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Dealing With Latin Populists

Populist rhetoric and policies will continue as long as natural resources prices remain high. But what happens after they fall?

BY JOACHIM BAMRUD

Last week's Ibero-American Summit in Chile was supposed to be a good opportunity for private-sector leaders in Spain, Portugal and Latin America to influence policy-makers to boost investor-friendly policies.

Instead, the summit turned out to be only the latest platform for populist, anti-business rhetoric, with presidents like Hugo Chavez of Venezuela and Daniel Ortega of Nicaragua attacking Spanish companies.

Ortega compared Spanish electricity company Union Fenosa to the mafia and accused it of using "gangster methods" and corruption. He also criticized a previous government of Nicaragua which sold state electricity companies to Union Fenosa. "We wouldn't have let them in," he said, while the Spanish king and prime minister were looking on. "They bought, amidst corruption, the generating companies which were in good shape."

Ortega blames Union Fenosa for Nicaragua's electricity problems and has repeatedly threatened to expel the company. Union Fenosa, however, blames the problems on users who are not paying their bills. Ortega's speech in Chile earned him a rebuke from the American Chamber of Commerce in Nicaragua.

CONTRACT RENEGOTIATIONS

The latest rhetoric comes after a series of populist policies implemented this year in Latin America. In January, Chavez nationalized Venezuela's largest telecom and electricity companies CANTV and EDC. He later renegotiated the terms of existing oil contracts – leading ExxonMobil and ConocoPhillips to leave rather than accept the less profitable terms. Meanwhile, Ecuador's populist president Rafael Correa this month announced he will renegotiate the contracts of foreign mining firms and revoke those who aren't being used. He also threatens to expel U.S.-based City Oriente and Mexico-based America Movil for alleged tax problems. That comes on top of his recent decision to hike oil royalties from 50 to 99 percent.

"Risks remain high while Correa is in office and beyond given Ecuador's long history of political instability and inconsistent policymaking," U.S.-based consultancy Global Insight warned in an analysis today.

City Oriente has taken its case to the World Bank's International Center for Settlement of Investment Disputes (ICSID). But it may face some problems. Correa says he won't recognize any verdicts from the ICSID. Ecuador already faces a suit from U.S.-based Occidental petroleum, which was Ecuador's largest foreign investor until it had its operations expropriated from the government last year.

And Bolivia – led by populist president Evo Morales – has decided to leave the ICSID altogether. It also faces a possible ICSID case brought by Swiss-based Glencore, which had its tin smelter seized without compensation in February.

LESS PRIVATE INVESTMENT

The result? More litigation and less investment, experts say. "Obviously there will be protracted litigation at certain levels," says Michael Diaz, managing partner at U.S.-based law firm Diaz, Reus, Rolff & Targ. "It will affect their trade policies with the U.S. and other developing countries."

Both Ecuador and Bolivia are seeking an extension of the Andean Trade Preferences and Drug Eradication Act (ATPDEA), which provides duty-free access for around 5,600 products. The two are also – along with Colombia and Peru – set to negotiate a free trade agreement with the European Union.

Meanwhile, investment will decline. "Who wants to invest in those countries if they won't respect the rule of law?," asks Diaz.

Venezuela is likely the best example of what populist policies can do to deter investors. The country last year posted a net FDI outflow of \$543 million after seeing FDI inflows of \$2.5 billion (mostly oil-related) the previous year, according to the United Nations Economic Commission for Latin America and the Caribbean (ECLAC). Spanish investment alone has fallen from 1.7 billion euro (approximately US\$1.5 billion) in 2001 to 106.7 million euro last year, according to data from Spain's Council of Chambers of Commerce quoted by *El Pais*. During the first half of this year, Spanish investment had fallen to a mere 6.6 million euro, the paper reports.

PDVSA: LESS OIL, MORE SPENDING

"The economic injury at this point is most severe in Venezuela," says James Roberts, a research fellow at the Heritage Foundation. "Chavez has repeatedly raided PDVSA's piggybank to pay for grandiose social spending, military weaponry, and foreign adventurism. Inflation is up and the value of the Bolivar is down. The *Chavistas* have mismanaged PDVSA...Although Chavez is inviting oil companies from other authoritarian countries such as China and Iran to take the place of the Western oil companies, they do not have sufficient technical capacity to turn around PDVSA's decline."

PDVSA was once considered one of the most efficient state oil companies in the world. Under Chavez it has become one of the least efficient ones, with falling production and profits. Instead of using profits to invest in the company itself - to assure long-term oil production - PDVSA is now using its windfalls on social and political programs. It has also replaced its well-regarded professionals with unqualified political loyalists.

"Radical policies brush aside the fact that extractive industries demand high capital investments that need to be executed over a fixed time period," Beatrice Rangel, managing director and president, AMLA Consulting. "For these investments to create wealth they demand human capital formation through training programs which are essential for the host country to acquire the operational know-how that will eventually transform itself into a competitive advantage."

RENT-SEEKING POLICIES

These policies are also sacrificing long-term and balanced growth in favor of short-term enhanced revenues that will be difficult to absorb, ending in waste and even worse, promoting a rent-seeking economic culture, she adds.

