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Political Risk in Latin America: Back to the future?

Latin America has experienced a difficult period since 2014. The slump in commodity prices has impacted activity via several channels (such as lower investments, export revenues, and a tighter public budget). After two years of recession, the region's GDP growth finally rebounded in 2017 by an estimated 1.1% year-on-year, and is expected to gain further traction in 2018 (growth forecast: +2.4% YOY). However, this optimistic outlook is linked to favourable global trends than domestic merits. Although a still-gradual tightening monetary cycle in advanced economies (especially in the United States), as well as a soft deceleration in China and the resulting improvement in commodity prices, has aided Latin America, the poor political environment has stained the region's image in the eyes of much-needed foreign investors – particularly with the multiple political and governmental corruption scandals since 2014.

Political risk has always weighed negatively on Latin America's economic prospects. The region has a notable track record of being led by dictatorial political systems and populist governments, which has led countries in the region to experience repeated episodes of hyperinflation and public debt crisis, to the detriment of long-term sustainable economic development.

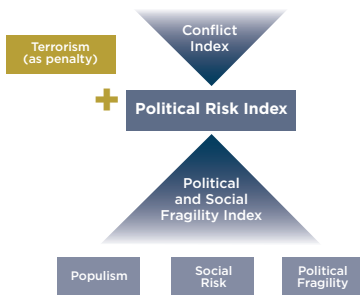
Although terrorism is not a main concern for Latin America, and (with the exception of Mexico) the largest economies in the region are generally less at risk of conflict, the political risk associated with social tensions is much higher. Poor social fundamentals, weak corruption perception outcomes, and a relatively high homicide rate – consequences of decades of both weak growth and inefficient social and economic policies that have created high levels of inequality – undermine the region's perspectives.

In this context, political risk will continue to represent a major concern for Latin America in 2018. Amid the general dissatisfaction with the traditional political class, several countries will elect their next president this year, including Colombia (May), Mexico (July), and Brazil (October). Hence, the risk of political uncertainties affecting the economic environment is increasing, especially in Brazil and Mexico.

Political risk in Latin America is mainly associated with social fragilities

The Coface Political Risk Model¹ (Chart 1) takes into consideration various measures grouped into political and social fragility, and security risk in 159 countries.

CHART 1
Coface Political Risk Model



Latin America countries generally rank around the median in the model: despite low levels of conflict and terrorism, the countries suffer from social fragility, and are relatively vulnerable to social risk. The macroeconomic variables included in the model (such as GDP per capita, unemployment rate, inflation, and income inequality as measured by the GINI coefficient) are usually weak points for Latin American countries. The social pressure indicator also takes into account the homicide rate, corruption, and freedom of speech. Examining the largest economies in the region, only Chile holds a level of social pressure

below the average of 45%. It is also worth noting that the countries' rankings have decreased since 2007 (Peru being an exception). This was particularly the case for both Brazil (impacted by its worst economic recession, social indicators, and corruption) and Mexico, which recorded low scores for homicide, corruption, and political freedom.

In terms of conflicts, Mexico reports the poorest performance across the region, in large part due to the increasing violence of gang wars in the country. Mexico has faced years of violence as the state has battled drug cartels that have increasingly splintered into smaller, more "bloodthirsty" gangs. In 2017, the homicide rate surpassed that seen at the peak of the country's drug war in 2011. The weak local rule of law and high impunity helps to explain the escalating violence in the country.

In contrast, Colombia has registered a significant improvement. Violence related to guerrilla groups has considerably declined. In late 2016, the Colombian government and the Armed Forces of Colombia (FARC) signed a peace agreement to end their 50-year conflict. Despite clear improvements, there are still some dissident groups in operation. Moreover, there is also a significant part of the population who believes that the agreement terms were too benevolent to the former guerrilla members.

Operation Car Wash has impacted many Latin America countries

Corruption has always been an issue in Latin America, but has become particularly acute since 2014, with scandals involving very high profile personalities and unprecedented large media coverage. Operation Car Wash, which began in early 2014, initially focused on corruption scandals involving Petrobras, the Brazilian state-owned oil company, and bribes paid by construction firms to the company's executives in return for awarding contracts at inflated prices. However, as the case unfolded, a sequence of plea bargains revealed a much larger network of bribes. Corruption for personal gain and/or for the financing of illegal campaigns has been discovered within several political parties and, more astonishingly, has spread to other governments in Latin America. According to various investigations, to ensure preference in public work projects, between 2001 and 2016, Odebrecht SA, a major Brazilian construction group, paid bribes worth some USD 788

million in eleven countries of the region, in addition to Brazil². This has caused political turbulence across the region. In Brazil, executives of big construction groups as well as politicians of several parties were implicated in corruption cases. In August 2016 then-president Dilma Rousseff (2011-2016) from the centre-left Labour party (PT) was officially impeached for illegally manipulating government accounts, but it is likely that Operation Car Wash scandal exerted indirect pressure on the impeachment result. She was replaced by Vice-President Michel Temer, who is highly unpopular and has also been accused of corruption. Moreover, in the latest stage of Operation Car Wash, former president Luiz Inácio Lula da Silva was arrested in early April 2018, after being sentenced for corruption and money laundering. He argues that he is a victim of a political campaign to stop him from running in this year's elections.

