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Latin America Review

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6 December 1985

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Venezuela: Foreign Investment Prospects

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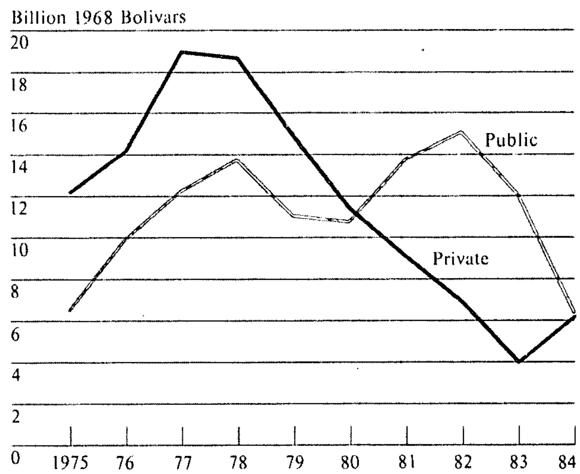
Confronted by the prospect of long-term stagnation in oil revenues, Venezuela has revised its development strategy to give more emphasis to import substitution. A key feature is the enhanced role assigned to foreign direct investment (FDI), which President Lusinchi's top economic advisers see as an important potential source of technology, managerial expertise, and capital. The administration's attempts to liberalize regulations governing FDI, however, have been constrained by domestic political considerations and restrictions imposed by the Andean Pact. The reforms announced by the government last June are, in the view of the US Embassy, unlikely to stimulate significant foreign investment. We believe that, for the medium term, the absence of important new commitments by foreign investors will probably combine with depressed private domestic investment to extend an economic recession that is now in its seventh year. Over the longer term, the failure to attract FDI probably will reinforce the role of the state as an entrepreneur and a source of risk capital. In our view, such reliance on the state raises questions about the prospects for economic development, because of the state's reputation for inefficiency and corruption. For the United States, the failure to liberalize investment regulations foreshadows reduced commercial opportunity.

A Decade of Neglect

Venezuela withdrew the welcome mat for foreign investors in 1974, as euphoria over a prospective oil bonanza led nationalists to conclude that FDI was no longer essential. They asserted that the nation's capital requirements could be drawn from—or borrowed against—the inflow of petrodollars and that the technology that normally accompanies foreign investment could be licensed. Acceptance of this view led Venezuela to join the Andean Pact in 1973 and, the following year, to enact legislation implementing the Pact's Decision 24, regulating FDI.

The Venezuelan regulations provide that firms that are more than 49 percent foreign owned:
- Convert to majority Venezuelan ownership within 15 years of entry.

Venezuela: Gross Fixed Investment, by Sector, 1975-84



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- Limit annual profit remittances to 20 percent of registered foreign capital.
- Limit increases in registered foreign capital to 7 percent per year.
- Limit borrowing in domestic financial markets to an amount equal to 40 percent of capital.
- Negotiate royalty and license fees to be paid abroad with the Office of Foreign Investment.
- Submit to a bewildering array of rules and regulations imposed by the Office of Foreign Investment.

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Investment consultants in Caracas note that potential investors object most to the requirement to convert to majority Venezuelan ownership. They add that fear of losing control of proprietary information causes some

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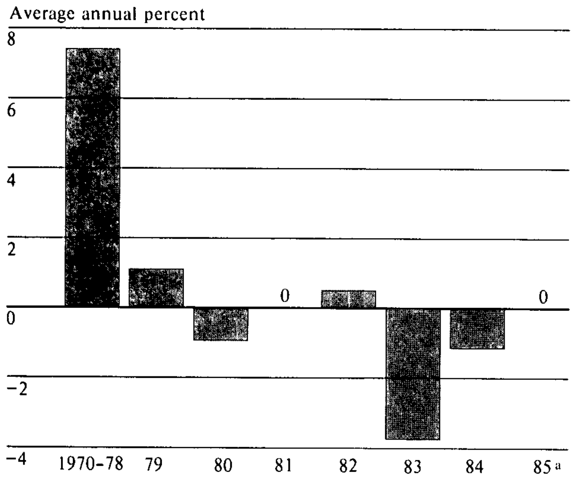
Venezuela: Real Nonpetroleum GDP Growth, 1970-85



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multinationals to reject even minority participation by host country investors.

The impact of Decision 24 over the past decade has been dramatic. Official data show that most registered foreign investment now in Venezuela entered before 1974. Since then, FDI has largely been financed through the reinvestment of retained profits, while investment financed by new money from abroad has slowed to a trickle.

The Politics of Reform

Last June, following nearly a year of intense debate, the President decreed a revision of the foreign investment code. According to the US Embassy, the move to liberalize the code was spearheaded by Development Minister Hurtado, Finance Minister Azpurua, and Minister of the Presidency Lauria—each a respected technocrat, but all without power bases in the ruling party.

