Politics, populism and policy: operational risk in Latin America

A report by The Economist Intelligence Unit

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Politics, populism and policy: operational risk in Latin America

- Latin America suffered some of the highest death rates and one of the steepest recessions in the world in 2020 in the face of the coronavirus (Covid-19) pandemic. In 2021 the immediate focus is on tackling the pandemic, rolling out vaccines, and helping to get economic activity back up towards pre-pandemic levels. But the pandemic will have long-lasting repercussions. There will be economic "scarring" from investment and human capital losses, and big sectoral shifts as some sectors race ahead while others struggle.

- Perhaps most significant, though, are the economic policy shifts on the horizon. In a big election year for Latin America, policy risks are already becoming evident. Political risk is high as voters rail against incumbents and call for policy change, providing space for populist proposals to thrive. Political demands for policy change will be most clear in pressure to prop up spending, presenting macroeconomic risk. But these fiscal pressures will also have implications for tax policy, labour market policy, infrastructure, and the legal and regulatory environment, all of which suggests significant risks to the business environment.

- Although our forecasts for Latin America in 2021 are cautiously optimistic, investors will need to prepare for these emerging risks—all of which are assessed in The Economist Intelligence Unit's Risk Briefing, which identifies and evaluates business operation risks in ten key policy areas in 180 countries around the world. Risk Briefing will help investors to identify, assess, monitor and mitigate emerging political, economic and policy risks, providing a tool to evaluate which countries are most at risk, in which areas, and outlining specific risk scenarios to prepare for. Using material from Risk Briefing, what follows is an assessment of the post-coronavirus risks to business operations in Latin America.

Operational risk in Latin America and the Caribbean by category
(score out of 100; 100=highest risk)

Source: The Economist Intelligence Unit, Risk Briefing.

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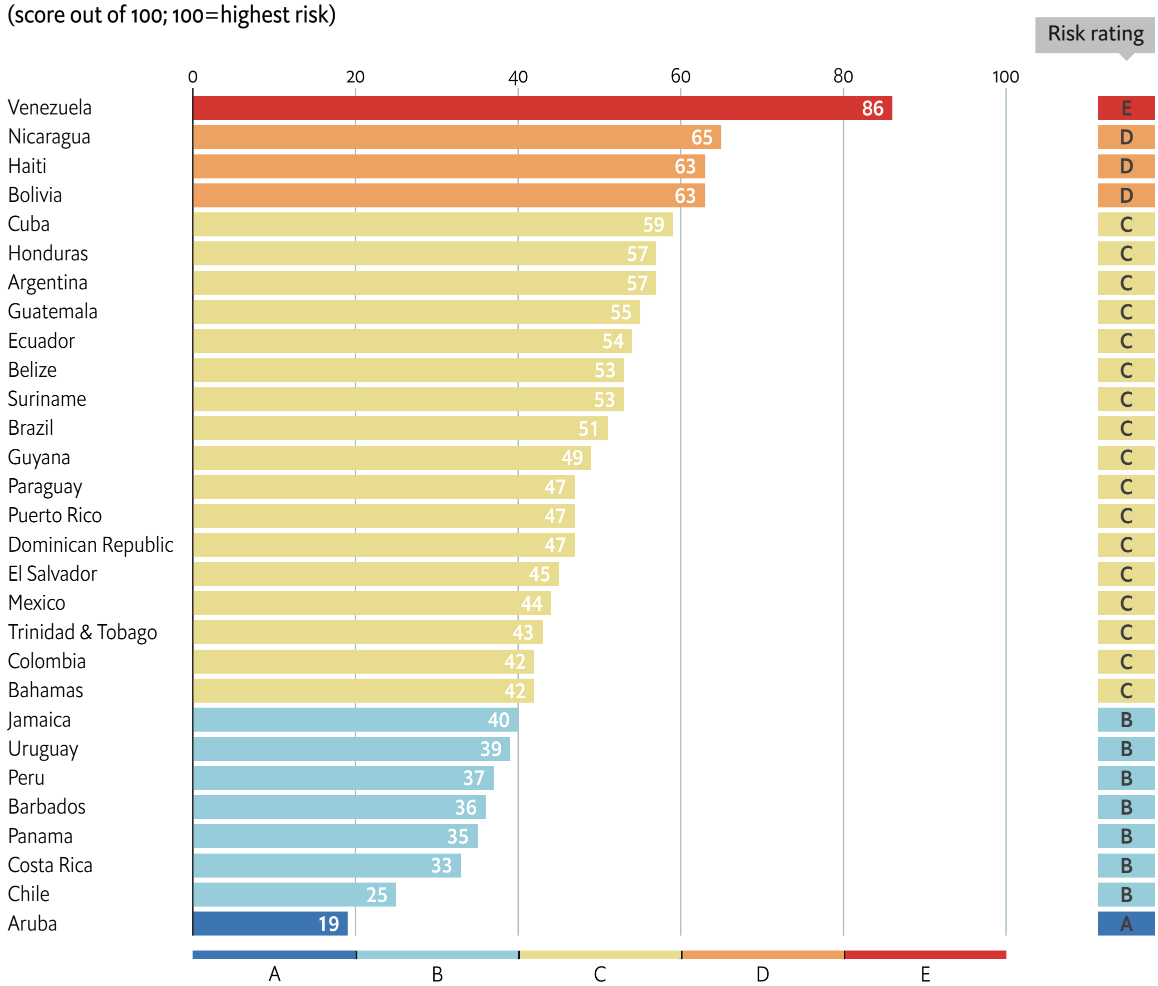
Operational risk in Latin America and the Caribbean by country
(score out of 100; 100=highest risk)



