

ECONOMICS: LATIN AMERICA PERSPECTIVES—JULY 23, 2010

Argentina and Venezuela: Prisoners of Populism?

■ **Lars Pedersen**
Senior Economist—Latin America Research

The governments of these two Latin American countries have chosen populism and power over globalization and economic integration. Venezuela appears to be the more vulnerable.

Populist governments in Argentina and Venezuela have steered their economies away from globalization, favoring policies of intrusive control to foster electoral gain. This choice puts them in a different league from other Latin American countries, such as Mexico and Brazil, which have embraced integration into the world economy as the path to sustainable growth.

With their lack of transparency, highly politicized nature and volatility, Argentina and Venezuela pose significant risks, but that risk has a silver lining—by keeping investors away, it has limited the nations' ability to take on excessive external debt. As a result, both countries have lighter financial obligations than more developed and integrated economies in the region, and less to gain by failing to service that debt. But they still have risk.

Redistributive Taxes Take on Many Forms

Both governments seek to redistribute wealth, and gaining access to the needed funds without strong administrations means taxing key drivers of the economy. Taking control of resource exports is a

logical starting point. Venezuela has obtained a greater share of the oil business for its national oil company PDVSA at the expense of the foreign companies still operating in the country. Argentina, meanwhile, has tapped into its export strengths in soy and other agricultural exports, appropriating, via export taxes, an unusually high proportion of revenue from those goods.

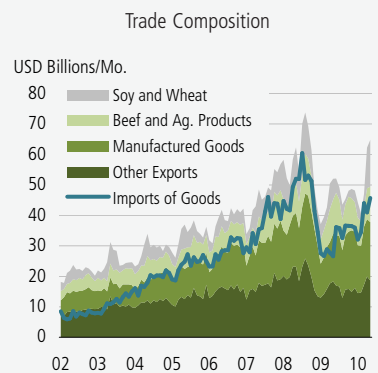
But heavy taxes on export earnings depress output in the long run. In Venezuela's economy, which is heavily oil dependent (**Display 1**), production has slipped from an estimated peak of 3.5 million barrels per day in 1998 to 2.2 million today. High cost heavy-oil fields in the interior, including Carabobo, have potential, but foreign oil companies are cautious about investing there until they fully understand their long-term ownership rights. In Argentina's diversified export trade (**Display 2**), a policy toward agriculture that borders on confiscatory doesn't seem to have impaired the country's capacity yet—this year's soy harvest should be a record. But this policy will eventually take a toll, too.

Display 1
Venezuela's Trade Is Concentrated...



* Estimated exports from IEA data
Source: Banco Central de Venezuela and Haver Analytics

Display 2
...While Argentina's Is Diversified



Source: Haver Analytics and Instituto Nacional de Estadística y Censos

Rationing foreign exchange toward favored import sectors is another lever to redistribute resources. In Venezuela, this takes the form of three different exchange rates, which the administration uses to subsidize some import sectors by providing them with low-cost currency exchange while other sectors receive less favorable rates. Argentina is starting a much less severe exchange-rationing program.

Redistributive economies also levy taxes on local financial systems through inflation and devaluation. Keeping interest rates very low acts as a tax on the public's deposits, which are forced to continually rebuild real-money balances. Eventually, massive currency devaluations pose a huge burden for local businesses that have issued foreign debt that must be serviced with local-currency income. It doesn't take many of these devaluations before the economy becomes leverage-averse, dooming it to slow growth. And ultimately, if existing debts aren't paid, it acts as a tax on foreign investors.

Venezuela Is More Vulnerable than Argentina

Populist taxes like these can cause significant economic damage, and we believe that Venezuela is more vulnerable than Argentina on several counts.

First, it's much more dependent on the price of a single commodity—oil. Argentina, on the other hand, has cultivated a diverse mix that includes soy, wheat, beef, other agricultural products and manufactured goods (including car sales to a booming Brazilian market). Venezuela's heavy dependence on the price of oil creates more potential danger if oil prices fall substantially.

Second, Venezuela is leaking dollar reserves (**Display 3**), which are critical to maintaining balance. Venezuela seems to need about US\$20 billion more in foreign exchange per year than is required by its import trade—which caused a US\$6 billion decline in total reserves in the first half of

2010. Apparently, the culprits are political requirements at home and abroad to support special projects and client states from Bolivia to Nicaragua. Argentinean reserves, meanwhile, are holding up well, with no comparable foreign-exchange drain. In fact, Argentina's reserves may be rising even faster than officially reported, as evidenced by the country's repayment of US\$3 billion in short-term credits to the Bank for International Settlements.

