

Economic

Credit Ratings:

Moody's: B2
S&P: BB-
Fitch: B+

Nominal GDP (2009):

USD 356 bn

Population (2009):

28.2 mn

Total Trade / GDP:

28%

Currency:

Bolivar Fuerte

Exchange regime:

Fixed. Two tiers:

- ✓ Essential goods VEF 2.60/USD
- ✓ Non-essential goods VEF 4.3/USD

Merchandise Imports from Canada (2009):

CAD 659 mn

Main sources of Foreign Exchange (excl. FDI):

Petroleum exports

Largest Merchandise Trading Partner:

United States
Colombia

Main imports:

Consumer goods
Intermediate goods

Risks to the Outlook:

Upside risks: Reduction in fiscal spending and imports

Downside risks: Low oil prices

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Market Spotlight: Venezuela devalued its currency and created a two tier exchange rate. ■ GDP contracted 3.3% y/y in 2009. ■ Oil output is trending down and PDVSA's production capacity constraints remain a concern going forward. ■ Eleven banks have been nationalized/intervened by the government so far.

Real Economy: Driven down by export receipts and domestic private demand, and after decreasing 5.3% y/y in 2009 Q4, GDP contracted 3.3% y/y in 2009 as a whole. This was the first annual contraction since 2003. On the back of higher fiscal spending, GDP is expected to rebound by 1.6% in 2010 and 3.5% in 2011. We expect inflation will increase (inflation was 27% y/y in February 2010) and we anticipate the government will step up its efforts to control price hikes and supply shortages.

External: Venezuela has devalued its currency and has created a two tiered-exchange rate regime (VEF 2.6/USD for essential imports and VEF4.3/USD for non-essential imports). Foreign exchange will be administered through CADIVI at both exchange rates. The parallel market rate is still in place and the value of the Bolivar traded in this market has recently hit a six-month low. This is a problem for importers that cannot access USD through CADIVI. CADIVI has finally begun giving approvals for USD payments after a six weeks halt following the devaluation.

The devaluation is not expected to dramatically discourage import growth going forward, thus improvements in the trade balance will mostly have to come from an increase in non-oil sector exports. This analysis assumes of course that the government will supply enough USD at the VEF4.3/USD official rate.

Monetary: As a result of the last banks' nationalizations, public banks now account for an estimated 28% of total deposits. Nevertheless, we believe that in the absence of massive bank nationalization, the government's latest actions should not affect FONGADE's (Deposit Guarantee Fund) accounts significantly or, by themselves, dent the sovereign's solvency situation over the short term.

Fiscal: *Short-term:* The new two-tier exchange rate will help shrink the fiscal deficit from an estimated 6% of GDP at VEF2.15/USD to around 3% of GDP this year by increasing government revenues (when measured in local currency) and by fostering the government's net creditor position. In addition, the need to issue debt to close the gap between the parallel market rate and the official rate, as well as to finance fiscal spending will decrease over the short run. *Medium-long term:* Without structural changes in the economy, continued high fiscal spending will accelerate inflationary pressures and will likely prompt the government to devalue the currency again within the next 5 years.

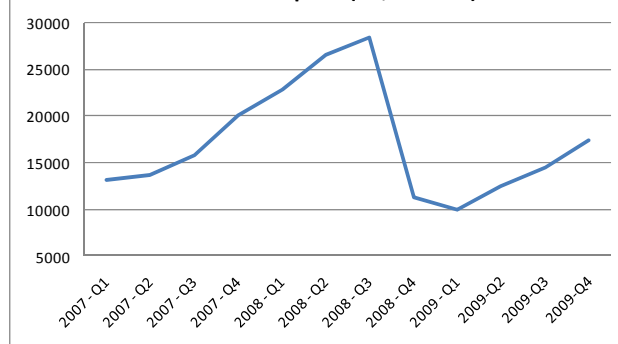
Outlook: Although the devaluation is deemed to be a positive development for the short-term cash position of the government, we do not expect it will cause a significant improvement in the sovereign's solvency situation over the MLT. Key ratios will improve temporarily but as inflation catches up they will likely come back to previous levels. Policy unpredictability will continue to adversely affect private investment and foreign investment in the country. Over the MLT, the sustainability of Chavez's economic model is still under question.

Economic Indicators

| | 04-08 avg. | 2009 | 2010 | 2011 |
|-----------------------------------|------------|-------|------|------|
| GDP (% growth, real) | 10.2 | -3.3 | 1.6 | 3.5 |
| Inflation (%chg, pa avg.) | 19.9 | 27.1 | 35.0 | 40.0 |
| Fiscal Balance (% of GDP) | 0.3 | -6.1 | -2.6 | -3.5 |
| Exports (% comp. annual growth) | 28.4 | -35.9 | 5.3 | 7.0 |
| Imports (% comp. annual growth) | 36.4 | -22.2 | -7.0 | -8.0 |
| Current Account (% of GDP) | 13.0 | 3.5 | 7.0 | 8.8 |
| Reserves (months of curr. debits) | 6.7 | 5.8 | 3.6 | 6.7 |
| External Debt (% of GDP) | 24.8 | 13.7 | 23.0 | 22.1 |
| Debt Service Ratio (due) | 10.8 | 9.8 | 14.4 | 14.6 |
| Exchange Rate (to USD; eoy) | 2.1 | 2.2 | 4.3 | 4.3 |

