Assessing Risk in Latin America

By Susan A. Hillman, Partner, Treasury Alliance Group LLC and Stephen P. Burrington, Partner, Treasury Alliance Group LLC

Although once spoken of as a "single block" in terms of risk, there has been a significant decoupling in terms of how companies view risk in Latin American countries. A radical study in contrasts marks the FX and regulatory environments today. Several countries in Latin America and the Caribbean have dollarized their economies, while others have effectively dollarized via rigid pegs between the currencies. Other countries have "floated" their exchange rates (free float vs. managed float) with varying degrees of success. There have also been experiments, mostly huge failures, in mandating domestic price controls. So in order to view risk in the region, it's best to compare and contrast countries and determine what options are available to effectively mitigate risk on a country-by-country basis.

Risk Snapshots

Venezuela

Of great interest today, is the ever changing and increasingly dire situation in Venezuela – made more bizarre by the fact that in these days of rising oil prices, their oil-based economy is suffering from significant structural issues. The official exchange rate is highly controlled in Venezuela, and the currency has been devalued multiple times in the past decade. According to the Federal Reserve Bank web site, the average exchange rate for the *Venezuelan Bolivar* (VEB) was 548.39 in 1998, 1,161.19 in 2002, and 2,144.60 in 2007. Because of government controls on the allocation of US Dollars, a parallel (black) market rate exists in the cash market around 25% above the official rate. The penalties imposed on companies dealing in the parallel market are extreme, so there is very little movement of multinational funds in the offshore parallel market.

In a purely political move, effective January 1, 2008, the government of Hugo Chavez lopped three zeros off the exchange rate and named the new currency the *Bolivar Fuerte* (VEF) or the 'strong' Bolivar. While this move from 2,144.60 VEB/USD to 2.14460 VEF/USD may have simplified basic arithmetic calculations, it was purely psychological propaganda, as it did nothing to address the underlying inflationary pressures or the very real economic risks that have been exacerbated in Venezuela since Chavez took office in February 1999. The country remains highly regulated, although the government recently reduced regulatory controls related to the importing sale of goods required for food production – all because of continuing food shortages – particularly milk. How long this supposed break will last is anyone's guess. Despite these desperate moves, it is inevitable that the VEF will have to be devalued in 2008, or at least by 2009.

Argentina

The colossal failure of the "currency board" which was used in Argentina for over 10 years in lieu of Central Bank management of monetary policy led to the currency crisis in 2002. The peso's (ARS) value had been constitutionally set at one-to-one with the US dollar for several years, which was grossly overvalued and made Argentine exports uncompetitive in world markets. The resulting economic pressures forced the government to sever this link in early 2002, and the exchange rate shot from 1.00 to above 3.50 per USD in only six months. The monetary crisis of 2002-2003 led to a collapse of the local economy. Although there has been a recovery in Argentina, inflation still remains high at an "unofficial" rate of 15%-25% and the FX rate of ARS/USD is at a "managed" floating rate pegged at 3:1.

Brazil

In contrast, Brazil has introduced economic and tax changes that have improved the liquidity and risk management outlook; most notably the elimination of the CPMF debit tax on the movement of funds between accounts in Brazil. CPMF has been a lucrative source of tax revenue for the Brazilian government, and to make up for the loss, there will be an increase in certain components of the IOF tax. The rate of tax on foreign loans will increase from 5% to 5.38% for loans under 90 days, and loans longer than 90 days, which previously incurred no tax, will be taxed at 0.38%. Also, foreign exchange transactions related to the import of services and export of goods and services, which incurred no IOF tax previously, will now be taxed at the rate of 0.38%.

Despite numerous currency changes and periods of maxi devaluations (devaluation in the currency by 20% or greater at one time) over the past two decades, exchange controls, and the strongly left leaning government of Luiz Inacio Lula da Silva, Brazil has one of the most robust financial sectors and efficient banking systems in all of Latin America.

Peru

Peru is a good example of a country that has significantly improved their risk profile and liberalized their economy. As a result, their GDP growth has been 5%-10% per annum for most of the past decade. The threat of devaluation is only a memory from the late 1980s and early 1990s. During that period, Peru experienced a disastrous bout of hyperinflation and currency devaluation, caused primarily by the populist-spending binge by the former and now current President Alan Garcia. Not unlike the current system in Venezuela, Peru maintained an artificially low 'official' exchange rate called the *Mercado Único de Cambios*, or MUC, which accomplished little more than to allow the politicians and bureaucrats to loot the public treasury of hundreds of millions of dollars. In today's far more stable economy and political regime, the exchange rate for the Nuevo Sol (PEN) is free floating.

Risk Management Strategies

Developing an approach to managing and hedging risk in Latin America is largely dependant on the maturity of the domestic financial markets and the ability to access the international markets. In highly regulated economies – such as Venezuela – these are limited. The most basic tools for the risk manager include "natural hedging" and active working-capital management. Sourcing goods and services locally for companies with large domestic markets is effective as a natural hedge and also works as an inventory management tool especially if key raw materials have to be imported and restrictive foreign exchange regulations are in place. This is one of the significant contributors to the difficulties in Venezuela today. Closely watching DSOs (Days Sales Outstanding) and controlling payables are standard techniques, but difficult to perfect in many countries. DSOs remain high for most companies in Argentina as inflation is running at about 15% - 25% and access to credit is limited. You may get paid, but with a post dated check. In contrast, countries like Mexico and Brazil, the credit terms tend to be lower and the efficiency of the banking system allows electronic collections and payments that improve working capital ratios.