Chavez' policies also include slashing CANTV's prices by 20 percent, creating unfair competition for rivals like Spain-based telecom company Telefonica - the largest pan-regional operator in Latin America - which operates in Venezuela.

Telefonica also faces challenges in countries like Ecuador and Argentina, Spanish newspaper *Expansion* points out. Ecuador's populist president Rafael Correa has said he wants to harden the terms for Telefonica's license in the country. And in Argentina, Telefonica - and other foreign companies - are still suffering from the artificial price ceiling in place the past five years. Ibero-American business leaders said in a statement after the summit that they were "deeply concerned about the increased political and legal uncertainty as well as the attacks against the private sector in certain countries." *El Pais* - Spain's most influential newspaper - echoed those feelings. "The legal insecurity is increasingly threatening Spanish investors in Latin America," it said in an editorial published today. "Demagoguery and [state] interventions suffocate any business."

JOB LOSSES

Radical policies typically aim at boosting jobs, but in reality will lead to job losses in many local communities, Rangel points out. "[Private and foreign] investments further need to align themselves with the interests of the local communities where the resource basins are located," she says. "By abruptly changing the rules of the game, radical governments are inviting foreign investors in these industries to accelerate production so as to generate revenues faster and cut potential losses. With this in mind they usually resort to capital intensive processes that reduce the need for local labor thereby negatively impacting employment levels."

The populist policies also lead to a different kind of foreign investor than Latin America needs, she adds. "Investors also begin to seek a way out of those countries placing their assets on the auction block," she says. "Under these conditions buyers usually are risk taking investors that have the least concern for the development of local capacities to operate the industry."

U.S. POLICY

So, what should the US do? Boost free trade agreements with the region, proposes Roberts. "The U.S. Congress should approve pending trade promotion agreements with Panama [and] Colombia," he says. "The Bush Administration should negotiate more FTAs with the remaining countries that surround Venezuela, especially Brazil, Paraguay and Uruguay. The U.S. should firmly oppose populist regimes that would enslave their own people in the name of economic justice, and pursue robust programs to assist its friends in the region to solve income inequality and poverty problems by completing the reforms that were started in the 1990s."

Rangel also agrees that the U.S. attention should be on business-friendly countries in Latin America. "The US should not be the least concerned with these [populist] countries, but with those that are executing significant reforms in their economies and political institutions so as to support them with a view that they can avoid social despair which almost surely leads to anonymity and populism," she says.

U.S. leaders must pay attention to the region and stop playing domestic politics in conditions there, says William Ratliff, a research fellow at Stanford University's Hoover Institution. "We have little moral or other authority to preach to people in the "populist" countries about what they should do, so we must now emphasize serious and consistent support for the countries that are following more productive roads," he says. "I don't think we will do so, as demonstrated by continuing indifference to the region generally and stupid resistance to the bilateral trade agreement with Colombia. Latin America is going to have a lot of heartbreak and unrest before things get better, and much of that will spill up north."

OUTLOOK

Last time Latin America implemented populist policies - in the 1970s - they ended in failure, which was followed by an unprecedented liberalization and market-friendly policies in most countries. So, how long will the current populism last?

Much depends on the prices of natural resources, which are helping finance the expansionary policies of the region's populists, experts say. "Mineral rich countries could soon find out that reductions in FDI, coupled with a world economic slowdown empty their public coffers while creating inflationary pressures that they can ill confront," Rangel says. "In such countries the pendulum will move faster and swifter."

Ratliff agrees, but adds a caveat on how possible changes are if the populist countries become increasingly undemocratic. "The people in these countries, following their leaders, are digging themselves into very deep holes," Ratliff says. "This situation is likely to continue until some form of economic crash shakes enough people in one or more countries to get them to demand a change of direction, and then the question will be whether it is too late to do so by nonviolent means."

LOSERS - AND WINNERS

There are already signs of problems in Venezuela. Oil revenues fell by 6.5 percent in the January-August 2007 period and oil-related tax collection saw an outright negative growth, Global Insight points out. "The recovery of the price of crude oil seen during the months of July and August was not enough to bring revenue up in real terms," it said in an analysis yesterday. And since government spending is growing, the result was a deficit.

However, as leftist policies fail, populist leaders may continue limiting democracy in order to stay in power, experts warn. Chavez, Morales and Correa have all used - or are trying to use - constituent assemblies to rewrite the constitutions and restrict political and economic freedoms. "Step by step Chavez, Morales and Correa are using democracy to subvert democracy," Ratliff

says. "They are making progress because they effectively manipulate the frustrations, poverty and ignorance of people to get them to make concessions they will not easily reverse, perhaps not even knowing they are doing so. In the end to maintain power they will have to use increasing force since the economies will produce less and less to go around."

For investors, that means hedging their bets and carefully looking at each Latin American market individually. In the end, that means countries like Brazil and Mexico (the region's top two economies) will benefit as will other Andean countries like Colombia, Peru and Chile and CAFTA nations like Costa Rica, the Dominican Republic and El Salvador. They all continue to have pro-business leaders that eagerly seek a growing slice of foreign investors' pie.