
REGULATORY RISK AND FOREIGN INVESTMENTS DEVELOPED IN LATIN AMERICA

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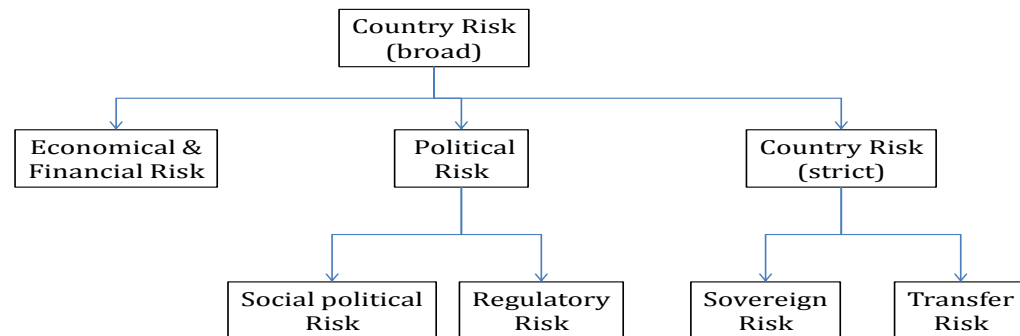
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Introduction

- The growing consideration of space and territory as essential variables to be considered has permitted the elaboration of new perspectives for the analysis of the economic system and of international financial regulation.
- Each national state presents particular models of inner institutional organization and faces individually its insertion into the global market.
- Geography (political) permits the improvement of the concrete focuses of work and of the indicators employed for financial economy
 - It is a branch of economic knowledge that has received enough relevance when deepening its investigations concerning the behaviour of the transnational capital concerned

Country risk and regulatory risk

- Country risk is one of the most significant risks international investors have to face.
 - it is conceived as a multidimensional concept originating from a set of factors whose measure is established through indicators combining different relevant variables of the problems.
- components :



Country risk and regulatory risk

- Political risk
 - possibility of patrimonial breakdowns as a consequence of governmental intervention and/or the intervention of political and social forces of the host society, or of nearby countries that can affect it
- Regulatory risk
 - possible decrease of profits deriving from increasing restrictions in the performance of foreign corporations as a consequence of non-specific interventions by the host country's authorities
 - more interventionist regulations, greater demands and requirements, new and higher taxes, increases of various types of controls and operating difficulties...

Country risk and regulatory risk

- Investments addressed to the supply of basic services and infrastructures (electricity, telecommunications, highways, sanitation, harbours, airports, etc.) present three specific characteristics:
 - First, they require a large volume of implicated financial resources
 - Second, the activity usually offers “economics of scale” (in certain cases, it will be a natural monopoly)
 - Finally, the service supplied tends to be essential for the proper development of economic activity and for the welfare of the populace as a whole.

Country risk and regulatory risk

- Consequence:
 - Many of these services are well-regarded by the public and are supplied directly or by means of public entities — private companies holding public concessions or some other formula of private management.
 - In the latter cases, governments are free to choose their licensee and public provider and to submit the activity to certain regulations.
 - Regulatory risk appears if the public administration might substantially change the economic bases affecting an activity submitted to regulation.
 - This would alter the long term profitability of a project once it has been ascribed and the initial investment has been made.

Country risk and regulatory risk

- Regulatory risk in Latin America
 - There is a big “social disappointment” regarding the results of the privatisation process of basic services companies.
 - Probably, many of these countries do not possess the basic conditions ensuring a universal access to essential public services which can be financed by private initiative.
 - In the case of the countries with major risk, the profits required by the stock holders of the foreign companies make the level of service tariffs for these services politically unviable and unsustainable.
 - On the other hand, in some sectors it is not easy to find the required investments aimed at the universal access to basic public services.
 - This is due to their volume and to the lack of culture of payment for these services (water, sanitation, electricity, etc.).
 - Consequently, if governments want to obtain the universalization of services, it will be necessary to take into consideration the implication (at least partially) of the public powers of these countries when financing the investments

An approach to regulatory risk in Latin America

- In our study we will employ a restrictive interpretation of Latin America
 - More functional for our objective.
 - We have, therefore, excluded the analysis of Mexico
 - We have also excluded the whole of Central America and the Caribbean
- Latin America will be identified with South America, but ...
 - The smaller territories (for instance, Surinam and Uruguay) are out of our analysis
 - Countries with populations of less than 5 million (Surinam (520,000 inhab.), Guyana (760,000 inhab.) and Uruguay (3,330,000 inhab.)) are also excluded.

An approach to regulatory risk in Latin America

- On the economic level, some economies of Central America have been considered simple satellites of USA
 - banana republics
- On the social level, the existence of a populace governed by a weak government, in general not much concerned about the principles of the welfare state
 - Consequence:
 - populations characterized by a large inequality
 - general poverty.
- On the political level, USA guaranteed itself obedient, pro-western and anticommunist regimes

An approach to regulatory risk in Latin America

- Changes during recent years:
 - On the one hand, the participation of U.S. foreign investments in South America has been continually decreasing compared with the increases recorded for the European Union and the rising participation of Chinese and Japanese companies
 - At a political level, the neo-liberal regimes of many nation states have been displaced by a new generation of left wing leaders
 - The new rulers are more interventionist and prone to the regulation of the financial sector

An approach to regulatory risk in Latin America

- Two main events:
 - The unionised working class, the indigenous movements and the representatives of the poorest social groups have reached the executive and legislative powers of their countries
 - This general left wing turn all around South America is taking place during one of the region's most stable periods of economic growth.
 - A growth sustained by the discovery of new and significant energy reservoirs (in Venezuela, Bolivia and Brazil),
 - Decrease of social and labour conflicts (many of their supporters are now in power)
 - A more serious public administration,
 - A stronger hold of democracy, and the reform of institutions which have traditionally been related to corruption and inefficiency (police and military forces, justice, etc.).