According to press accounts, the reformers contended that the development strategy followed over the past decade had contributed to stagnation by making the economy overly dependent on the state for entrepreneurship, risk capital, and technology. In their view, FDI could alter this by tapping a largely unexploited source for these key elements. Proponents also argued that, although the direct impact of increased foreign investment would be important, FDI's catalytic effect on domestic investors probably would likely be far more significant. Investment by foreigners would create opportunities for domestic investors in related industries and, by boosting the general investment climate, would also encourage the repatriation of capital from dollar accounts abroad. 25X1

The call for reform drew wide-ranging opposition, however. According to the US Embassy, leftist and nationalist elements within the ruling party, as well as opposition parties of the left, rejected FDI liberalization on ideological grounds. In addition, domestic industrialists opposed any moves that might threaten their market shares and profits. 25X1 25X1

Complicating Lusinchi's dilemma was his concern for his image. The President did not want to be perceived as caving in to foreign interests, having been subjected to such charges when, shortly after taking office in 1984, he established a preferential exchange rate for repayment of the external private debt. Consequently, the June decree incorporates many of the changes advanced by the cabinet reform group, but also attempts to placate opponents by not carrying reform beyond the spirit of Decision 24. 25X1 25X1 25X1 25X1 25X1

The principal features of the reform are:

- Foreign investment may now be registered in the currency of origin, thus shielding the 20-percent cap on profit remittances against devaluations.
- Agriculture, agro-industry, tourism, and construction are exempted from the principal provisions of Decision 24.

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- Investment in most other sectors may be approved if it emphasizes technology transfer, employment, local value added, or exports.
- The hard currency debt of foreign-owned firms may be converted to registered investment.
- Foreign-owned firms will be allowed greater administrative freedom from the Office of Foreign Investment. [redacted]

Dim Prospects

We believe the June revisions are far too modest to generate a significant surge in foreign direct investment, despite ambitious forays abroad by the Office of Foreign Investment to convince potential investors of the benefits of investing in Venezuela. The decree fails to address the core concerns of investors, in particular the requirement to convert to majority Venezuelan ownership within 15 years. A liberalization of Decision 24 will probably be required before investors again make significant commitments to Venezuela and the other Andean nations. Andean Pact foreign ministers will meet in January to consider proposals for liberalization, a move that is gaining support within the Pact, according to reports from US Embassies. [redacted]

In our judgment, however, foreign investment flows are likely to remain depressed over the medium term, even if Decision 24 is liberalized. Investor confidence in Venezuela has been severely shaken by six years of economic stagnation, the deteriorating prospects for oil exports, a decade of policymaking flip-flops, and the Latin American debt crisis. Other countries with more positive foreign investment climates offer potential investors better profit prospects. [redacted]

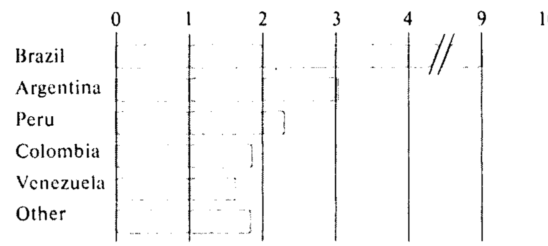
Implications

Balance-of-payments management will be more difficult to the extent that foreign investment and associated domestic investment from funds deposited abroad fall short of their potential. This will, in our view, aggravate the pressures that stagnant oil revenues are likely to place on the government to limit current account deficits through austerity measures. [redacted]

We believe the failure to attract significant foreign and associated domestic private investment also implies continued reliance on the state for entrepreneurship and risk capital—a situation that the reformers had hoped to correct. Such reliance could increase the potential for social unrest by retarding economic development. Over the past decade, the government has squandered huge sums of oil revenues on poorly conceived and ill-managed projects, and its management of investment funds has been riddled with corruption. In the view of the US Embassy, such inefficiency and corruption have been key factors in the seven-year stagnation of output and job creation. [redacted] 25X1

US Direct Investment Position in South America, 1983

Billion US $ Note scale change



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For the United States, we believe that continued restrictions on foreign direct investment clearly foreshadow reduced commercial opportunities in Venezuela, our most important export market in South America. An improved investment climate would enable US firms to invest and produce behind Venezuela's heightened import barriers, thus offsetting, in part, US export revenues lost to such barriers. [redacted] 25X1

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Table 1
Venezuela: Cumulative Foreign Direct Investment by Country of Origin

Percent shares yearend 1984

Total	**100.0**
Belgium	1.8
Canada	5.7
France	1.4
Japan	3.2
Panama	6.0
Switzerland	6.0
United Kingdom	7.8
United States	52.8
Others	15.3

