

## ARTICLE

# THE VIZCARRA ERA: POLITICAL INSTABILITY AND BUSINESS UNCERTAINTY IN PERU

Madrid, 28 August 2019



In his July 28 Independence Day address to the National Congress, Peruvian President Martin Vizcarra proposed a constitutional amendment to move general elections from 2021 to 2020. He did this with the specific goal of ending Peru's government functionality crisis, brought on by constant disagreement between the executive and legislative powers. "All of us must go," asserted the president before a shocked House of Representatives. This announcement has left Peru's government in an increasingly volatile state replete with uncertainty, paralyzing legislation and adversely affecting business expectations.

Although not as bombastic as other incidents, the truth is that this is Peru's most serious crisis of the last 19 years. Close analysis of Peru's political dynamics can explain how we reached this point, but it is difficult to predict how this crucial moment in history will resolve.

Vizcarra's five-year term (2016-2021) began with high expectations. In fact, by mid-2016, business confidence had reached its highest levels since 2013, with the economy growing at a rate of nearly 6 percent. Consensus among the private sector was that a highly-skilled executive branch (led by a seasoned technocrat like Pedro Pablo Kuczynski) working alongside a

Fujimorism-dominated Congress continuing the liberal reforms of the 90's would create space for sweeping reforms and allow Peru OECD membership. These good economic prospects and high business confidence triggered an investment boom, with investors encouraged by macroeconomic health and an excellent international market for Peru's raw exports, such as copper.

As we now know, few of these expectations were met. Peru's political landscape turned volatile and complex, deflating business expectations and discouraging private investment. Optimistic ideas that the "Ppkaukas" and Fujimorists would work together failed to stand up to the pressures of both history and the country's political-institutional design. In the last century, no Peruvian government has survived an absolute opposing congressional majority. This environment is what led to Pedro Pablo Kuczynski's resignation in March 2018 amid intense pressure from Congress. Martin Vizcarra, his vice president, succeeded him.

During both Kuczynski's and Vizcarra's administrations, Fuerza Popular (led by Keiko Fujimori, daughter of former president Alberto Fujimori) has maintained parliamentary control, initially holding 73 of 130 congressional seats.

This has led to numerous clashes between Peru's executive and legislative branches, manifesting not only via institutional means, such as subpoenas, interrogations and censorship, but also in a negative attitude toward executive reform proposals, leading to frequent appeals to popular sentiment.

## **“The relationship between the executive and congressional bodies continued to erode, bringing overall governmental effectiveness and the country's economy down with it”**

This uncertain landscape was increasingly worsened by continued investigations into high-profile corruption cases (the construction sector's "Car Wash" scandal and the "corruption tapes" regarding the upper echelons of the legal system). These investigations involved many traditional and well-known political leaders, significantly increasing intra-governmental tension and uncertainty. This focus on investigation also lent prosecutors and judges greater prominence in the political arena, leading to a phenomenon known as the "judicialization" of politics. Catalyzed by the fight against corruption, serious disagreements between the executive and legislative powers continued, with the former accusing the latter of inequitably favorable treatment of judges handling more serious accusations.

Throughout Vizcarra's first year in power, the relationship between the executive and congressional bodies continued to erode,

bringing overall governmental effectiveness and the country's economy down with it. Nonetheless, Vizcarra's voter approval ratings remained quite high, largely due to the following:

- Public perception that Vizcarra was fighting corruption.
- Vizcarra's image as facing the congressional majority head-on.

However, his approval ratings ultimately fell due to:

- A decline in public administration, stunting economic progress.
- Feelings that the government had no comprehensive development plan for the country.

After a full year, it is no surprise that 75 percent of the population supports an early general election. Support for Vizcarra's "All of us must go" message reflects the public's exasperation about Peru's institutional power and the traditional political class.

After Vizcarra's proposal was announced, the political environment grew increasingly complex and uncertain. Circumstances change daily, even though President Vizcarra has yet to obtain the necessary support in Congress to pass his proposal. Furthermore, half of his already small group of legislators have resigned, leaving a meager five. Among those who have resigned is Mercedes Araoz, Kuczynski's second vice president and first in line to succeed Vizcarra. It is widely predicted that Congress will declare Vizcarra's presidential seat vacant rather than acquiesce to his demand for an early election.

However, it is not only lack of congressional support that is eating away at the president's power. He is also losing support from regional governments—especially in the south, where social conflicts over mining continue to mount, culminating in strikes and demonstrations against two flagship projects: Tia Maria and Quellaveco. In the former, Vizcarra attempted to come to an agreement with local authorities in

person, but the meeting was recorded and the audio leaked to the press, leaving the president in yet another awkward situation.