Model: objective and methodology

- The objective of the present study is the classification of different Latin American countries according to their perceived level of regulatory risk.
 - The countries to be classified are: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Peru and Venezuela.
- We will undertake a post hoc segmentation according to the method of hierarchical clusters by means of the SPSS statistical program.
 - Consequently, the number of groups, size and description will result from the application of this technique
- A description of the characteristics of each group will be given, and there will be an attempt to give an approximation of the regulatory security perceived in each one of them.

Model: variables and measures

- Independence of the judicial system
- Political stability and absence of violence (Source: IDB)
- Trust in the judicial system (IDB)
- Democracy at risk
- Monitoring by External Organisations (IDB, 2008)
- Trust in the Public Administration (IDB, 2008)
- General Quality of Infrastructures

Model: results

- The analysis of the clusters has been performed employing a hierarchical procedure without predetermining the numbers of groups (post hoc analysis)
 - Table 1 shows the assignment of the different countries to groups according to the number of clusters chosen for the analysis: 3, 4 or 5.

Model: results

Case	5 Clusters	4 Clusters	3 Clusters
1: Argentina	1	1	1
2: Bolivia	2	2	2
3: Brazil	3	3	3
4: Chile	4	3	3
5: Colombia	4	3	3
6: Ecuador	2	2	2
7: Peru	2	2	2
8: Venezuela	5	4	1

Model: results

- The results obtained from the analysis of the clusters will permit the identification of three different profiles of regulatory risk:
 - Group 3 (Brazil, Chile and Colombia) would describe a geographical space of regulatory stability, which is able to attract international investments.
 - In the opposite extreme, Group 2 (Ecuador, Peru and Bolivia) might represent the group of countries with the weakest institutions and lowest political stability, which is translated into a greater risk generated by regulation.
 - Finally, Group 1 (Argentina and Venezuela) represents an intermediate position fluctuating between the two former groups according to the variables considered.
 - This poses reasonable doubts when the time comes for assigning them a precise level of regulatory risk.

Conclusions

- In the present work we have reviewed the concept of regulatory risk, deeming it a component of political risk, which forms part of the country-risk.
- The analysis of regulatory risk is a fundamental aspect to be considered for the evaluation of international investment projects carried out within a regulated context.
- It is natural that governments hosting international projects within their territory should play a key role when increasing or decreasing the risk derived from regulation.

Conclusions

- Latin America is one of the geographical spaces with greater potential for attracting the interests of companies from the European Union, the United States, Japan and China.
 - In spite of this, the continent should not be treated as completely homogeneous regarding the possibility of regulatory risk.
- The present work has identified three groups of Latin American countries in terms of the level of regulatory risk
 - based on certain variables (political stability, trust in the administration, trust in the judicial system, independence of the latter from political and/or business influences, belief that the democratic system is in danger, possibility of exerting external controls, and overall quality of the infrastructures).

Conclusion

- Ecuador, Peru and Bolivia form a cluster with the greatest registered level of regulatory risk.
 - State administrations having serious difficulties in historic consolidation
 - The majority of the population is below the poverty level (especially the indigenous communities)
 - there are all sorts of liabilities hindering economic development (deficient inner connectivity, a poorly remunerated public workforce, a tendency to governmental instability that has only started to be overcome in recent years, etc.).
 - the situation has shown a tendency toward improvement,
 - there is still a high level of insecurity for investments and a high level of regulatory risk for foreign investors
 - limited trust in the public administration and in the judicial system,
 - the perception of a lack of political stability.

Conclusions

- Brazil, Colombia and Chile form a cluster with the lowest risk of regulation of the three groups
 - A long and lasting economic development stage and to a relative democratic political stability (with the exception of Colombia).
 - division of power, trust in the institutions, the possibility of control, the improvement of infrastructures, and the consolidation of independent means of mass communications.
 - The increasing purchasing power of the internal markets shows that these countries offer the safest options for the development of infrastructures by foreign firms
 - The most attractive for foreign investors

Conclusion

- Argentina and Venezuela form a third group
 - Level of regulatory risk situated between the two former groups,
 - although it is closer to the one integrated by Bolivia, Ecuador and Peru.
 - It should be stated that the political stability and the relative trust in the judicial system derive from apparently consolidated democratic systems.
 - In Venezuela, the peculiar regimen of Chávez shows militarism, populism, and restriction of certain liberties, but the system of representative democracy has not yet been questioned.
 - Argentina has had a democratic government for almost thirty years, and the parliamentary and presidential political system is not presently questioned.
 - Both countries have a per capita income higher than average for Latin America
 - this has brought about quality infrastructures
 - However, reliable countries do not take into consideration the possibility of making investments there at the present time
 - the continuous economic and political ups and downs of recent years,
 - the tendency towards an increasing statistical opacity,
 - the aggressive nationalism of its rulers
 - the perceived danger of a social or political crisis, explain why.

Conclusions

- In future works:
 - To perform a more thorough study of the regulatory risk model of analysis.
 - For this purpose, two differentiated parts will be established:
 - one regarding causes and antecedents,
 - another regarding the consequences of foreign investments.
 - to determine new variables and to introduce measures alternative to the ones employed in the present study.