Lastly, Venezuela has embarked on a dangerous crash program to conserve its foreign exchange. It announced a semi-devaluation of the currency at the start of 2010, and then closed one of three parallel foreign-exchange markets. This, along with a shortage of electricity, has led to a collapse in economic activity and forced down imports. This is ominous, because Venezuela's government threatens to expropriate companies that are unable to produce without imported inputs. Argentina stands in stark contrast: its recent surge in foreign-exchange earnings has flowed at least partly into the economy, fueling an economic boom and import gains.

The ultimate goal for both populist administrations—whether Hugo Chávez in Venezuela or the Kirchners in Argentina—is to stay in power. At some point, this short-term mind-set could lead them to consider defaulting on their external debt, even though both countries have relatively low amortization payments coming due and would gain little by defaulting. But of the two countries, we believe that Argentina is in better standing overall. It's not vulnerable to single-commodity exposure, has stronger reserves, and is enjoying economic growth, while Venezuela is bracing for a potential downward spiral. ■

Display 3
Dollar-Reserve Strains in Venezuela



Source: Banco Central de la República Argentina, Banco Central de Venezuela and Haver Analytics

The information contained here reflects the views of AllianceBernstein L.P. or its affiliates and sources it believes are reliable as of the date of this publication. AllianceBernstein L.P. makes no representations or warranties concerning the accuracy of any data. There is no guarantee that any projection, forecast or opinion in this material will be realized. Past performance does not guarantee future results. The views expressed here may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. AllianceBernstein L.P. does not provide tax, legal or accounting advice. It does not take an investor's personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions. This information should not be construed as sales or marketing material or an offer of solicitation for the purchase or sale of, any financial instrument, product or service sponsored by AllianceBernstein or its affiliates.

Note to Canadian Readers: AllianceBernstein provides its investment management services in Canada through its affiliates Sanford C. Bernstein & Co., LLC and AllianceBernstein Canada, Inc.

Note to UK Readers: UK readers should note that this document has been issued by AllianceBernstein Limited, which is authorised and regulated in the UK by the Financial Services Authority. The registered office of the firm is: Devonshire House, One Mayfair Place, London W1J 8AJ.

Note to Australian and New Zealand Readers: This document has been issued by AllianceBernstein Australia Limited (ABN 53 095 022 718 and AFSL 230698). Information in this document is intended for wholesale investors only, and is not to be construed as advice.

Note to Readers in Vietnam, the Philippines, Brunei, Thailand, Indonesia and India: This document is provided solely for the informational purposes of institutional investors and is not investment advice, nor is it intended to be an offer or solicitation, and does not pertain to the specific investment objectives, financial situation or particular needs of any person to whom it is sent. This document is not an advertisement and is not intended for public use or additional distribution. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in any of the above countries.

Note to Readers in Malaysia: Nothing in this document should be construed as an invitation or offer to subscribe to or purchase any securities, nor is it an offering of fund management services, advice, analysis or a report concerning securities. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in Malaysia. Without prejudice to the generality of the foregoing, AllianceBernstein does not hold a capital markets services license under the Capital Markets & Services Act 2007 of Malaysia, and does not, nor does it purport to, deal in securities, trade in futures contracts, manage funds, offer corporate finance or investment advice, or provide financial planning services in Malaysia.

Note to Singapore Readers: This document has been issued by AllianceBernstein (Singapore) Ltd. (Company Registration No. 199703364C). The Company is a holder of a Capital Markets Services Licence issued by the Monetary Authority of Singapore to conduct regulated activity in fund management.

Note to Taiwan Readers: This information is provided by AllianceBernstein funds Taiwan Master Agent, AllianceBernstein Taiwan Limited. SFB operating license No.: (97) FSC SICE no. 049. Address: 57F-1, 7 Xin Yi Road, Sec. 5, Taipei 110, Taiwan R.O.C. Telephone: 02-8758-3888. AllianceBernstein Taiwan Limited is a separate entity an independently operated business.

Note to Hong Kong Readers: This contributor is not licensed by the Hong Kong SFC and does not intend to provide investment advice in Hong Kong. For Financial Representatives General Information only and shall not be regarded as provision of investment advice.