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How could the Covid-19 crisis impact the future of natural resource development in Latin America?

NEW RISKS AND OPPORTUNITIES IN AN EVOLVING POLITICAL, ECONOMIC AND SOCIAL LANDSCAPE

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How could political, economic and social fallout from the Covid-19 crisis impact natural resource development in Latin America?

This is one of a series of Critical Resource thought pieces exploring the impacts of the Covid-19 pandemic on the natural resource sector. This piece was informed by conversations with Critical Resource's senior advisory network, which includes the foremost regional experts. Please get in touch if you would like to discuss how these issues affect your business.

Summary of key findings

Latin America is expected to be among the hardest hit of emerging markets and developing economies by the macroeconomic impact of the Covid-19 crisis. An April 2020 report published by the UN Economic Commission for Latin America and the Caribbean (ECLAC) estimated that regional GDP will contract by over 5% in 2020. By comparison, GDP in sub-Saharan Africa and the Middle East and Central Asia region is forecast to contract by 1.6% and 2.8% respectively, while emerging and developing Asia will see 1% growth according to International Monetary Fund (IMF) projections. This will push an additional 30 million people across the ECLAC region into poverty and another 16 million into extreme poverty. The regional unemployment rate will likely hit 12%.

The responses of governments to the socio-economic ramifications of the pandemic have been varied. Mexico's President Andrés Manuel López Obrador (AMLO), an ostensible leftist, has embraced Thatcher-style austerity, eschewing new debt and stimulus spending. In contrast, Peru announced a record $26 billion stimulus package (worth roughly 12% of GDP). But even with aggressive countercyclical moves governments will only be able to mitigate so much of the damage. Debt levels across the region are generally higher than they were before the 2008 financial crisis (with some countries like Ecuador and Argentina in particular trouble), social safety nets are very weak, over half of the region's labour force is employed in the informal economy, and key sources of revenue (for example, oil exports and tourism) have been hit very hard.

Governments' heightened anxiety around their ability to attract investment in the depths of recession may create new opportunities for the natural resource sectors. But project development and operation will likely be complicated by unpredictable political shifts, potential changes to the fiscal and regulatory regime as governments seek to increase their takes, higher local stakeholder expectations, and increasingly dynamic and challenging security contexts. Companies will also likely face operational complications in keep assets running with constraints on movement, disrupted supply chains and social distancing requirements for onsite workforce. Among the specific risks:

- The potential **outcomes of upcoming elections are increasingly difficult to forecast**. Anti-establishment sentiment is high, and the Covid-19 crisis may exacerbate voters' exasperation with rising inequality, insufficient public services and government corruption. If incumbent centre-right governments cannot capitalise on recent increases in approval ratings to turn things around, the region may see a second pink tide or a proliferation of dark-horse candidates (including potentially ultra-right populist candidates) in upcoming elections.

- As governments come under fiscal pressure, **companies may benefit from a political push to attract investment and get projects online**. However, socio-economic fallout from the crisis is likely to strain government's time, resources and political capital and they may struggle to support companies to navigate stakeholder and regulatory challenges. Civil society, local communities and opposition parties may also put incumbents under pressure to extract higher rents from the sector as macroeconomic challenges mount.
- Local governments and communities may be more receptive to the economic benefits of mining and oil and gas projects – but **local expectations of and dependence on companies will be much higher** in the context of a potentially severe economic recession.
- The behaviour of criminal groups across the region is likely to shift as they seek to adjust to new risks and opportunities. This may **expose the sector to higher security risks** in some countries and may also **complicate local stakeholder relationships** in some situations as criminal groups step up to provide socio-economic relief in marginalised areas and build closer links with communities.

As economies fall apart, will the centre right hold its ground in the next wave of elections?

The centre-right governments elected in the mid-2010s were languishing under pressure from irate electorates in late 2019. Now, enjoying considerable boosts in approval ratings, several looked poised for potential comebacks. But if Covid-19 prevents the centre-right's second coming, it is unclear who will capitalise on electorates' discontent – and whether the region will see a second "pink tide" (turn to the left) or a proliferation of populist leaders of varying ideological hues à la Brazil's Bolsonaro or Mexico's AMLO.