Liquidity management also presents a risk challenge. Excess cash in fact is more problematic than being in a cash deficit. Again, referring to Venezuela as the most egregious example, excess cash can be trapped in country for months or years due to the cumbersome process of repatriation, which exposes the cash to risks of subsequent maxi-devaluations of the currency. Older techniques such as the use of cross-border swaps, or buying local debt through bank bond offerings has fallen out of favor due to both tax and legal ramifications.

For exporters, keeping these collection proceeds offshore may or may not be an available option, although for Brazil this amount has increased to 100% from the previously imposed restriction of 30%. In Argentina, there is a specified amount of time required before export proceeds must be remitted or converted, but it is possible to hold time deposits in USD, EUR or other currencies, which is a technique that can be used as a hedge against further ARS devaluation. Also, Argentina offers an array of options for overnight investments with higher rates for deposits seven days and longer.

For companies requiring cash, the choice is to increase capital, intercompany borrowing, or local borrowing. Striking a balance is essential; too much capital injection at once increases a multinational's overall exposure, but being undercapitalized is not always the best choice either. Companies tend to undercapitalize for fear of not being able to repatriate. This is often counterproductive for two reasons:

Local borrowing is an essential risk management tool in an environment with high FX risk. But a company's ability to borrow in the domestic market may be jeopardized by thin-capitalization rules that limit the deductibility of interest on excessive debt levels. US companies who have loan covenants in place may find they are restricted in their ability to borrow locally. Also local borrowing costs may be high and funds can be scarce, especially if a liquidity crisis is imminent.

Using internal cash through intercompany borrowing to fund operations in Latin America has a high cost due to withholding taxes and the fact that in many Latin countries the interest on intercompany loans is not immediately deductible.

Nonetheless, the application and registration process and cost of bringing in capital needs to be weighed carefully against any local financial taxes (such as IOF in Brazil). But this may be preferable to creating a transaction exposure for the local operation if the debt is dollar denominated – debt is a transaction exposure (FAS 52). On the local financial statements, the currency variation must be booked as an expense or gain for the subsidiary on a monthly basis. There is a strict local currency-dollar correlation in the case of loan amounts (adjusted on a monthly basis) when compared to capital. This in turn means that there would also be US GAAP exchange gains and losses in Brazil on the dollar denominated intercompany loans.

Market Instruments

Depending on the country, the financial markets and available hedging instruments may not be developed. Aside from Mexico, traditional derivative instruments such as swaps, forwards and options are not available, because there is no forward market for these currencies outside of the local country. In countries that are considered emerging markets, the cost of hedging through forward contracts or options may well outweigh the potential benefits. This can be verified by checking local short-term interest rates in these countries (and that is how the forward rate is set or the option purchase price struck – the higher the interest rate differential and volatility, the higher the cost). If the interest rate differential exceeds the amount of anticipated devaluation – which it often does in emerging markets – it may not be worthwhile trying to hedge. Hence, many companies use Non-Deliverable Forward contracts (NDFs) or short-term foreign exchange contracts (typically up to two years) in currencies that have restricted convertibility. When used for commercial purposes, this tends to be a two-step process; an NDF contract is entered into when the risk occurs and an on-shore spot transaction on the settlement date.

An NDF is similar to a regular forward foreign exchange contract, except at maturity there is no physical delivery of currencies. Settlement typically takes place in an offshore financial center in US dollars as the other currency (such as many Latin currencies that have FX controls in place) is "nondeliverable".

NDF pricing is impacted by the perceived probability of changes in foreign exchange regime, speculative positioning, conditions in local onshore interest rate markets and the relationship between the offshore and onshore currency forward. On settlement date, if the reference rate (often the 12.00 pm EST Fed official exchange rate) is greater (in foreign currency per dollar terms) than the previously agreed forward exchange rate, the holder of the contract who is long the emerging market currency must pay the holder of the other side of the contract the difference between the contracted forward price and the spot market rate, which is settled in US dollars. At the same time, an onshore spot transaction is undertaken, and the net cash flows provide the effective forward rate.

Conclusion

Risk comes as part of doing business in Latin America. The real economic and political risk has remained over the decades and risk now fluctuates with the election of more leftist regimes that have replaced right wing dictatorships that were so common of the past. Assessing the risk levels on a country-by-country basis and situation-by-situation basis is the best approach in a region with such a range of risk parameters. There is no single solution. ■

Treasury Alliance Group LLC
Susan A. Hillman, Partner
Email: sahillman@treasuryalliance.coma
Phone: +1.847.295.6414

Stephen P. Burrington, Partner
Email: stephen.burrington@treasuryalliance.com
Phone: +1.513.469.6606