benefit from the inability of the previous administrations to access capital markets was that the Macri administration inherited a relatively low level of external debt. As at the second quarter of 2016, public external debt was just above 20% of GDP, giving the Macri administration the room to finance much-needed investment to boost future growth (Exhibit 41). Under the era of populist policies the investment rate in Argentina had dropped to the lowest in the region (Exhibit 42).

6. Source: IMF, World Economic Outlook, October 2016.

Forecasted Conditions for Brazil Indicate Revenues Should Exceed Expenditures by 2022

Exhibit 37: Forecast-Based Economic Assumptions

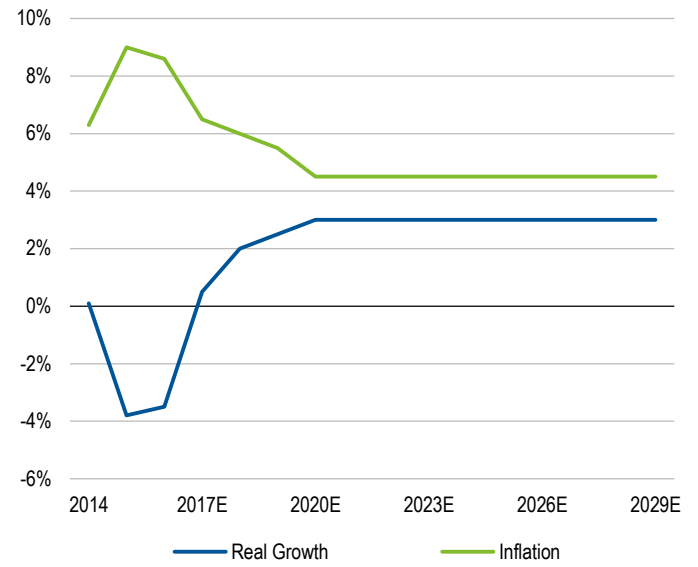
As at 5 December 2016



Source: Templeton Global Macro.

Exhibit 38: Medium-Term Inflation and Growth Assumptions

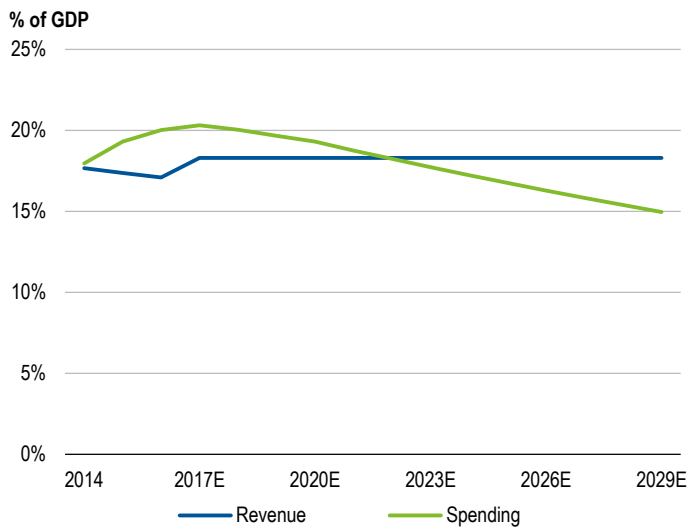
As at 5 December 2016



Source: Templeton Global Macro.

Exhibit 39: Fiscal Forecast

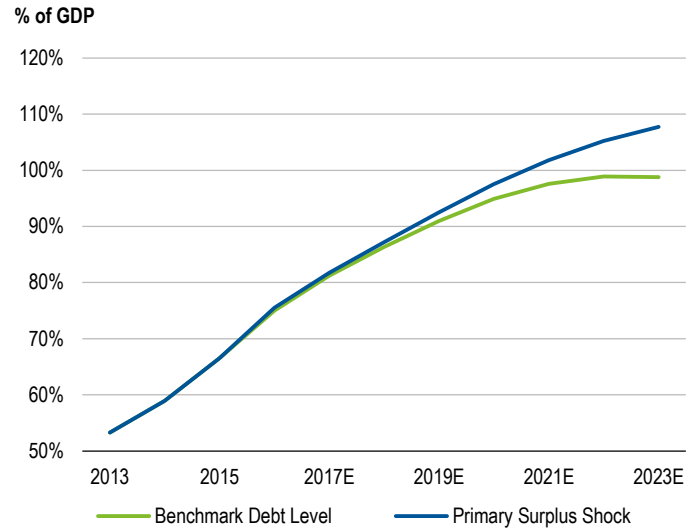
As at 5 December 2016



Source: Templeton Global Macro.