- Latin America was racked by mass anti-government protests in 2019 broadly rebuking socio-economic inequality, insufficient public services, and corruption. Like governments across the world, several presidents battered the hardest by protest are now enjoying substantial boosts in approval ratings due to the crisis and the pandemic may resuscitate their political fortunes. In **Chile**, economic fallout from the crisis is likely to make protestors' demands (which include an increase in the minimum wage, constitutional changes, and reforms to the education, healthcare, and pension systems) even more salient in the long term, though a tight lockdown has mostly kept protestors off the streets and relieved some of the immediate pressure on President Sebastian Piñera. His approval rating increased from an all-time low of 9% in November 2019 to 25% in April 2020, an increase that would have been unthinkable in late 2019 when over one million Chileans

> "The pandemic is having severe impacts in Chile. The urgency of the situation has forced the Piñera government and the opposition to leave aside their confrontational attitudes and collaborate – but it remains to be seen whether this new political climate will last beyond the crisis."
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> *José Letelier, Critical Resource advisor*

were protesting for his resignation. While Piñera himself is not eligible for a consecutive term, if he is perceived to have adeptly navigated the country through the pandemic and moves to embrace aspects of the new consensus on constitutional reform, his National Renewal (*Renovación Nacional*, RN) party and the Let's Go Chile (*Chile Vamos*) coalition may succeed in fending off the resurgent leftist parties which were otherwise poised for victory in next year's elections. In **Colombia**, President Ivan Duque's approval rating rose to 52% in April 2020 from 23% in February 2020. The crisis could strengthen his mandate as he enters the second half of his term, providing a boost to his Democratic Centre (*Centro Democrático*) party and its right and centre-right allies in Congress going into 2022 elections (though he is not eligible for a second term).

"Duque has a bump in approval ratings because people recognise the exceptional circumstances. But that does not mean they approve of his government or the direction of the country. People are not satisfied with the economy. They are not satisfied with the peace process or security. They are unhappy about corruption. It will be difficult for Duque to turn things around."

Sergio Guzman, Critical Resource advisor

- Conversely, if the left can seize on anti-incumbent sentiment and present a credible plan to address voters' socio-economic concerns, they could pull another pink tide across the region in the wave of national elections scheduled for 2021 in Ecuador (February), Peru (April), Chile (November), Honduras (November) and Nicaragua (November) and for 2022 in Colombia (May) and Brazil (October). The left does have some advantage. Current governments in many of the aforementioned countries lean right and no incumbent government in Latin America has won a re-election bid in a free and fair election since 2017.
- But many leftist political parties were discredited in the Odebrecht corruption scandal, in which politicians across the region were have revealed to have provided kickbacks to construction conglomerate Odebrecht in exchange for donations. In **Brazil**, the scandal was a major blow to leftist Workers' Party (*Partido dos Trabalhadores*, PT), including former PT president and leftist icon Luiz Inácio Lula da Silva (2003-2011) and his successor Dilma Rousseff (2011-2016). Currently, incumbent right-wing nationalist president Jair Bolsonaro has seen his approval ratings plummet because of his botched handling of the Covid-19 pandemic (Compounding his political difficulties, justice minister Sérgio Moro unexpectedly resigned in late April 2020 and accused the president of inappropriate political interference in police investigations, allegations which have instigated a formal investigation and raised the possibility of impeachment. But right-wing politicians, including São Paulo governor João Doria and Moro himself, currently look mostly likely to benefit from Bolsonaro's missteps in the run-up to 2022, as opposed to the left.
- Moreover, the left is weak and divided in key countries. In **Peru**, left-wing candidate Verónika Mendoza won 19% of the popular vote in the 2016 presidential elections and was just a percentage point away from making it into the runoff. Her party, Broad Front (*Frente Amplio*), picked up 20 seats in congress. However, it split into two camps and lost 11 of its seats in the 2020 elections, and

now faces an uphill battle going into the 2021 elections. In **Colombia**, hard-left candidate Gustavo Petro made it into the runoff against Duque in 2018 presidential elections. However, a split between the hard left (which suffered a number of defeats in October's regional and municipal elections) and several centre-left parties (which performed much better) will hamper the coalition building necessary for success in the run-up to 2021.