Table 2
Venezuela: Cumulative Foreign Director Investment by Sector

Percent shares yearend 1984

Total	**100.0**
Agriculture, fishing, mining	2.4
Manufacturing	74.0
Electricity, gas, water	4.5
Construction	3.1
Commerce, restaurants, hotels, services	4.8
Transportation, communications	1.0
Finance, insurance, real estate	10.2

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Latin America Briefs

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Argentina

Election Fallout for the Peronists

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Peronist losses in last month's congressional election were not as severe as many Argentine observers had expected, according to the US Embassy. While some polls had indicated that party support would be as low as 20 percent, Peronist candidates captured nearly 35 percent of the vote, as opposed to the governing Radical party's 43 percent. Moreover, candidates favoring the reform and democratization of Peronism bested old-style party bosses in Buenos Aires province, where reformist leader Antonio Cafiero outpolled party Secretary General and rightwing strongman Herminio Iglesias by a three-to-one margin. Party bosses were further discredited by losses to the Radicals in several traditionally Peronist-dominated interior provinces. Party First Vice President Vicente Saadi—senior leader in the official Peronist hierarchy—resigned his post shortly after the election opening the way for a new round of divisive infighting within the party.

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The relatively respectable electoral showing, at a time when Peronism is in total disarray, indicates, in our view, that the movement retains considerable vitality and popular appeal. To challenge the supremacy of President Alfonsin's Radicals, however, Peronist reformers must capture the official party apparatus from the old guard and begin the difficult task of modernizing and introducing a measure of ideological coherence into a highly disparate and conflict-ridden movement. While the reformers have attracted support from the party's ideological center and the middle class, many Peronist workers and peasants are likely to back the old-style leaders, some of whom still control powerful political machines. Moreover, the reformers must meld diverse labor and regional interests within their ranks and overcome numerous personal rivalries. Although prospects for Peronism are now better than before the elections, we believe that the unification and revitalization of Argentina's main opposition party will be a long uphill battle. 25X1

Suriname

Seeking Economic Support 25X1

Suriname's worsening economic plight is prompting the Bouterse regime to court virtually any country offering hope of financial support or expanded trade. As a lure to potential supporters, the regime is touting its tentative steps toward democratization. Despite disappointment over Libya's failure to deliver a promised economic package reportedly worth as much as $100 million, Suriname appears to be expanding ties to Tripoli; a Libyan delegation recently visited Suriname to discuss increased economic cooperation. Economic arrangements with other countries in recent months have included:

- Taiwan has provided a $40 million credit line.
- Brazil has opened a $20 million credit line and agreed to purchase more Surinamese alumina.
- Colombia has agreed to a $10 million credit line.
- China has made a $7 million, interest-free loan to finance construction of an indoor stadium.
- Venezuela has provided a $3 million credit line and agreed to help develop Suriname's fishing industry.
- Czechoslovakia apparently has agreed to supply capital goods in return for bauxite and related derivatives.

Moreover, Iranian representatives reportedly have visited Suriname to explore expanding trade relations. 25X1

Largely in hopes of attracting Western assistance—particularly a resumption of $600 million in Dutch aid suspended in 1982 after the execution of 15 prominent opposition leaders—Head of Government Bouterse last month gave leaders of three previously banned political parties a limited voice in his policymaking council and pledged to return Suriname to democracy by April 1987. 25X1

Suriname's gradual progress in expanding economic relations will partially ease the country's critical shortage of foreign exchange and enable the regime to enhance its political credibility by overcoming the external isolation that resulted after the 1982 murders. Nevertheless, Bouterse's recent steps toward democracy are unlikely to prompt the Netherlands to release its blocked aid. Unless Suriname's economic situation improves dramatically—an unlikely prospect—the regime probably will continue to make at least token steps toward democratization in order to attract Western donors and boost its low domestic popularity. Meanwhile, however, the regime will also continue to seek funds from any willing quarter. [redacted] 25X1

Trinidad and Tobago

Discouraging Labor-Intensive Investment [redacted] 25X1

Recently enacted legislation will further discourage labor-intensive investment at a time when Trinidad and Tobago's unemployment rate—now 25 percent—is rising. The new law requires employers to make lump-sum payments—based on length of service—to laid-off workers and gives such payments a priority claim on the assets of a liquidated firm. Such preference will discourage banks from making business loans. Moreover, fearing a sizable financial burden in the event of any layoffs, existing firms will hesitate to expand payrolls, while new investors—foreign and domestic—will be reluctant to commit funds to operations requiring substantial labor input. Labor-intensive investment in Trinidad has long been deterred by high labor costs, which have been amplified by the government's unwillingness to devalue the Trinidadian dollar. By supporting the new law, the government has sacrificed long-term job creation for immediate political support from the country's influential labor groups. [redacted] 25X1

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