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GLOBAL FINANCE

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Cover Story: **Continental Shift**

LATIN AMERICA REGIONAL REPORT

Latin American governments' attempts to gain more control over their countries' economic fortunes are having far-reaching effects on international corporations doing business in the region.

A decade after winning the presidency of Venezuela for the first time, Hugo Chávez continues to lead his "Bolivarian Revolution" based on the spread of what he calls the new "21st century socialism." With his country awash in petrodollars, the president has had little trouble supporting Latin America's push to the political left. Businesses say the situation has led to the establishment of a new business and regulatory environment throughout the region, but while the challenges are great, the profits so far are even greater.

"There are considerable differences between the populist left of Hugo Chávez and the pragmatic left of [Chilean president] Michelle Bachelet or [Brazilian president] Lula da Silva," says Terry McCoy, director of the Latin American Business Environment Program at the University of Florida in Gainesville. "Argentina has a foot in both the pragmatic and populist arenas because the rhetoric is populist, but, if you look carefully at the government's policies, they're not as reckless as the rhetoric would suggest," he adds.

While both camps emphasize social welfare programs, McCoy says Latin America's pragmatic leftists have pursued orthodox economic policies and done nothing to upset the region's macroeconomics. "The pragmatic left has followed the holy trinity of macroeconomic responsibility, which is a floating exchange rate, fiscal discipline and inflation targeting," he notes. McCoy feels that while companies can still turn a hefty profit in markets with populist regimes, investors are more likely to make long-term commitments in those with pragmatic policies where, he says, the rules of the game are clearer and more business-friendly.

McCoy illustrates his point by reviewing FDI data for the region, which grew from $28 billion in 2006 to $77 billion last year. When broken down by country, those with pragmatic regimes, such as Chile and Brazil, posted a rise in FDI from $5 billion in 2006 to $8.5 billion in 2007, and from a $9 billion outflow in 2006 to a $32 billion inflow last year, respectively. On the other hand, populist hardliner Venezuela posted the region's fastest GDP growth last year but has reported net outflows of FDI in the past two years, while close ally Ecuador has seen FDI dwindle from $1.3 billion in 2001 to last year's scant $400 million. **"The leaders of Venezuela,**

Argentina and Bolivia have adopted a populism that has inspired an extremist anti-free-market and anti-private-property stance," says Lawrence Kogan, president and CEO of the Institute for Trade, Standards and Sustainable Development in Princeton, New Jersey.

Venezuela, the epicenter of the region's new left, presents perhaps the most challenging business environment. The government has nationalized companies that previously had been privatized, requires exporters to request separate licenses for each transaction, introduced three new taxes last year and expanded its ban on firing workers to now cover any employee who earns less than three times the minimum wage. In a World Bank survey of nations with the fewest obstacles to doing business in 2006-2007, Venezuela ranked 172 among 175 countries included in the ranking.

In January Venezuela introduced a new forex law that reduces the amount of dollars that Cadivi, the government's forex agency, makes available to companies at the official rate of 2.15 bolivars per dollar. The measure aims to narrow the gap with the parallel rate, which stands closer to 5 bolivars per dollar, but analysts say it will force more companies to seek dollars on the black market, in turn further fueling inflation. The currency is believed to be as much as 50% overvalued, though an adjustment is not expected any time soon.

Chávez has convinced other allies to adopt measures that are making the business environment more challenging. Ecuador's president Rafael Correa, for example, recently revoked 587 mining contracts, claiming companies had not paid annual fees. "A resurgence of populism in Latin America is stirring concern among international investors," writes Michael Patsalos-Fox, chairman of the Americas at consultant McKinsey, in the firm's quarterly publication. "Yet these developments should hardly be surprising, for the fruits of recent regulatory reforms, trade liberalization and economic growth have failed to reach many of the region's people. When given the choice, they sometimes vote for politicians who promise populist solutions."

Patsalos-Fox feels the situation is frustrating for businesses. "In our work in the region, we see that its governments frustrate its business leaders," he says. "Many of them wonder if their countries will ever grow as fast as China or India. They are tired of the excuses and the lack of progress on important reforms, particularly at the macroeconomic level." He recommends that companies in the region take advantage of recent economic growth and deepening capital markets to create value "by innovating, moving up the value chain in commodities or consolidating and restructuring fragmented industries."