- There is a heightened risk of wildcard election outcomes with anti-establishment sentiment high and many party systems significantly weakened and fragmented. This will increase the risk of outsider, anti-establishment candidates taking office, such as in AMLO's victory in **Mexico** and Bolsonaro's win in **Brazil** in 2018. For example, in **Chile** this could see the emergence of a candidate like José Antonio Kast as a main contender in the presidential elections (Kast was a far-right candidate in the 2017 elections, receiving roughly 8% of the vote). Moreover, erratic and unpredictable voting patterns may produce highly fragmented legislatures with little experience governing and no clear mandate, a recently seen in **Peru** (see box 2 below for further details).

Box 1: How will the Covid-19 crisis impact Peru's 2021 elections?

In January 2020 Peru held special legislative elections, triggered in October 2019 when President Martín Vizcarra used a controversial constitutional provision to dissolve congress after it repeatedly obstructed his governing programme. These elections produced a fragmented legislature. Popular Force (*Fuerza Popular*, FP), the main opposition party led by Keiko Fujimori (daughter of former president Alberto Fujimori, currently serving a 25-year sentence for human rights abuses and corruption), lost 58 of 73 seats. No party received more than 11% of the vote and several inexperienced parties won considerable representation. The Agricultural People's Front of Peru (*Frente Popular Agrícola del Perú*, FREPAP) – a fringe Christian fundamentalist party linked to a religious sect – won almost 9% of the vote and took 15 seats, the second-largest share. The extremist Union for Peru (*Unión por el Peru*, UPP) won 13 seats.

Peru will replace this new legislature with a standard 5-year term congress and elect a new president in April 2021. The key issue for the mining sector will be whether the new government has the mandate and political capital to unblock billions of dollars in stalled investment. A centrist government with broad support in the legislature and facing the economic imperative to generate more revenues to deal with fallout from Covid-19 may have the best shot at this.

However, the potential outcomes of 2021 are uncertain and will hinge on what happens politically over the next twelve months. Vizcarra's government won widespread popularity with its aggressive anti-corruption reformist push and has further solidified its support base with an adept response to the pandemic. A late March Ipsos poll put his approval rating at 87%. If the president can advance key political and judicial reforms while maintaining economic stability, the set of centrist parties that broadly support his agenda may stand to benefit in 2021 at the expense of parties like FREPAP and UPP . Notably, Salvador del Solar, briefly Vizcarra's prime minister, has emerged as an early frontrunner in the presidential polls. Former footballer George Forsyth of the centre-right We are Peru (*Somos Peru*) party, currently the mayor of Lima's La Victoria district, is also a possibility.

Governments will be hungry for hard cash – but may lack the political capital to get projects over the line

Governments under fiscal pressure may launch a political push to attract investment and push projects into production and increased support at the highest levels of government is likely to be extremely valuable for the sector. However, this will not necessarily mean smooth sailing for companies. Distracted and over-burdened central governments may struggle to help projects over stakeholder and regulatory hurdles. Moreover, they may also try to squeeze more revenues out of companies and into state coffers as economic malaise sets in.

- Governments are likely to see natural resource projects as important sources of jobs and hard cash as economies contract, unemployment rises, and dollar-dominated debt squeezes public finances. There are early indications they may be motivated to incentivise natural resource investment and push projects ahead. In **Argentina**, the government moved to fix local oil prices at $45 a barrel, close to $30 higher than Brent crude prices, via executive decree in April 2020 to shore up production and investment in Vaca Muerte (though political and economic uncertainty may still deter investors). Companies across the region are likely to benefit from a strong political push to attract investment and develop projects, particularly those that are able to clearly communicate a compelling value proposition to governments in terms of royalty and tax revenues generated, jobs created and contributions to GDP.
- However, governments may have less time and political capital to expend on supporting natural resource projects. In **Colombia**, President Duque, like his predecessors, was struggling to deliver on his commitment to kickstart Colombia's mining sector – including by addressing longstanding challenges related to ASM and community opposition – well before the Covid-19 crisis hit, hamstrung by difficult dynamics in the legislature and anti-government protest. Now, facing a bleak macroeconomic picture and a public health crisis, it looks less likely that his government will have the political capital or bandwidth to bring major developments over the line (for example, AGA's Quebradona project and Minesa's Soto Norte project). Moreover, in a recent discuss about mining, several congressmen made clear that environmental and social requirements cannot be lowered to rush projects into development. In **Argentina**, recently-elected President Alberto Fernández looks unlikely to be able to deliver on his campaign promise to simplify the mining code and revise a controversial glacier protection law any time soon (he is currently wrangling with the country's international creditors to stave off a ninth sovereign debt default).