In December 2017, Ecuador's court sentenced Vice President Jorge Glas to six years in prison after finding him guilty of receiving bribes from Odebrecht in return for awarding government contracts. In Peru, President Pedro Pablo Kuczynski (PPK) delivered his resignation on the 21st April 2018, after newly-discovered evidence of corruption with the Brazilian construction group. His movement came one day before his second impeachment vote in three months. Other former presidents are also being investigated for receiving illegal money from the Odebrecht.

Operation Car Wash spread to Argentina, when Odebrecht admitted paying USD 35 million in bribes for contracts during the presidency of Cristina Kirchner (2007-2015), of the centre-left Citizen's Unity Party³. the Head of the Argentine Federal Intelligence Agency, Gustavo Arribas (a confidant of current president Mauricio Macri) has also started to be investigated. He is cited as the recipient of USD 850,000 from a front company investigated as part of Operation Car Wash. Mr Arribas is the first senior government official of the Macri government to be denounced in the corruption investigation.

Suspected corruption comes from the campaign of President Enrique Peña Nieto (Institutional Revolutionary Party, PRI) in 2012, regarding amounts paid to former officials of state-owned oil company Pemex. In 2017, a Mexican court banned Odebrecht from participating in bids in Mexico for four years⁴. Moreover, in April 2018, the government also prohibited federal institutions and state governments from doing business with the Brazilian firm for two and a half years, and fined the company roughly USD 60 million. The investigations, however, made little progress. Other corruption scandals, some of which involved Pemex, have contributed to lowering the Mexican government's popularity. The last three years have seen corruption investigations against ten state governors, eight of whom are affiliated with the PRI party.

In Colombia, a former deputy transport minister and a former Liberal Party senator have been arrested as a result of Operation Car Wash. In March 2017, President Juan Manuel Santos apologized for using illegal funds to finance his electoral campaign, but denied knowing that Odebrecht donated USD 1 million to finance his electoral campaign.

Even Chile, which usually reports the best corruption index in the region, is not immune from such scandals: during her second mandate, former president Michelle Bachelet (2006-2010 and 2014-2018, member of the Socialist party) was rocked by corruption scandals involving close relatives. Moreover, current president Sebastián Piñera (2010-2014 and 2018-present, centre-right National Renewal Party) faced allegations of

1 - Daudier, J.-L., Nizard, R. & Tozy, S., 2016. Panorama: The rise and rise of political risks, Paris: Coface.

2 - United States District Court, Eastern District of New York, 2016. United States of America against Odebrecht S.A., Cr. No. 16-643 (RJD), New York: US Department of Justice.

3 - Nolen, S., 2017. Corruption beyond Brazil: Where the 'Car Wash' scandal has splashed across Latin America. [Online]

Available at: <https://www.theglobeandmail.com/news/world/brazil-odebrecht-lava-jato-explainer/article35231409/> [Accessed 22 May 2018].

4 - Reuters, 2017. Mexico government bans Odebrecht unit from public contracts for four years. [Online]

Available at: <https://www.reuters.com/article/us-mexico-corruption/mexico-government-bans-odebrecht-unit-from-public-contracts-for-four-years-idUSKBNIE62G31> [Accessed 22 May 2018].

irregular payments issued by a mining company to his first presidential campaign in 2009. With the exception of Chile, the largest economies rank low on Transparency International's Corruption Index (**Chart 2**)⁵. In comparison, OECD countries (excluding Mexico and Chile) reported an average outcome of 70 points in 2017.