Source: The Economist Intelligence Unit, Risk Briefing.

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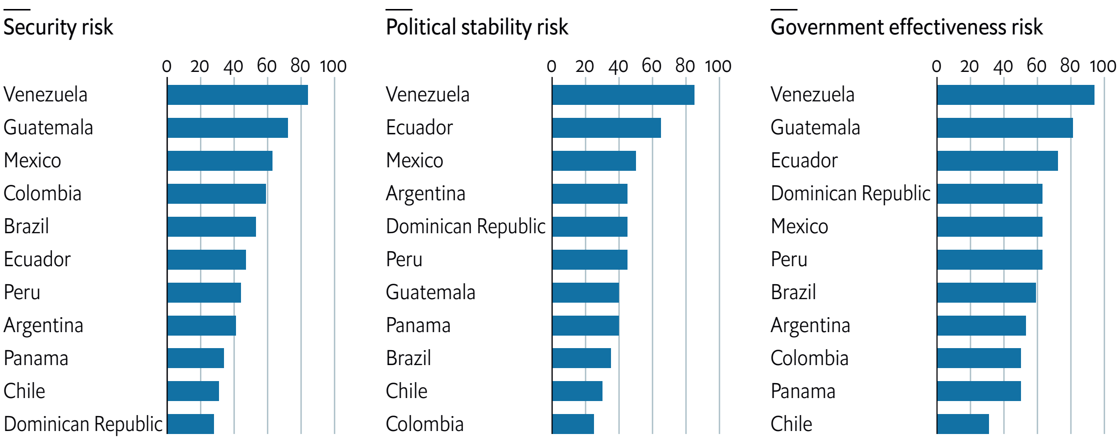
Political risk

Risk Briefing looks at political risk in three main areas—security risk, political stability risk and political effectiveness risk—assessing whether the physical environment is sufficiently secure, and if political institutions are stable and effective enough to support the needs of business and investors. The pandemic poses clear risks both to the security environment and to political stability, and weaknesses in political effectiveness in Latin America will hinder governments' abilities to address these challenges. Amid high levels of violent, organised, and frequently drug-related crime, Latin America has long suffered from high levels of security risk, and security challenges have tended to worsen in the aftermath of economic recession. The post-Covid environment will be no different and the pandemic itself will produce new opportunities for organised crime; the rise of tech, from ecommerce to fintech in the region, will also bring with it growing risks from cybercrime.

Meanwhile, the pandemic has clearly exacerbated the problems that created an upsurge of social protests in late 2019. This upsurge was abruptly, but in our view only temporarily, interrupted by Covid-19. For the most part, none of the issues that have driven deep dissatisfaction with government performance in the region—including security, corruption, and economic malaise—has been addressed. Movement restrictions and an increased sense of social cohesion at the start of the pandemic were enough to contain protests early on, but both are falling by the wayside, heightening risks of social unrest.

But more than this, deep dissatisfaction with political leaders in the region raises another major political risk highlighted by Risk Briefing: that opposition groups could come to power and cause a significant deterioration in business operating conditions. 2021 is another major election year for Latin America, with presidential elections in several large economies such as Ecuador, Peru and Chile, and mid-term elections in key regional markets including Mexico and Argentina. A few main trends seem to

Risk Briefing: Political risk in selected markets
(score out of 100; 100=riskiest)



Source: The Economist Intelligence Unit, Risk Briefing.