Source: EIU, EDC Economics

Petroleum exports (SA, Mn USD)



Source: HAVER Analytics

Political Environment

After leading a failed military coup in 1992, current President Hugo Chávez was elected in 1998, 2000, and December 2006. Chávez has significantly increased the government's control by rewriting the constitution and hugely expanding the powers of the executive over the legislature, the judiciary, the military, the Central Bank and the domestic economy. His authoritarian tendencies stirred large-scale anti-government unrest including a 63-day strike and a coup that removed him from power for 48 hours in 2002, and a recall referendum in 2004 that put his position under siege.

Chávez has proven resilient to these threats. After a decisive win in the 2004 recall referendum, his political party and allies took 100% of the seats in the National Assembly in 2005, in part due to an opposition boycott. Chávez interpreted these victories as a vote of confidence propelling him to perpetuate his policy course, including advancing his Bolivarian Revolution that features increased social programs and greater state control. Chávez's policies have created a high risk environment for private investors and concerns about economic stability over the medium to long term.

In the December 2006 presidential elections, Chávez prevailed with 63% of the vote due to his sustained popularity and high degree of influence, and despite the fact that most opposition groups had united behind presidential candidate Manuel Rosales. Chávez's PSUV had a strong showing in state and municipal elections in November 2008, although the opposition made important gains. In early 2009, Venezuelans voted to abolish term limits; Chavez can now stand for election indefinitely.

Chávez's anti-American rhetoric continues and he nurtures new allies both within South America and abroad. In addition to his strong ties with Cuba's former President Fidel Castro, Chávez is strengthening ties with other leftist South American leaders. A new virtual currency for trade between ALBA members, the *sucre*, is intended to deepen economic ties and boost the political sustainability of his ALBA concept. He is also building relationships with countries in Central America and the Caribbean through Petrocaribe, a scheme of long-term low-interest rate financing to purchase Venezuelan oil. Beyond Latin America, Chávez has developed alliances with Russia, Spain, China and Iran with the goal of expanding his network of allies, diversifying the country's oil markets and acquiring new military equipment.

Investment Environment

The business climate is turbulent and the Chávez administration has been openly hostile towards private capital and foreign direct investment. Chávez's willingness to expropriate businesses and breach contracts is a significant worry for both domestic and foreign-owned businesses. Investors in the oil and gas sector are forced to incorporate higher taxes and royalties and enter into joint-venture structures with the state-owned oil & gas company, PDVSA. In April 2008, the government also announced the imposition of a new windfall tax on oil company profits. Private business is under constant threat, and other sectors impacted by expropriation are petrochemicals, oil services, cement, telecommunications, steel, media and food.

Currency controls were introduced in 2003, administered by the Foreign Exchange Administration Commission (CADIVI). The most recent updates to the system are being implemented after the January 2010 devaluation of Venezuela's currency. Two official exchange rates are now applied to payments through CADIVI depending on how goods are categorized by the government. CADIVI-related delays can be significant, and delays are now worse given almost a month passed between ending the old regime and beginning with the new system.

The judicial system has problems with corruption and is subject to political interference. Crime rates are accelerating, and as a result personal security is a concern. Canada and Venezuela signed a Foreign Investment Promotion and Protection Agreement (FIPA) and a double-taxation agreement, although in practice the FIPA has not offered much protection.

Political Violence

Fears of major street demonstrations in the context of the presidential elections proved unfounded, but large protests are emerging more often to express dissatisfaction with government policies.

Occasional incursions by Colombian guerrillas do not pose a broad security threat to the state. Chavez's bellicosity towards Colombia belies the immense superiority of Colombia's military.

Political

Political Structure
Federal Republic

President
Hugo Chávez

Vice President
Elias Jaua

Legislative Body
National Assembly – 167 members

Major Parties
Chavez's alliance:
• Movimiento Quinta República (MVR) – 114 seats
• Other allies – 53 seats

Opposition: **boycott**
• Democratic Action (AD)
• Primero Justicia (PJ)

Last Elections
Legislative: December 2005
Presidential: December 2006

Next Elections
Legislative: September 2010
Presidential: December 2012

Press Freedom Survey:
• 2009 Score: 73 Not Free
(0: Free; 100: Not Free)
freedomhouse.org

Control of Corruption Index:
• 2008 Score: -1.13
(-2.5: Worst; +2.5: Best)
worldbank.org

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Political Outlook

Opposition inroads in elections in late 2008 are counterbalanced by Chávez's victory the February 2009 referendum abolishing term limits. Chávez is now even more likely to stymie opposition efforts to be an effective check on his power and he will probably win the September legislative elections. The lack of basic infrastructure, including water and electricity rationing, could lead to widespread unrest that pits Chavez against Chavistas. In spite of financial difficulties, Chávez is determined to maintain a strong focus on social programs.