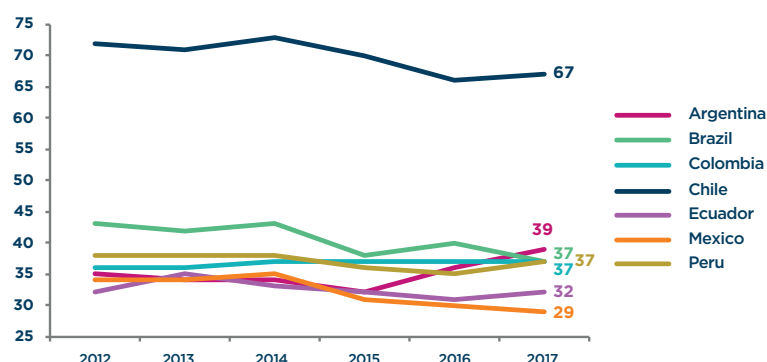
Mexico and Brazil: two political risk factors to come

2018 has the potential to be a game changer for many countries in the region, with many presidential elections due to take place. The current erosion of trust in political institutions creates opportunities for "outsider" contenders, and many candidates have taken advantage of this to promote themselves fighters of corruption - although their real willingness and capacity to tackle the issue has yet to be demonstrated.

The first test will take place in Colombia in May. The scenario seems less risky due to the candidates' profiles, as they are neither polemic outsiders with a high chance of winning nor members of extremist political parties. In the March 2018 legislative elections, voters turned to right-wing parties who were critical about the peace deal signed with the FARC. In the meantime, FARC turned into a political party, but failed to garner support for its radical agenda. They will therefore only get the ten seats guaranteed under the 2016 peace agreement. Ivan Duque, the presidential candidate backed by former President Álvaro Uribe, is currently leading the polls. Mr Duque is a lawyer and was a Senator until the 10th April. According to a Datexco poll in early April 2018, Mr Duque benefits from 42.2% support, 8.8 percentage points in front of his nearest rival, the left-wing candidate Gustavo Petro (33.4%). Mr Duque is likely to face Mr Petro in a runoff on the 17th June. If elected, Mr Duque promises a tough fiscal policy and pension reform, while Mr Petro pledges to raise taxes on large companies in order to reduce the fiscal deficit.

Mexico's elections are scheduled for the 1st July 2018. The country has basically only ever been ruled by one of two parties⁶. However, this tradition might be broken this year: escalating violence in the country and general dissatisfaction with the traditional political class are weighing on the elections race. Currently, the anti-establishment candidate Andrés Manuel López Obrador (AMLO) is leading the polls by a wide margin. A former mayor of Mexico City, AMLO heads the National Regeneration Movement (MORENA). This is his third attempt to become president. According to polls by Parametria, as of early April 2018, AMLO holds 38% of intention votes, followed by Ricardo Anaya, PAN (20%) and Jose Antonio Meade, PRI (16%). However, Mr Anaya's chances have since diminished, as he has been accused of money laundering, while Mr Meade is burdened with the negative image of the PRI. Moreover, as Mexico's elections consist of a single round of voting, a candidate could win with relatively weak support. To try to attract disappointed voters, AMLO has promised to curb corruption and to restore security. Although he has historically positioned himself against private investments in industries traditionally run by the state (e.g. the 2013 energy oil reform), he has recently softened his rhetoric. He issued a letter in early April 2018 in which he pledged to adopt a responsible economic policy and respect the rule of law and private property. He has promised not to roll back the energy reform and has said he will work with the private sector on infrastructure projects. AMLO has also said that he will not introduce new taxes or increase existing ones. Nevertheless, an AMLO

CHART 2
Corruption Perception Index 2017



administration would face challenges. The ideological divergence among his political allies could hamper his ability to build a strong coalition and congressional support. If he wins, although there might be some currency volatility, and a short-term negative shock to business confidence, the probable low congressional support would likely prevent a radical policy shift.

In Brazil, the first round of presidential elections is due on the 7th October. The past six elections have been dominated by the PT and the PSDB, but this time could be different. The scenario of general dissatisfaction with the traditional political class raises the chances of higher polarization. Paradoxically, the favourite until recently was former president Lula, who was convicted of money laundering and passive corruption in July 2017, and began serving his 12-year sentence on the 7th April 2018. Lula's still-high popularity among part of the population could be attributed to the economic prosperity ordinary Brazilians experienced during his tenure. He will probably not be able to run, as under the local electoral law, a candidate is forbidden from running for elected office for eight years after being found guilty of a crime. Amid this judicial battle, there is a controversial candidate who could take advantage of this momentum: Jair Bolsonaro, a former military officer, a member the Chamber of Deputies since 1991, and the most-voted congressman in Rio de Janeiro in 2014. Described in the media as pro-gun and anti-gay, Mr Bolsonaro's political trajectory is marked by a statist bias. Despite this, he now says that he will leave the economic decisions to Paulo Guedes (his possible Minister of Finance), whose ideas are known and respected in the business market, both in Brazil and internationally. Nevertheless, should Mr Bolsonaro be elected, it is unlikely his Finance Minister will have sufficient autonomy to conduct a pro-business economic agenda. Polls currently show Mr Bolsonaro placing second in a simulation considering Lula as a candidate. However, any simulated scenarios without Lula, Mr Bolsonaro appears as the front runner. It is worth noting that it is very early in the Brazilian electoral process, and the definitive list of candidates is not yet available, with the centrist candidate remaining unannounced: Brazilian Finance Minister Henrique Meirelles indeed resigned in early April 2018 to prepare to run for elections. Geraldo Alckmin from the Brazilian Social Democracy Party (PSDB) who resigned from his role as São Paulo governor. If elected, Mr Alckmin is expected to move forward with the pro-business agenda of President Temer. The next administration definitely needs to pass a fiscal reform to stabilize debt metrics over the medium term.

