

Economic

Credit Ratings:

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

Nominal GDP (2009):

USD 325.4 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

Veronica Lares
vlares@edc.ca

MARKET SPOTLIGHT: Venezuela devalued its currency and created a two tier exchange rate. Although short-term domestic currency liquidity will increase, external public solvency indicators are not expected to improve ■ GDP contracted 5.6% y/y in Q1 2010. ■ Electricity shortages are causing very significant losses for private sector companies. ■ The government has introduced new restrictions to FX access.

Real Economy: Driven down by export receipts and domestic private demand, and after decreasing 5.3% y/y in 2009 Q4, GDP contracted 5.6% y/y in 2010 Q1. The Venezuelan economy is clearly in recession. Fiscal spending will not be enough to offset the slowdown in the rest of the economy this year, so that GDP is expected contract 3.5% in 2010 and grow a timid 0.6% in 2011. We expect inflation will continue to increase (32% y/y May) despite government's efforts to control price hikes and supply shortages.

External: Venezuela 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) last January. Foreign exchange will be administered through CADIVI at both exchange rates. In addition, the governments has issued a new Law that declares the parallel (bond) exchange rate market illegal and implemented a new currency band (VEF 4.2/USD and VEF 5.4/USD) for FX exchanged by the Central Bank. EDC Economics anticipates the measure will limit access to FX even further, act as an incentive to reduce imports, create new speculative opportunities and a bigger black market for USDs trading, worsen supply shortages, increase inflation, exacerbate distortive pressures on the economy and continue to damage both the health of the private sector and the business environment. On the upside, according to the government, the Central Bank will use USD 1bn in international reserves to bring up to 80% of total CADIVI pending USD demand up to date.

Monetary: The Central Bank law has been modified for the second time in six months. The latest modification aims to allow the government to access international reserves to finance priority projects. The first modification of the law was aimed to allow the Central Bank to buy PDVSA bonds. In the absence of massive bank nationalization, the government's actions to date should not affect FONGADE's (Deposit Guarantee Fund) accounts significantly or, by themselves, dent the sovereign's solvency situation over the short term.

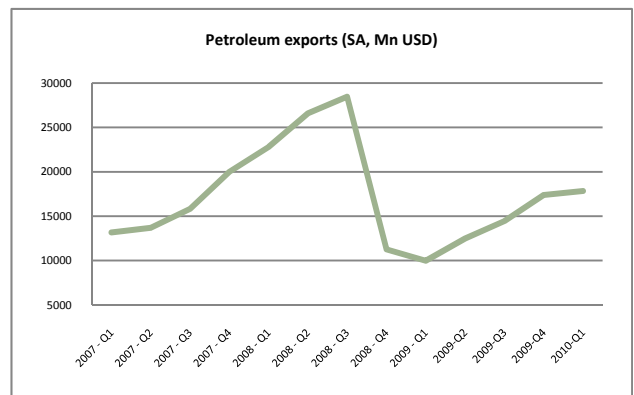
Fiscal: Short-term: The new two-tier exchange rate will help shrink the fiscal deficit from an estimated 6% of GDP at VEF2.15/USD to around 3% of GDP this year by increasing government revenues (when measured in local currency). Nevertheless, new actions to eliminate the parallel market will exacerbate inflationary pressures in the economy and eroding real income. **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 2 years. External public solvency indicators are not expected to improve.

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. The recently introduced measures to restrict access to FX access will mean new payment delays from Venezuelan buyers. We do not rule out a potential devaluation could take place over the next year.

Economic Indicators

	04-08 avg.	2009	2010	2011
GDP (% growth, real)	10.2	-3.3	-3.5	0.6
Inflation (%chg, pa avg.)	19.9	27.1	37.0	42.0
Fiscal Balance (% of GDP)	0.3	-6.2	-3.2	-3.9
Exports (% comp. annual growth)	28.4	-39.5	4.7	-9.4
Imports (% comp. annual growth)	36.4	-22.3	-6.7	-1.3
Current Account (% of GDP)	13.1	2.6	5.9	3.4
Reserves (months of curr. debits)	6.7	5.9	3.7	3.2
External Debt (% of GDP)	25.1	15.5	26.9	27.3
Debt Service Ratio (due)	10.8	10.6	15.8	14.8
Exchange Rate (to USD; eoy)	2.1	2.2	4.3	5.5

Source: EIU, EDC Economics



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:
26 September 2010
Presidential: December 2012

Press Freedom Survey:

- 2010 Score: 75 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

Barbara Grinfeld
bgrinfeld@edc.ca

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). Updates to the system implemented after the January 2010 devaluation of Venezuela's currency included instituting two official exchange rates for payments through CADIVI depending on how goods are categorized by the government. In May 2010 the government again tightened access to foreign exchange, and so more CADIVI-related delays are likely.

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. Dissatisfaction with the economy could produce protests leading up to the September elections.

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 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. Mismanagement of the economy, food shortages, and the lack of basic infrastructure, including water and electricity rationing, could lead to an increase in dissatisfaction that will manifest via widespread unrest that pits Chavez against Chavistas. In spite of financial difficulties, Chávez is determined to maintain a strong focus on social programs.