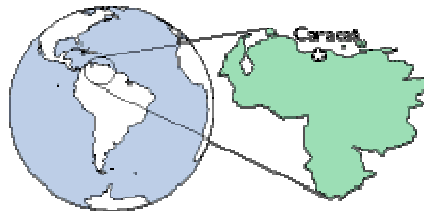


COUNTRY REVIEW

Venezuela



September 2010

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EULER HERMES COUNTRY RISK GRADE: D

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Large petroleum reserves
- Moderate external debt levels

Weaknesses

- Deeply divided political system
- High dependence on oil, with corresponding vulnerability to external shocks
- A radical populist policy programme
- Rapid growth of public expenditure
- High inflation and monetary policy that relies on a multiple exchange rate system and FX controls
- Weak Structural Business Environment

Country Risk Assessment

| Ratings | Venezuela | | Median Grade D | Peers | | |
|---------------------------------|------------|------------|-------------------|------------|------------|-----------|
| | Latest | Previous | | Colombia | Jamaica | Kenya |
| Systemic Political Risk: | P3- | P3- | P3- | P2- | P2- | P4 |
| Systemic Economic Risk: | E6 | E6 | E6 | E4 | E6 | E5 |
| ME rating: | ME6 | ME5 | ME6 | ME4 | ME6 | ME5 |
| <i>Structure</i> | 5.7 | 5.7 | 6.0 | 4.0 | 5.7 | 6.0 |
| <i>Policy</i> | 6.0 | 6.0 | 5.6 | 4.3 | 6.0 | 6.0 |
| <i>Solvency</i> | 1.7 | 1.7 | 4.3 | 3.5 | 5.6 | 2.8 |
| <i>External Liquidity</i> | 5.2 | 4.3 | 4.3 | 2.2 | 4.3 | 4.8 |
| SBE rating: | SBE6 | SBE6 | SBE6 | SBE3 | SBE4 | SBE5 |
| COUNTRY GRADE: | D | D | D | B | D | D |

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

| Country Profile | |
|------------------------|--|
| Capital city: | Caacas |
| Population: | 28.58 mn (2009) |
| GDP: | USD 326129 mn (2009) |
| Currency: | Bolivar (VEB) |
| Form of state: | Federal Republic |
| Head of government: | President Hugo Chavez |
| Next elections: | 2012 December Presidential, 2010 September Legislative |

| Major Industries (% of GDP 2009) | Global Assumptions | 2010 | 2011 | |
|---|---------------------------|---------------------------|------|-----|
| Petroleum | 12.3% | Real GDP grth (% yr/yr) * | 3.3 | 2.9 |
| Mining | 0.6% | Inflation (% av) * | 1.2 | 1.4 |
| Manufacturing | 16.4% | Dated Brent (USD/b) | 75 | 70 |
| Utilities | 2.5% | * World | | |
| Construction | 7.4% | | | |
| Services | 60.8% | | | |

| Main Exports (% of total, 2009) | Main Imports (% of total, 2009) | | |
|--|--|--------------------|-------|
| Petroleum | 94.1% | Consumer goods | 22.6% |
| Non-petroleum | 5.9% | Intermediate goods | 52.9% |
| | | Capital goods | 24.5% |

Basic indicators

| Selected economic indicators | 2007 | 2008 | 2009 | 2010f | 2011f |
|---|---------|---------|---------|---------|---------|
| Nominal GDP (USD mn) | 226,549 | 311,132 | 326,129 | 353,349 | 475,550 |
| Population (mn) | 27.66 | 28.12 | 28.58 | 29.04 | 29.50 |
| GDP per capita (USD) | 8,190 | 11,064 | 11,411 | 12,168 | 16,120 |
| Real GDP growth (% yr/yr) | 8.2 | 4.8 | -3.3 | -2.8 | -2.3 |
| Inflation (% eop) | 22.5 | 30.9 | 25.1 | 33.0 | 38.0 |
| Fiscal balance (% of GDP) | 3.0 | -1.2 | -5.1 | -1.7 | -3.5 |
| Current account balance (% of GDP) | 8.0 | 12.0 | 2.6 | 4.5 | 3.1 |
| External debt/GDP (%) | 24 | 16 | 20 | 17 | 13 |
| External debt/Exports of goods & services (%) | 75 | 50 | 106 | 93 | 93 |
| Interest payments/Exports of goods & services (%) | 4 | 3 | 5 | 6 | 6 |
| Foreign exchange reserves (USD mn) | 24,196 | 33,098 | 21,703 | 13,100 | 18,000 |
| Import cover (months) | 6.1 | 7.7 | 6.4 | 4.0 | 4.0 |
| Exchange rate assumption: | 2.15 | 2.15 | 2.15 | 2.59 | 2.59 |
| f: CRU central forecast | | | | | |