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be emerging in most of these races: a clear rise in anti-incumbency sentiment, demands for a greater role for the state in the economy (at least while the pandemic continues), and an increasing preference for populist policy solutions among a growing proportion of the population.

Selected political risk scenarios

Country	Risk	Scenario	Likelihood	Impact	Intensity
Panama	*Government effectiveness*	Covid-19 crisis gives rise to increased corruption, eroding trust in government	*Very high*	*High*	**20**
Peru	*Political stability*	Peru abandons political consensus on economic orthodoxy in favour of populism	*High*	*Very high*	**20**
Mexico	*Security risk*	Organised crime activity expands beyond drug-trafficking	*Very high*	*High*	**20**
Argentina	*Government effectiveness*	Divisions within ruling coalition exacerbate problems of governability	*Moderate*	*High*	**12**
Brazil	*Government effectiveness*	Bolsonaro government weakens democratic institutions	*Moderate*	*High*	**12**
Mexico	*Political stability*	Political polarisation increases, undermining stability	*High*	*Moderate*	**12**
Uruguay	*Political stability*	Coalition government dissolves amid growing tensions	*Moderate*	*High*	**12**
Brazil	*Security risk*	Fall in cargo theft on major highways goes into reverse	*Moderate*	*High*	**12**
Colombia	*Security risk*	Covid-19 derails implementation of FARC peace agreement	*Moderate*	*High*	**12**

Intensity colour key: 1 to 4 5 to 8 9 to 12 13 to 16 17 to 25

Notes. A selection of risk scenarios taken from Risk Briefing. Risk Briefing assesses operational risk in 30 markets in Latin America and the Caribbean. Intensity is a product of the probability and impact ratings, where 'very low' scores 1 and 'very high' scores 5.

Source: The Economist Intelligence Unit, Risk Briefing

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Economic risk

Above all, these demands are focused on increased public expenditure to support populations that are continuing to struggle with the effects of coronavirus on incomes and employment. To varying degrees, governments across Latin America have rolled out a combination of tax relief, spending measures (including, most effectively, direct cash transfers) and loan guarantees to try to protect businesses and individuals from the effects of the pandemic.

The problem for Latin American policymakers is the lack of room for policy manoeuvre to continue to bolster fiscal support measures without creating concerns over creditworthiness that then bubble over into macroeconomic instability. Risk Briefing assesses macroeconomic risk, financial risk and foreign-trade and payments risk, gauging whether economic conditions are stable and predictable, whether investors can get inputs and money into and out of the country, and whether the financial system is adequate for the needs of business. It is clear that in all these areas, risks are growing, stemming not merely from the steep collapse of economic activity last year, but from the large ongoing fiscal burden of the pandemic. This in turn presents risks of increased exchange-rate volatility and a return of inflation, which would complicate the monetary policy environment and raise financial risk. At present, banks in Latin America appear highly liquid and prudential indicators seem adequate, but emergency support measures are in the process of being withdrawn and there is a significant risk of a much larger deterioration of asset quality in the region that any significant increase in lending rates would exacerbate.

As for foreign-trade and payments risk, it is true that there has been no significant sign of either tariff or non-tariff barriers or new capital or foreign-exchange controls so far (with some notable exceptions like Argentina, where foreign-exchange controls were tightened in 2020). Even so, in some markets a likely deterioration in balance-of-payments dynamics as imports recover from last year's collapse suggests that risks of protectionism will be on the rise.

Risk Briefing: Economic risk in selected markets
(score out of 100; 100=riskiest)

Source: The Economist Intelligence Unit, Risk Briefing.

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Selected economic risk scenarios

Country	Risk	Scenario	Likelihood	Impact	Intensity
Argentina	*Macroeconomic risk*	Failure to correct macroeconomic imbalances produces sharp currency and inflation adjustment	*Very high*	*Very high*	**25**
Brazil	*Foreign trade and payments risk*	Lax stewardship of Amazon rainforest leads to sanctions from EU and US	*High*	*Moderate*	**12**
Ecuador	*Financial risk*	Dollarisation is abandoned and sucre reinstated	*Low*	*Very high*	**10**
Ecuador	*Foreign trade and payments risk*	Import restrictions are imposed as revenue dries up	*Low*	*Very high*	**10**
Argentina	*Foreign trade and payments*	Govenrment raises non-tariff barriers as part of import substitution policy	*Moderate*	*Moderate*	**9**
Mexico	*Macroeconomic risk*	Renewed currency depreciation lifts inflation	*Moderate*	*Moderate*	**9**
Mexico	*Financial risk*	Weak recovery from recession hampers private-sector credit availability	*Moderate*	*Moderate*	**9**
Colombia	*Financial risk*	Financial soundness indicators weaken sharply as a result of coronavirus driven recession	*Low*	*High*	**8**
Guatemala	*Macroeconomic risk*	Recession persists in 2021	*Low*	*High*	**8**