Exhibit 40: Debt-to-GDP Forecast

As at 5 December 2016



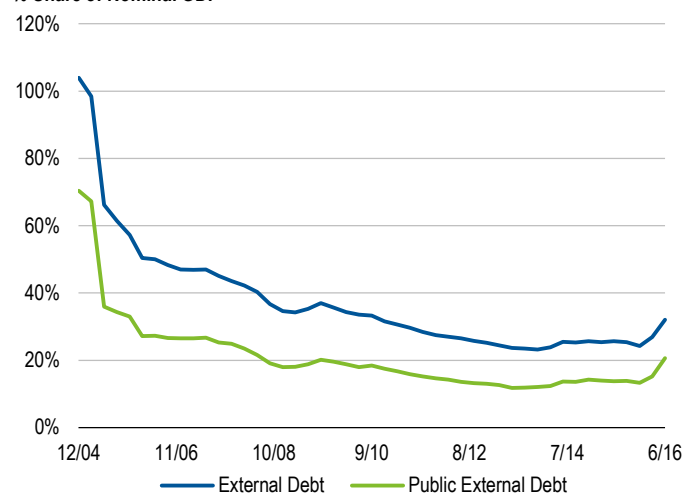
Source: Templeton Global Macro.

Argentina's Low Debt Levels Provide Capacity to Finance Future Growth

Exhibit 41: Argentina: External Debt

December 2004–June 2016

% Share of Nominal GDP



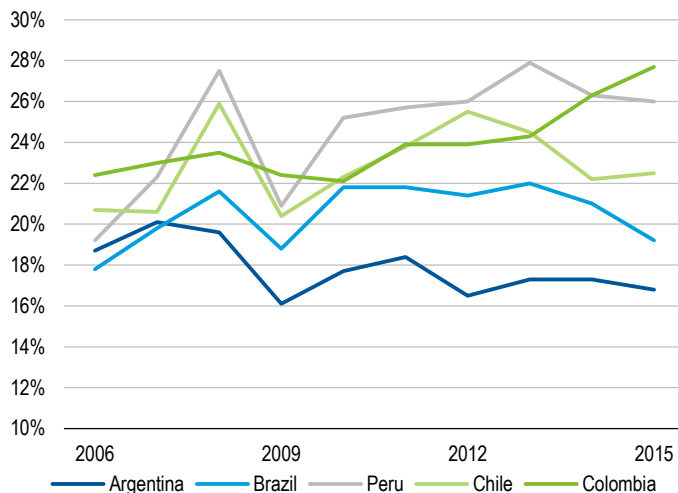
Source: Calculations by Templeton Global Macro using data sourced from National Institute of Statistics and Censuses (Argentina) and Central Bank of Argentina.

The liberation of key institutions like the central bank and the national institute of statistics (INDEC) has already had a positive impact, and certainly improves Argentina's longer-term prospects of achieving and maintaining macroeconomic stability. Market-based inflation expectation measures indicate a sharp reduction in inflation over the next three years. Year-end inflation is expected to halve from 40% yoy this year to 20% by December 2017, and further to 14.6% in 2018 and 9.1% in 2019.⁷ While these expectations exceed the upper band of the central bank's own (ambitious) targets by 250–350 basis points,⁸ the bank has shown commitment to maintaining tight monetary policy in order to achieve those targets.

Exhibit 42: Expenditures by Country (GFCF as a % of GDP)

December 2006–December 2015

% of GDP



Source: IMF, World Economic Outlook, October 2016. GFCF is gross fixed capital formation.

The benefits of the policy correction can also be seen in the form of regained confidence. The chart below shows that private deposits into the banking system have started to recover at a rapid pace, particularly FX deposits (Exhibit 43). This has occurred even as the central bank has cut its policy rate.

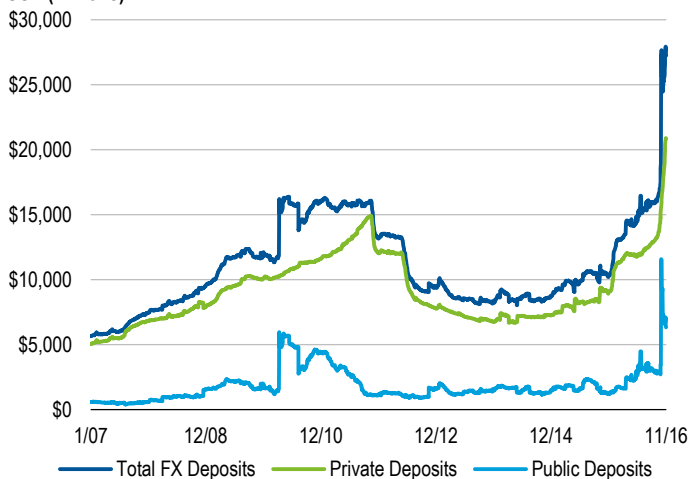
As Exhibits 45 and 46 show, between 2003 and 2012 the increase in private sector foreign exchange deposits could, to a large extent, be explained by rising export revenues. It is interesting to note that the recent steep rise in private sector deposits has taken place even as the merchandise trade balance has just begun to recover and while export revenues are still increasing by smaller increments than in the past few years.