Despite the complex environment, companies are making money. While Citi reported net losses of $9.83 billion in the fourth quarter of 2007, its Latin American and Mexican division posted net profits of $3.6 billion. Avon Products, the global cosmetics company, reported a 30% year-on-year drop in net income during the same quarter, though Latin American sales were up 28%, with sales in Brazil and Colombia each soaring by 40%. Appliance-maker Whirlpool's fourth-quarter earnings soared 72% in the region, with the company forecasting another 8% rise in appliance shipments to Latin America this year. Hernan Rincon, president of Microsoft Latin America, says the region remains one of the software giant's fastest-growing markets in the world, with 2007 its best year there in at least a decade.

Merrill Lynch remains bullish on Latin American equities and estimates a 26% return in local currency terms this year. The quality of earnings growth, according to the bank's analysis, will be supported by an improvement in earnings growth dispersion as credit penetration remains strong and domestic demand and investments outpace regional GDP expansion, a high price outlook for Latin American commodities and strong corporate balance sheets.

The region's economy should grow 4.6% in 2008 and 4.2% in 2009, despite a US economic slowdown, according to Merrill Lynch. The IMF predicts 4.3% growth, while the World Bank and the United Nations Economic Commission for Latin America and the Caribbean forecast 4.5% and 4.9% regional GDP expansion, respectively. Domestic consumption will be the main economic engine this year, with private consumption expected to rise 6.5% in Argentina, 5.3% in Brazil, 6% in Chile and 4.1% in Mexico, according to Merrill Lynch's analysis.

While many of the region's governments have increased taxes to fund social programs, the threat of further increases looms large. Furthermore, the OECD's latest Latin American Economic Outlook says fewer than one in four Latin Americans believe tax revenues are being well spent, for which the organization suggests funds should be better invested to reduce poverty and maintain citizens' trust in democratic systems.

The IMF agrees. "Increased fiscal transparency in Latin America will strengthen the investment environment and address weaknesses in fiscal management," says an IMF working paper. The multilateral further recommends that promoting a transparent business environment by simplifying the tax system, reducing discretion in dealing with the private sector and reinforcing oversight to promote investment should be a priority.

"Simplified tax regimes would not only be more transparent but would raise revenue collection while reducing the costs of collection," says the IMF working paper. "Regulations affecting business operations need to be streamlined with minimal discretion to promote fairness, permit easy entry and exit of firms and reduce uncertainty faced by businesses."

Washington Pumps in Cash

While US companies continue to thrive under the new environment, Washington hopes money will help convince some Latin Americans to ease their mounting anti-US rhetoric. US president George W. Bush's proposed budget for fiscal year 2009 includes $2.7 billion in aid to Latin America, a 25% jump from fiscal year 2007. Most of the additional aid, however, is earmarked for military and police activities and not for economic development.

For that, Chávez got some of his closest allies to launch the Banco del Sur (Bank of the South) last December as a multilateral regional development bank to compete with the Washington-based IMF, World Bank and Inter-American Development Bank. In December 2005 Argentina and Brazil announced plans to prepay $9.8 billion and $15.5 billion, respectively, to the IMF. Ecuadorian president Rafael Correa also expelled the World Bank's representative in Quito last year, declaring him persona non grata.

“Developing nations must create their own finance mechanisms instead of suffering under those of the IMF and the World Bank,” Brazilian president Luiz Inácio Lula da Silva said during the Banco del Sur’s launch. US-led multilaterals reacted cautiously. “As far as the World Bank is concerned, this new initiative is not perceived as a competitor,” said Augusto de la Torre, World Bank chief economist for Latin America. Pamela Cox, the World Bank’s vice president for Latin America and the Caribbean, chimed in, saying, “a little competition is a good thing.”

Another of Chávez’s initiatives, the Bolivarian Alternative for the Americas (ALBA), presents another challenge for Washington. The plan is touted by Caracas as an alternative to US-backed free trade agreements, including the now-defunct Free Trade Area of the Americas (FTAA) that was scheduled to create a hemispheric trade bloc by 2006. With membership so far consisting only of Venezuela, Cuba, Bolivia, Nicaragua and the island of Dominica, ALBA is not likely to have much of an impact on companies in the region.

“The business environment is still good, even with the move to the left,” says McCoy. “But uncertainties may continue to hold back investments.”

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