Intensity colour key: 1 to 4 | 5 to 8 | 9 to 12 | 13 to 16 | 17 to 25

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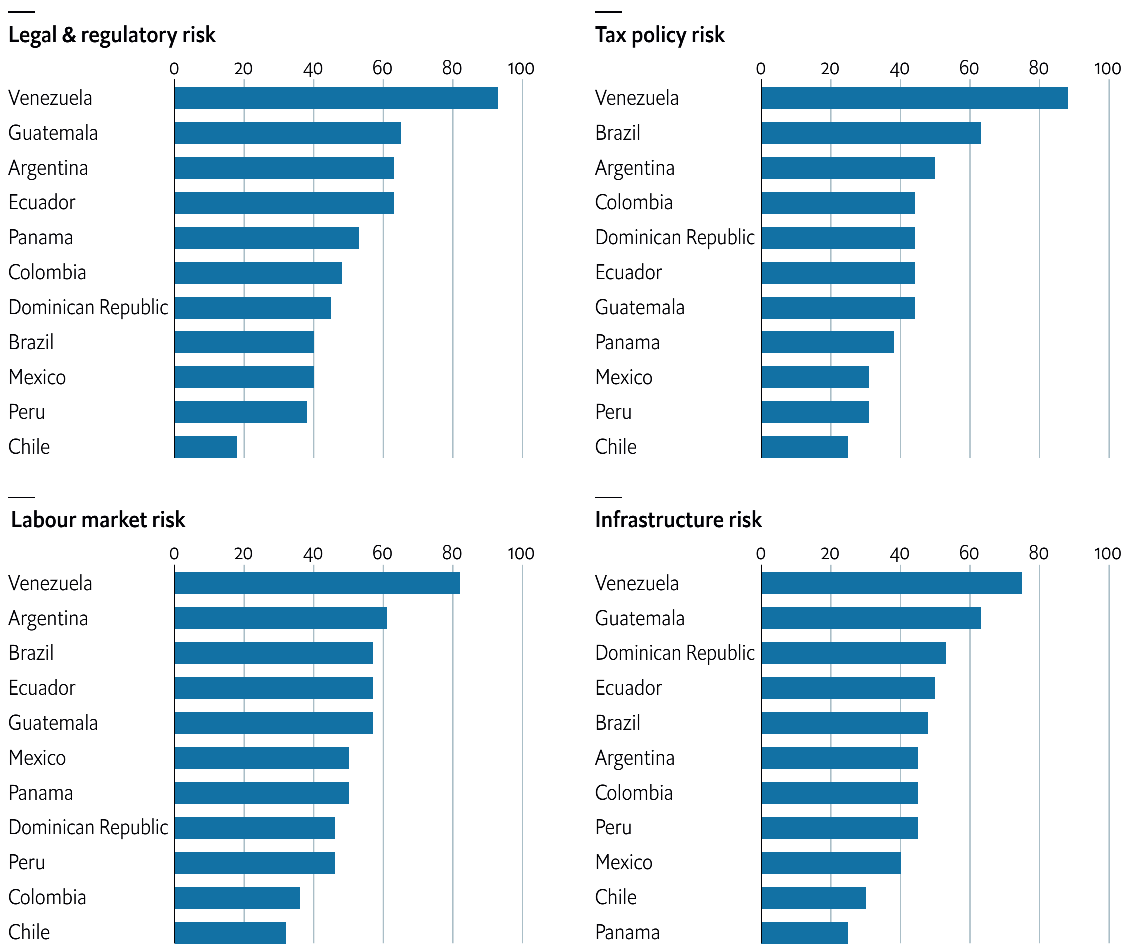
Policy risk

Growing fiscal pressure, post-pandemic demands for a greater role for the state in many key sectors, and a rise in populist political actors and policy proposals suggests that there are brewing policy risks to business over and above the macroeconomic risks highlighted above. In four key areas assessed by Risk Briefing, including legal and regulatory risk, tax policy risk, labour market risk and infrastructure risk, it is clear that new risks are on the horizon driven by pandemic-related changes to the political and policy environment. Legal and regulatory risk will take several forms. In some markets, in a difficult economic environment, there is a risk of unfair competition policies that favour domestic over foreign businesses. There is also, in some markets (such as Mexico), a growing risk of attempts on the part of governments to diminish the powers of independent regulators, as part of broader efforts

Risk Briefing: Policy risk in selected markets
(score out of 100; 100=riskiest)



Source: The Economist Intelligence Unit, Risk Briefing.