Argentina's Foreign Currency Deposits Have Increased even as its Central Bank Has Cut Rates

Exhibit 43: Argentina: Foreign Currency Deposits

January 2007–November 2016

USD (Millions)

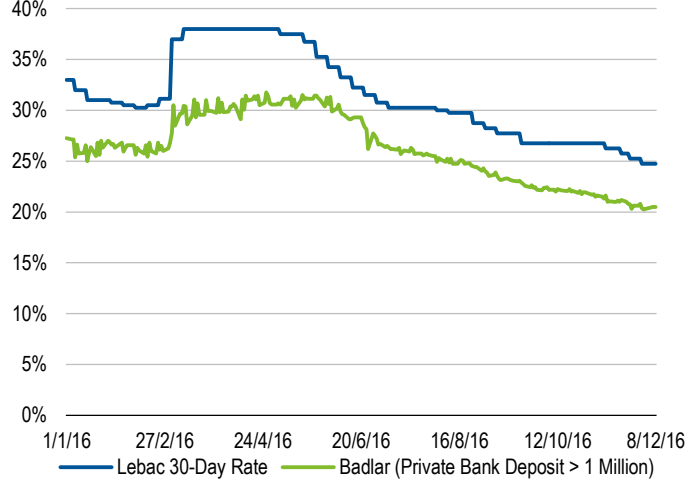


Source: Central Bank of Argentina.

Exhibit 44: Argentina: Central Bank Rates

1 January 2016–8 December 2016

% Rate



Source: Thomson Reuters, Central Bank of Argentina.

7. Source: Central Bank of Argentina, Survey of Market Expectations, November 2016.

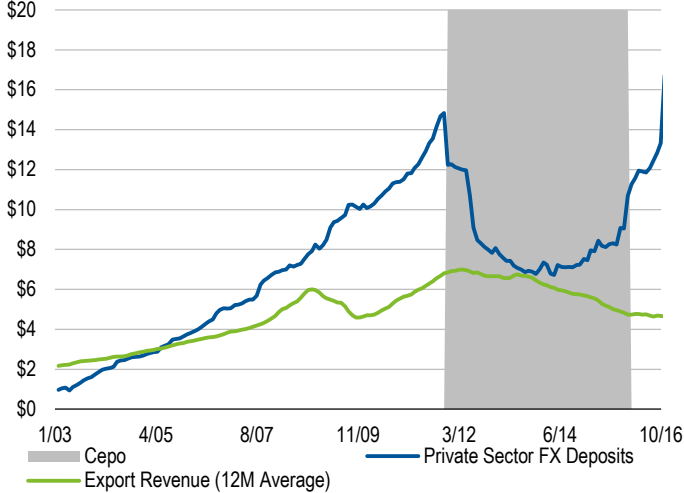
8. 100 basis points = 1 percentage point (i.e., 1.00%).

Private Sector Deposits Have Risen Significantly

Exhibit 45: Argentina: Private Sector Deposits vs. Export Revenue

January 2003–October 2016

USD (Billions)



Source: Central Bank of Argentina, National Institute of Statistics and Censuses (Argentina). Shaded area corresponds to November 2011–December 2015.

The most recent spike in deposits in September and October 2016 is likely related in part to the tax amnesty on declared assets held domestically and abroad that had previously been undeclared to the tax authorities. Even abstracting from this one-off factor, however, the strong recovery in deposits shows that the move to exchange rate flexibility coupled with other liberalization measures has been more effective in safeguarding the level of FX reserves than the previous recourse to capital controls in a context of unsustainable interventionist policies. During the previous regime of capital controls, deposits had collapsed even as the trade balance remained positive. In fact, the imposition of capital controls appeared to have the immediate impact of a sharp decline in deposits: Between 2003 and 2011, about 10% of merchandise trade balance value would translate in an increase in private sector FX deposits; as capital controls were imposed in 2012, FX deposits fell by US\$4.2 billion even as the merchandise trade balance improved (Exhibit 47).