Sources: National, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Widespread public disenchantment with the political establishment culminated in the election of President Hugo Chavez in 1998 on a radical populist programme of income re-distribution via increased state intervention, aimed principally at marginalised elements of society (the “Bolivarian Revolution” or “21st Century Socialism”). Chavez was re-elected comfortably in 2002 and by a landslide in 2006. Yet the president is a deeply divisive figure and there were several failed attempts to unseat him, including a recall referendum, a military coup, a general strike and mass street demonstrations, though the net effect was consolidation of his control of the military, PdVSA (the state oil company) and his core popular support.

In December 2007 Chavez suffered his first electoral defeat when a national referendum narrowly rejected proposed constitutional reforms, including the end of presidential term limits, direct appointment of regional officers and suspension of “due process” in a state of emergency. The referendum defeat was followed by opposition gains—five of the more populous states and Caracas—in local and regional elections in November 2008. However, another referendum held on 15 February 2009, this time only on the abolition of term limits—permitting Chavez and other elected officials to remain in office indefinitely—was approved by 54% of the vote. This re-established the president’s mandate, but it was tested again in the September 2010 legislative elections, in which the main opposition—united under one umbrella grouping—made significant gains (having boycotted the 2005 elections) leaving Chavez’ PSUV with a majority but less than the two-thirds necessary for major reforms. The new congress, however, does not convene until January, leaving some time for new legislation. Despite the gains the opposition looks to be facing a long haul and it remains to be seen how effective its challenge will be in the 2012 presidential elections. The government retains extensive control over political institutions and the media and has considerable ability to maintain grassroots support. The opposition may also need to find a charismatic leader to rival Chavez, before then. Nonetheless, poor economic performance, including high inflation and rising crime is likely to continue to undermine Chavez’ popularity.

Policies are geared towards achieving “21st century socialism”. These have included:

- Greater state control over strategic sectors, including politicisation of PdVSA, the unilateral imposition of new contracts with the oil majors in the Orinoco Basin and re-nationalisation of various companies.
- Increased social spending, particularly on education and health—both provided free for the poor through the Misiones de Bolivarianos—and heavily subsidised basic foodstuffs distributed through an extensive government network (MERCAL)
- A cap on central bank FX reserves with the surplus going into to an off-budget National Development Fund (FONDEN) to be used for public programmes
- Land reform, with high profile takeovers of foreign owned estates.

However, the boundaries of 21st century socialism remain unclear. Experience of other countries with total state control of production, among them Cuba, should ensure the continuation of a private sector in some form, but it is likely to be heavily circumscribed, subject to creeping intervention in good times and vulnerable to gesture nationalisation in bad.

President Chavez’ has adopted a high profile anti-US stance, aligning with governments to which the US is hostile, including Cuba. However, the importance of bi-lateral trade (50% of exports go to the US) creates a mutual dependency that will probably ensure that both sides stop short of a complete breakdown in relations. The Chavez administration has also sought to rival the US in the region, supporting Cuba and other radical-left governments, Argentina and the Caribbean through PetroCaribe. Relations with Colombia will remain tense. Venezuela is also a member of Mercosur.

Economic Stability

Petroleum accounts for almost 95% of exports and 50% of government revenues (in good years, 30-35% in bad). Economic performance is thus closely linked to the oil price cycle, which in practice has usually meant boom and bust cycles owing to weak economic policies of governments of whatever hue. Annual average growth of real per capita GDP was 2.1% in the past ten years. Per capita GDP was an estimated USD11,411 in 2009.