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to promote state firms over private-sector operators. Rising resource nationalism amid increasing objections to projects in the mining, energy and large-scale agriculture sectors also presents risks, in the form of elimination of incentives, increased local content requirements and, in extreme cases, outright nationalisation. The Argentinian government, for example, broached the idea in 2020 of nationalising a financially troubled soy exporter before backtracking in the face of local business and political objections.

Meanwhile, tax policy risk will be high as governments try to close fiscal gaps while remaining reluctant to cut expenditure. At the end of the commodity boom in 2014-15, several governments found themselves in a difficult fiscal position and plumped for revenue-raising tax reforms rather than spending cuts; the situation this time will be similar. Wealth taxes are on the cards, as was already evident in 2020, and new indirect taxes, on digital services among other things, are also likely (partly because they are easier for regional governments to collect). In theory, governments could widen the narrow base of corporate taxpayers in Latin America, by increasing the flexibility of the labour market

Selected policy risk scenarios

Country	Risk	Scenario	Probability	Impact	Intensity
Brazil	*Tax policy risk*	Tax simplification and budget management reforms fail to pass	*Very high*	*High*	**20**
Argentina	*Legal and regulatory risk*	Government nationalises strategic businesses	*High*	*High*	**16**
Brazil	*Infrastructure risk*	Infrastructure concessions/privatisations face long delays or are abandoned altogether	*Very high*	*Moderate*	**15**
Mexico	*Labour market risk*	Strike action increases given empowered labour unions	*Very high*	*Moderate*	**15**
Ecuador	*Legal and regulatory risk*	Obstacles to mining investment rise, hurting investors	*Moderate*	*Very high*	**15**
Jamaica	*Infrastructure risk*	Weather-related shocks cause extensive infrastructure damage	*Moderate*	*High*	**12**
Peru	*Infrastucture risk*	Planned divestment of water and sanitation services fails to proceed, delaying investment	*High*	*Moderate*	**12**
Uruguay	*Legal and regulatory risk*	Government extends price controls to control inflation	*Low*	*Moderate*	**12**
Colombia	*Tax policy risk*	Revenue shortfalls lead to tax increases in 2021	*Moderate*	*High*	**12**
Mexico	*Tax policy risk*	Government uses tax evasion laws to weaponise the tax system	*Moderate*	*High*	**12**
Ecuador	*Labour market risk*	Labour costs rise and make business uncompetitive	*Low*	*High*	**8**
Colombia	*Labour market risk*	Pension reform increases burden for employers	*Low*	*Moderate*	**6**

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to encourage labour formality. However, labour market reforms have historically proven difficult to implement owing to formidable opposition from trade unions (partly arising from the fact that jobs are often linked to access to quality healthcare). Although reforms to increase flexibility and bolster healthcare provision would be very welcome, they would also be difficult politically, and we do not expect many governments to go down this route. In this environment, there is a significant risk of corporate tax hikes. At the very least, governments will be cracking down on tax evasion, and tax incentives will come under the microscope; there is a strong risk that the latter will be eliminated. In Peru, for example, recent legislation has reduced tax and labour incentives in the agricultural export sector.

Labour market risk will materialise, in our view, in four key ways. First is the risk of skills shortages becoming more acute in future as a result of educational and training setbacks in the region in the past year because of covid-related school closures. The risk of labour conflict rising as the pandemic eases and employment recovers will also, in our view, grow this year and next. Notwithstanding weak wage pressure generally, we also see a risk in some markets of rising labour costs amid political and union pressure in key economic sectors. Finally, instead of focusing on making labour markets more flexible (to broaden the tax base), there is a risk that in some markets governments will put new policies in place that raise the cost of hiring and firing staff and decrease labour market flexibility.

In all of these policy areas, risks may materialise in the form of reversals of existing legislation. However there is also a risk that governments will abandon reform agendas the positive effects of which we had previously incorporated into our forecasts. Infrastructure risk provides a good example of the latter; in Brazil for example, there is now a growing risk that infrastructure concessions and proposed privatisations could take longer than expected to get off the ground, or be abandoned altogether. In other markets, there is a risk that reforms to improve the operation of private-public partnerships (PPPs) are abandoned amid growing public opposition to private-sector-led projects. Such risks to the reform outlook will also need to be taken into account.

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