"Colombia will need to rethink mining, as oil will no longer provide the lion's share of hard currency. But expectations may be unrealistic. Mining will not automatically be streamlined. The timeframe for development has not changed. Social and environmental requirements will not be loosened. Community engagement will be more complex, as needs are greater and reliance on mining revenues higher."

Sergio Guzmán, Critical Resource advisor

- Moreover, natural resource companies may find themselves in the cross hairs of cash-strapped governments' fundraising efforts. In **Brazil**, a bill was introduced in the Senate in April 2020 proposing an increase in the social contribution (CSLL) tax rate from 9% to 29% for mining companies with annual revenues over $1.7 million. The aim of the bill is to increase government cashflow in response to the Covid-19 pandemic. In **Mexico**, AMLO has resisted increasing debt to fund a stimulus package but pressure is mounting on his government to provide more substantial relief to reduce the risk of social and political instability. There are early indications that AMLO – who has had a turbulent and confrontational relationship with Mexico's business leaders – may seek to tap the private sector to increase spending. In this scenario, major miners could find themselves in the spotlight and potentially exposed to more onerous taxes. Coupled with adverse security developments (see below) this would create a significantly more challenging operating environment in the country from a license-to-operate perspective.

Box 2: Economic crisis and the obsolescing bargain in Ecuador's mining sector

Ecuador is in a particularly tenuous fiscal position compared to other countries in the region, sparking concerns of a crisis. Already deeply indebted, it will see oil revenues decline by an estimated US$4.3 billion in 2020 and with a dollarized economy has limited monetary policy tools at its disposal to combat recession. The cash-strapped Moreno administration – which was struggling to make debt payments well before the onset of the Covid-19 crisis – could spend up to one third of its fiscal revenues on debt servicing in 2020 and may struggle even to pay government salaries.

The government and international institutions have moved to stabilise the situation, but it is unclear if this will stave off economic calamity. On 16 April 2020 President Moreno presented two emergency bills to the National Assembly proposing immediate fiscal reforms, including temporary tax hikes and cuts to public sector wages. However, mass anti-government protest in late 2019 were damaging to Moreno and it is unclear if he has the political capital to push reforms though the legislature. The government has negotiated to delay $800 million in interest payments on its foreign debt and the IMF provided $643 million in emergency assistance to support Ecuador's balance of payment needs and bolster key sectors (including healthcare and social protection) but this is likely a fraction of what will ultimately be needed.

Ecuador's precarious economic situation raises concerns for its nascent mining sector – particularly with a national election on the horizon. The business-friendly Moreno administration's commitment to developing the sector and a favourable fiscal and regulatory regime have been key to advancing projects against a backdrop of mounting opposition from indigenous groups and some local communities. Changes in the national political landscape, such a shift back to left-wing populism in 2021, just as a major projects like Mirador and Lundin's Fruta del Norte enter commercial production would pose major risks to their sponsors and could deter future investment, particularly if the new government seeks to undo the favourable fiscal reforms and tap mines for additional revenue in the ongoing financial crunch.

Companies will not be able to buy community support – even in a major downturn

Natural resource projects in Latin America continue to face high levels of stakeholder opposition. Previous experience suggests that a greater need for jobs and investment may not necessarily ameliorate local conflict. Moreover, a deteriorating economic context is likely to raise stakeholders' expectations of or dependence on companies, increasing license-to-operate risks.

- Economic difficulties and the need for jobs and investment may make communities more receptive to mining and oil and gas projects. Companies with a compelling proposal around local social and economic benefits – including in relation to direct employment, supply chain development, voluntary social investment, infrastructure development and impact compensation payments – may find more success engaging with local stakeholders and winning support.
- However, GDP contraction and recession have not historically corresponded to increased community and local government support for natural resource projects in Latin America. Conversely, it has often exacerbated social opposition to investment and agitated conflict between pro-investment governments and local communities. In **Peru**, President Alan García's reforms to increase foreign investment in the natural resource sector in the aftermath of the 2008 financial crisis (which saw Peru's GDP growth decline from 9.8% in 2008 to 0.8% in 2009) were met with widespread opposition from indigenous groups, local communities and civil society, which ultimately forced the repeal of several legislative decrees, stalled investments and in several instances produced violent, high-profile clashes between public security forces and protestors. In **Ecuador**, President Rafael Correa's push to attract mining investment in his first term (2007-2012) was met with intense civil society and indigenous opposition, even though he sought to impose a harsh fiscal regime on miners to fund social projects, including advanced pre-production royalty payments.