Annual average growth of real GDP was 11.8% in 2004-07 as high oil prices facilitated a public spending-led boom which was accompanied by loose monetary policy behind exchange controls, notwithstanding declining output in the petroleum sector in 2005-2007. Growth slowed in 2008 to an

estimated 4.8% and contracted by 3.3 % in 2009, as oil prices fell sharply in late 2008 and early 2009 before rising and then stabilising—though well below the 2008 peak—power shortages hit output generally, inflation remained high, eroding purchasing power, investment was hit by the uncertain business environment and public expenditure was reined in. The pace of contraction has slowed in 2010 and in Q2 2010 for the first time in several quarters real GDP grew on a qtr/qtr basis, but overall in 2010, growth is likely to contract, with a similar tendency in 2011. Future economic growth will be limited by the politicisation of PDVSA, constraints on foreign participation in the oil and other sectors and other political intervention which is likely to dampen investment.

The fiscal balance (central government) swung into deficit of 5.1% of GDP in 2009, as revenues declined sharply as a proportion of GDP and expenditure, though constrained, continued to increase as a proportion of GDP. In 2010 the deficit should narrow to less than 2% of GDP as revenues improve under the combined effect of exchange rate devaluation (which largely serves to boost fiscal revenues) and higher average oil prices, though expenditure will probably increase again with legislative elections in September. The deficit can be expected to widen to around 3.5% of GDP in 2011 unless oil prices rise unexpectedly. The official deficit is not the whole story in any event as there is substantial off-budget spending, though data is not available. For example, in 2010 the government has transferred USD7bn funds from the FX reserves to the off-budget FONDEN to be used to stimulate the economy. The government and PDVSA is issuing dollar denominated debt and will continue to do so as bond issuance is a means of providing foreign exchange (bonds can be purchased in local currency and sold in USD) under the new exchange rate system, which may avoid another devaluation in the immediate future. However, the public debt-GDP ratio is beginning to rise as a result—depending on which exchange rate is used, it may already be over 30%—and without a major re-direction of policy, further devaluations, scarcity of foreign exchange and rapid inflation are likely. The fiscal balance may also be affected by various bail-outs of state owned companies.

Real interest rates remain negative, but formerly rapid credit expansion rapid moderated sharply as FX reserve accumulation slowed. Nonetheless, and despite price controls and subsidies on key commodities, which in fact have created shortages, inflation has remained high. Although it edged down to 25.1% yr/yr at end-2009 and 24.3% yr/yr at end-January 2010 it has since accelerated (30.5% yr/yr in July) and will be in the mid- to high-30s in 2010-11 without major adjustment of monetary and fiscal policies. The exchange rate was devalued in early 2010 and a three-tier rate has since been established. FX controls remain in place.

The current account surplus fell to 2.6% of GDP in 2009 as oil exports dropped and were not fully matched by the fall in imports. Based on our central oil price case we expect a surplus of 4.5% of GDP in 2010 and 3.1% in 2011. FDI flows remain low (negative in 2009) and will probably remain so as uncertainty over the business climate persists. ST debt and MT debt amortizations in 2010 and 2011 are larger than current FX reserves, but the projected current account surplus plus net FDI, less ST debt and MT amortisations are more than fully covered by FX reserves in both years. Foreign exchange controls should continue to suppress, though not eliminate, capital flight, but in any event any tightening of external liquidity will met by tighter controls on imports/access to foreign currency.

Import controls which effectively ration/prioritise the use of FX controls are likely to remain in place and devaluation also remains a threat. The economy is also likely to contract further. Both the fiscal and external balance positions remain highly sensitive to oil prices.

Structural Business Environment

The Structural Business Environment is weak in our assessment, with a ranking of 184 out of 210. Based on data and definitions from the World Bank's 2010 Doing Business Survey, Dealing with Construction Permits and Registering Property were weaker areas, ranking below average and Starting a Business, Employing Workers, Getting Credit, Protecting Investors, Paying Taxes, Trading Across Borders and Closing a Business were particularly weak. The World Bank Institute's Governance Research Indicator puts Regulatory Quality, Control of Corruption and Rule of Law all well below the average for the Latin American Region and the upper middle income group of economies. Transparency International's Corruption Perception Index, 2009, assigns Venezuela a score of 1.9—on a scale of 1 (bad) to 10 (good)—and a ranking of 162= out of 180 (the same as Angola, Congo Democratic Republic, Kyrgyzstan, among others). As a broad measure of the pro-business environment The Heritage Foundation's 2010 Index of Economic Freedom ranks Colombia 174 out of 179.

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Charts