This political turbulence has brought economic growth to a standstill. However, this kind of situation is nothing new. It is certainly true that the 1990s' new economic model improved quality of life for the populace by focusing on macroeconomic responsibility, opening trade, promoting private investment and establishing a subsidiary role for the state. However, this economic progress did not lead to the development or advancement of public administration.

To the contrary, during this same period of economic development, Peru saw the collapse of the party system and frequent corruption cases. This trend had already begun in 2000, with the fall of Alberto Fujimori's government amid the "vladivideos" scandal. In it, Vladimiro Montesinos, Furjimori's chief advisor, was recorded bribing representatives at nearly every level of Peru's government. The environment of corruption was later cemented by revelations in the Car Wash investigation and recordings of major legal figures.

Thus, according to APOYO Consultoría, in 2019 Peru should experience a growth rate of 2.2 percent down from the projected 3.7 percent. Growth will be driven by a small handful of factors, mainly mining and agriculture, with only marginal progress in key infrastructure projects. The current political situation hinders the country's overall growth potential significantly.

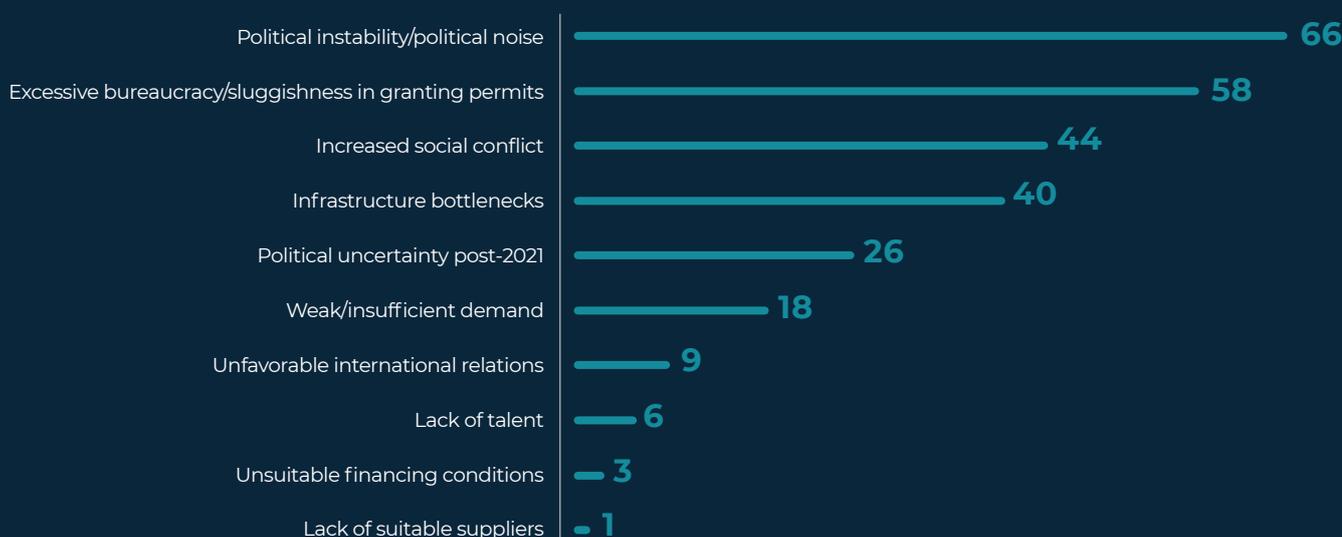
## POLITICAL IMPACT ON THE BUSINESS LANDSCAPE

The political situation in Peru perfectly fits the definition of VUCA (volatile, uncertain, complex and ambiguous), which has a severe impact on the country's business environment. To most appropriately respond, it is vital to clearly map out those channels through which politics affect business decisions, and—most importantly—identify the key channels for each sector. We have identified four main channels through which the political world directly impacts the economic sphere.

The first is political noise and its effect on private investment. This refers to such things as constant confrontations between various government

## WHAT FACTORS DO YOU BELIEVE MIGHT AFFECT COMPANIES' INVESTMENT PLANS THIS YEAR?<sup>1</sup>

% OF EXECUTIVES IN STAFF



Source: APOYO Consultoría's Business Advisory Service client poll

<sup>1</sup> Multiple choice, maximum three options.

figures or frequent, high-profile instances of corruption. Thankfully, the nation’s business community is highly resilient to this type of noise, remaining able to make decisions independent of political issues, with conclusions shaped instead by other relevant factors (such as metal prices). However, business confidence does suffer when the political sphere is characterized by so much uncertainty. In fact, one of Peru’s most dramatic drops in investment confidence occurred in 2011, when Ollanta Humala defeated Keiko Fujimori in the presidential election. This was because Humala was far less aligned with the interests of private investment and the market.