> "In Ecuador, this emergency could help the mining industry be acknowledged as a leader in sustainable development. Mining will become an essential contributor that the country needs in the face of economic upheaval. The challenge is the stability of pro-mining policies started and applied by different political coalitions."
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> *Jerónimo Carcelén, Critical Resource advisor*

- Moreover, fallout from the crisis is likely to amplify local economic expectations of companies, particularly around employment and delivery of public services. In remote, rural areas economic meltdown will set back the development trajectory. As public services come under significant strain and national governments struggle to provide adequate social protection programmes to the economically vulnerable, local governments and communities may expect the private sector to step up to fill the void. With a collapse in other economic activity and higher rates of unemployment and poverty, companies are likely to see a resurgence in unhealthy levels of local economic dependence on projects. Companies will need to be attuned to the type of support that communities need to remain viable and ensure social investment programmes are reoriented accordingly.

Security dynamics will evolve as criminal groups shift their behaviour to make up for disruptions to key revenue streams

The Covid-19 crisis has disrupted criminal groups' core business activities and as they seek new revenue streams large-scale mining may be exposed to new security risks. Moreover, in many countries, notably Mexico and Colombia, criminal groups have stepped up to provide local crisis relief, weakening the state's already tenuous authority in remote communities.

- Changes to the regional security situation are likely to create new risks for companies. Criminal groups' drug revenues have been hit, as with global trade flows disrupted it has become much harder to move product to markets in North America and Europe. Kidnapping ransoms and extortion revenues are down due to low levels of day-to-day travel and commercial activity. In **Mexico**, there are indications that cartels may be targeting the mining sector to compensate for lost revenue. For example, unlike in states such as Guerrero (where there has been sustained cartel targeting of mines and their workforce), cartels in Sonora have previously avoided targeting mining companies. However, in late March, armed men stole two armoured trucks transporting gold and silver from Fresnillo's La Herradura mine in Sonora. In early April, an armed group stole an unspecified number of doré bars from Alamos Gold's Los Mulatos mine, also in Sonora, before fleeing the scene in a light aircraft. AMLO has struggled to get the security situation under the control since taking office, despite repeated promises to do so on the campaign trail.
- Across the region, criminal groups are using the crisis to expand their support bases and increase control, with several groups reportedly setting up informal welfare schemes and distributing food packages to the poor. In **Mexico**, Alejandrina Guzmán (the daughter of the now-jailed Sinaloa drug kingpin Joaquín Guzmán, also known as El Chapo) was seen handing out "Chapo Packages" comprised of toilet paper, canned goods, beans and rice in a video posted to Facebook in April 2020. Following campaigns of territorial expansion in 2019, on-the-ground sources reported that illegal armed groups in **Colombia**, including FARC dissident groups, the ELN and the Clan del Golfo, are leveraging the Covid-19 crisis to consolidate their social control. This is likely to complicate the stakeholder environment for mining companies in the longer term, as stronger links between local communities and criminal groups will make it more challenging for companies to limit their influence, for example in relation to supply chains or social investment funds.
- Illegal gold mining remains an important source of revenue for criminal groups in Latin America and looks likely to increase in importance as the price trends upward. In **Venezuela**, Nicolás Maduro's government continues to collaborate with criminal groups to illegally mine, process and export gold, using state-owned enterprises to source gold from illicit mines controlled by criminal golds and sell it internationally. By some estimates, this operation yields $1.5 billion for Maduro and those in his inner circle. In **Colombia**, a high price environment may drive an uptick in illegal mining, especially if drug trafficking, kidnapping and extortion revenues continue to take a hit. Moreover, the higher the gold price goes, the harder it will be to control artisanal and small-scale mining (ASM) activity across the region.