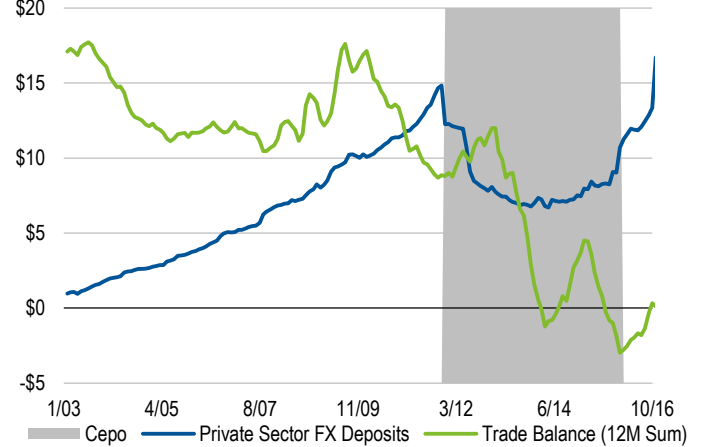
In the case of both Brazil and Argentina, we see the reversion to orthodox policies has begun to bear fruit, by way of declining interest rates in the case of Brazil and a return to market access in the case of Argentina. While we do not expect either country to return to rapid growth next year, the policies being followed right now point in the direction of sustainable growth in the period ahead.

Finally, in the case of **Colombia**, as we go to press a peace agreement has been reached with the FARC-EP. While the peace agreement did not initially pass a popular vote, a revised treaty was approved by the parliament. This marks the end of one of the longest running civil conflicts in the world, and this together with the continued adherence to prudent macroeconomic policies makes us confident in the outlook for the country.

Exhibit 46: Argentina: Private Sector Deposits vs. Merchandise Trade Balance

January 2003–October 2016

USD (Billions)



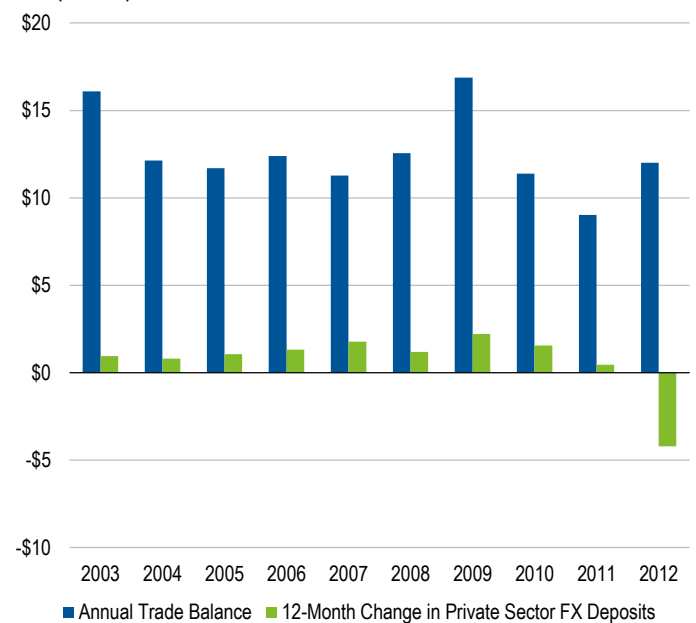
Source: Central Bank of Argentina, National Institute of Statistics and Censuses (Argentina). Shaded area corresponds to November 2011–December 2015.

Capital Controls Caused a Decline in Deposits Despite an Improved Trade Balance

Exhibit 47: Argentina: Annual Trade Balance and Change in Private Sector FX Deposits

December 2003–December 2012

USD (Billions)



Source: Central Bank of Argentina, National Institute of Statistics and Censuses (Argentina).

Conclusion

In this paper, we have tried to summarize the experience of four Latin American countries, three of which were lured into the trap of populist policies, whereas one was not. All these countries were hit to varying degrees by the end of the commodity supercycle, and their ability to sustain their respective policy frameworks was tested—those that turned to populism were found wanting. The damage that was inflicted on these economies by the drift away from prudent macro policies is in the process of being reversed in Argentina and Brazil; the experience of Venezuela, which has refused to follow this path, speaks for itself. We also highlighted the experience of Colombia, which stands as the mirror image to Venezuela, steadfast in its rejection of populism. Once again, a starker contrast is hard to draw.

Sticking to prudent policies in the face of an adverse shock required some short-term pain but left Colombia in a strong position for a rapid and sustained recovery, safeguarding macro and financial stability. Populist policies followed by other countries promised the chimera of an easy, pain-free way out—but instead caused lasting declines in living standards and inflicted serious damage to economic institutions, necessitating further sacrifices to right the ship. In closing, we would reiterate that the examples we have drawn from Latin America have important lessons to offer to the developed world. While we are not suggesting that the US or the various countries in Europe that are flirting with populism are at risk of traveling down some of the extreme paths we have described in this paper, these examples do offer a cautionary tale at a time when orthodox economic policymaking is falling increasingly out of favor.

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