The current political crisis has been no exception. In fact, business confidence is at its lowest since the 2008 global financial crisis. This is not only due to the political uncertainty around the proposed early elections, but also the escalating trade war between China and the United States, which increases the chances of a major global economic slowdown putting downward pressure on metal prices.

The second political risk channel is the enactment of laws which alter the economic sector’s landscape, either from the executive branch (including ministries, regulators, municipalities, etc.) or Congress. Regulation—even “micro-regulation”—occurs on many fronts and in great numbers, and can thus be unpredictable and contradictory, leading to heavy costs for businesses.

For example, from 2016 to 2018, 3,632 bills were submitted to Congress, 514 (14 percent) of which were regulations and 87 of which became laws. APOYO Consultoría confirmed this information in a study using data analysis tools in conjunction with law systematization processes.

**“It is vital to clearly map out those channels through which politics affect business decisions”**

The situation becomes even more complex when considering the executive power, since most laws are not published for comment before they are implemented. So, in this same period, 41,555 legal implementations were published in El Peruano, the official national newspaper, of which 1,496 were regulations.

## INVESTMENT CONFIDENCE

POINTS



Percentage of respondents planning to increase their investments in the next six months minus the percentage planning to reduce them in the next six months

Source: APOYO Consultoría’s Business Advisory Service client poll

Furthermore, since 1990, the number of executive governing bodies in the country has increased significantly. Peru has over 1,800 municipalities, each one able to autonomously enact regulations with no procedural standardization.

Another key aspect of regulatory risk is that these sorts of legal changes can occur unexpectedly and may include significant details in the fine print. These details can be difficult to detect, and when undetected, often lead to vague and uncertain legal circumstances.

Yet another layer of complexity lies in the fact that congressional ingroups are more plentiful than ever. At present, Congress is fragmented into twelve blocs, most of which lack a clear or consistent ideology. In fact, there are only two blocs that have gained any ground through this fragmentation. These two groups (Frente Amplio and Nuevo Perú) both lean left, and have gained 19 seats due to their exceptional talent for negotiating with other political bodies. This has gained them a significant presence in the lawmaking process.

And the current political crisis has increased Peru’s already perilous regulatory risk levels. We are entering an electoral period regardless of whether or not the election takes place early, so congresspeople are heavily incentivized to prioritize proposals with greater public support in order to improve their political capital.

The third channel through which politics affects the business world appears when public administration is slow or inefficient, making navigating the red tape of bureaucracy much more cumbersome. This sort of situation affects businesses threefold: As users of public services, as suppliers of goods and services and as entities that rely on a healthy macroeconomic environment.

In both Kuczynski’s and Vizcarra’s administrations, the effectiveness of public administration has steadily decreased, with particular concerns over lack of investment in infrastructure. This means a large number of major projects contracted are at a standstill (see table), beholden to the sluggish decision-making of executive officials.

CONTRACTED INFRASTRUCTURE PROJECT STATUS					
PROJECT	PROJECT START	INVESTMENT (\$ MILLION)	% PROGRESS	KEY PENDING PROCESSES	ESTIMATED INVESTMENT 2019 (\$ MILLION)
Metro Line 2 (Lima)	2014	5350	25	Approval of engineering analysis and passage of land rights	400
San Martín port (Ica)	2014	260	19	Approval of EIA modification	120
Autopista del Sol Highway (La Libertad - Piura)	2009	400	42	Passage of land rights	5
Southern Pan-American Highway (Arequipa - Tacna)	2013	135	25	Approval of technical modification and passage of land rights	5
New Jorge Chavez airport (Lima)	2001	1500	0	Preparation of final design	0
Majes Siguas II (irrigation project) (Arequipa)	2001	550	15	Approval of technical modification	0

Source: Proinversión, Ositrán, APOYO Consultoría

This standstill is the result of several factors:

1. "Fear of signing" due to ongoing corruption investigations, paralyzing executive decision-making.
2. High turnover rate of government officials.
3. Recent changes to regional and municipal authorities, positions which were entirely replaced due to the prohibition on consecutive reelection.

These issues have led to constant delays in decision-making, low-budget execution and slow progress on major public projects.

Changes in regional and municipal authorities tend to have a high impact on public investment rates. In 2018, these entities were responsible for 57 percent of public investment. Turnover among these authorities has historically accompanied drops in public investment, so it follows that current changes in Peru's 1,800 municipalities will see an especially large drop. APOYO Consultoría predicts public investments will decrease by 1.5 percent this year.

The fourth channel through which politics affects the business environment is social conflict, which has intensified significantly in the first half of the year, especially in relation to extractive activity in southern Peru.