⁵ - The index ranks 181 countries and territories by their perceived levels of public sector corruption according to experts and business people. Scale: 0 - 100, where 0 is a perceived high level of corruption and 100 is a perceived low level.

⁶ - The Institutional Revolutionary Party (PRI) remained in power for seven decades until 2000, when the centre-right National Action Party (PAN) won the electoral race. The latter party ruled the country for twelve years, until Peña Nieto's took office in 2012.

The effect of political weakness over economic activity

This renewed political risk has already had some impact on regional growth. For example, the spillover effect of Operation Car Wash has clearly contributed to Brazil's worst recession (GDP contracted by 7% between 2015-2016). Some construction groups involved in the scandal were forced to file for Chapter XI protection, while other companies whose turnover was dependent on Petrobras were also hit hard. The economy is gradually rebounding, but it will take time to recover the lost activity.

Another example is Peru's GDP. Economic growth in 2017 faltered to 2.5%, down from 4% in 2016. While the bad weather conditions related to the *El Niño* weather phenomenon played a large role in this, Operation Car Wash also had an impact. In Mexico, uncertainties related to the NAFTA renegotiations and the upcoming presidential elections have also taken a toll on activity (mainly through a reduction in investments).

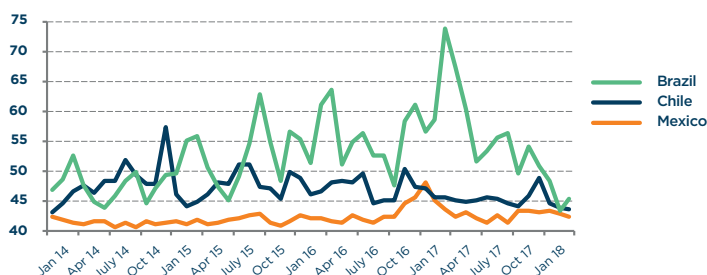
Increased political risk can affect the economic environment. The impact of this political uncertainty on growth primarily involves two transmission channels that are likely to support each other mutually: a

decline on equity markets and an increase in bond rates (taking a toll on financing terms for all economic agents and hence their investment and spending outlook), and a lower level of corporate and household confidence (prompting delays or cancellations in investment or spending decisions). If these persist, a third channel can also occur: budget policies. In the event of a long-lasting government vacuum, any freeze on public spending causes a negative impact on activity.

An IMF study⁷ covering a sample of 169 countries found that higher degrees of political instability are associated with lower growth rates of GDP per capita. Researchers found that political instability adversely affects growth by lowering productivity growth rates and, to a lesser degree, physical and human capital accumulation. In addition, according to a World Bank study⁸ on the implications of rising uncertainty for investments in emerging markets and developing economies since the 2008-09 crisis, rising domestic policy uncertainty negatively impacts investment rates: a 10% increase in Brazil's policy uncertainty (as captured by the EPU index⁹), reduces investment growth by roughly 0.8pp within a year.

In Latin America, the EPU index⁹ covers the Brazilian, Chilean and Mexico economies (**Chart 3**). The index improved in all the three countries, when compared with the same period of 2017. In Chile, the most recent negative peak was reached in December 2017, when the country held its presidential election runoff. Uncertainty, however, has receded since the pro-business Mr Piñera was elected. In Mexico, the index reached its highest level in January 2017, when Donald Trump took office as the President of the United States. Since then the index has improved, even in the current context with AMLO leading the presidential election polls. Curiously in Brazil, the peak was in March 2017, triggered by the Tainted-Meat Scandal - far from the August 2016 impeachment of President Rousseff.

CHART 3
Economic Policy Uncertainty Index



7 - Aisen, A. & Veiga, F. J., 2011. IMF Working Paper: How Does Political Instability Affect Economic Growth? Washington, DC: International Monetary Fund.

8 - World Bank Group, 2017. Global Economic Prospects, January 2017: Weak Investment in Uncertain Times. Washington, DC: World Bank.

9 - The Economic Policy Uncertainty index (EPU): is a news-based measure to capture policy-related uncertainty developed by Bloom, Banker and Davis (2016).

DISCLAIMER

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