This situation is cause for concern for two main reasons. On one hand, the government has tried to resolve these conflicts with inappropriate incentives. For example, after a number of breaks in the NorPeruano Pipeline in the Peruvian Amazon, the Petroperú state oil company agreed to hire individuals for pipeline maintenance—specifically, members of the community under investigation for damaging that same pipeline. Since this measure was taken, infrastructure sabotage has repeatedly been used to put pressure on the State.

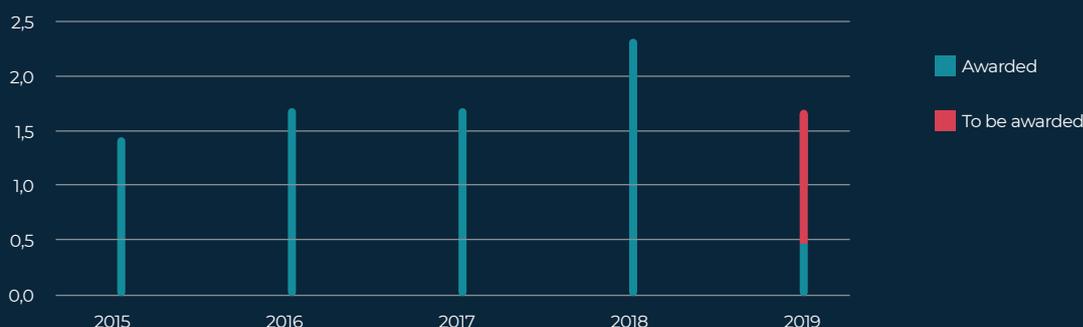
Furthermore, some agreements made in negotiations jeopardize the legal safeguards for investments. For example, one of the deals made after a transport workers' strike in February was that the State would review highway concession contracts all over the country to work out a way to change the method used to calculate tolls.

However, the most troublesome, high-impact cases are seen in the mining sector, where project investments of close to \$13.4 billion are at risk due to the increased conflict. One of the most relevant cases was the blockade of access to Las Bambas mine, carried out by local communities. This mine accounts for 9 percent of Peru's total mining production, representing around 0.8 percent of GDP annually. The road block lasted 68 days, significantly affecting mining production in the first semester.



## PUBLIC WORKS.

TOTAL GRANT AMOUNT<sup>1</sup>. \$ BILLION



Source: Seace

<sup>1</sup> August 1-22, 2019. Only includes projects with investments totaling over \$15 million

Another case is the construction license for the Tia Maria copper project in the Arequipa region, a \$1.4 billion investment. The Ministry of Energy and Mines granted the southern copper company authorization just weeks before the five-year term of its environmental impact study came to an end. The government's decision was met with protests in the project's area of influence, although on a lower scale than previous protests over the same project. However, government talks with the regional and local authorities failed, leading to the temporary suspension of the license for 120 days, until the Mining Council (a technical body attached to the Ministry of Energy and Mines) could settle a number of challenges. Due to Tia Maria's economic importance, as well as the State's legal obligation to grant the license since the Environmental Impact Study was approved, any complications in this process—whether related to the worsening conflict or a not-primarily-technical decision from the Mining Council—will adversely affect general business confidence.

Although social conflict in the country is at a critical point, there are specific long-term strategies companies can implement to manage relations with their areas of influence and reduce business risk. APOYO Consultoría and Ipsos Perú carried out a study to identify the key variables that impact the probability of social conflict, systematizing data from over 15 mining projects over a 10-year period and interviewing over 16,000 people to do so.

The study found that the main determining factor for local areas to have view companies favorably, thus significantly reducing the likelihood of social conflict, was whether their workers were well-regarded in the local communities. This proved to be even more important than the environmental handling of the mining operation.

The coming months will continue to be full of turbulence and risk on the political front. The relationship between the executive branch and Congress will continue to erode after this latest episode of confrontation and high uncertainty. Additionally, in a context of bad incentives and an imminent electoral campaign, social conflict is likely to increase, further hindering the country's governability and progress in private investment.

**“In a context in which politics has overtaken headlines and is generating major uncertainty in the business environment, risks must be identified, measured and carefully monitored”**

Thus, in a context in which politics has overtaken headlines and is generating major uncertainty in the business environment, risks must be identified, measured and carefully monitored. This will allow companies to tackle risks to their businesses, understand their scopes and incorporate them into how they manage their reputations and sustainability. That is, companies must plan ahead in an environment of high volatility, ambiguity and complexity, both in the market and in Peruvian institutions.

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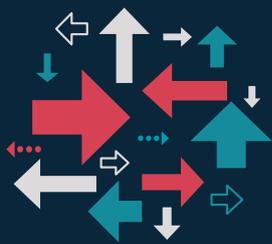
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