VENEZUELA

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Short term political risk:
Venezuela: 5 / 7
Brazil: 2 / 7
Colombia: 1 / 7

Executive summary

- **Since 1999, Hugo Chavez has dominated the political scene but his re-election in October 2012 should not be taken for granted;**
- **Economy is increasingly reliant on oil revenues and growth prospects remain sluggish amid high inflation as well as energy and input shortages;**
- **Tight exchange controls are not sufficient to control capital flight. As a result, foreign exchange reserves are depleting despite positive current account balance. As a consequence, the government is likely to devaluate the Bolivar, the domestic currency, in 2013;**
- **Endemic corruption and arbitrary state interventions characterize the business climate;**
- **High MLT political risk still mitigated by moderate level of external debt and extensive oil reserves.**

Country risk assessment

President Chavez' re-election not for granted

President Hugo Chavez took power in 1999 and gradually concentrated the power in his hands by amending the constitution, controlling the armed forces and the judiciary and interfering into the economy. Hugo Chavez has gradually taken steps to transform the Venezuelan economy to match his vision of "21st-century socialism", meaning that he has increased government intervention in the economy, eroded private property rights and nationalized companies in various sectors (oil, steel, telecom, electricity, financial, food and construction sectors).

The 7 October 2012 presidential election will pit Chavez against Henrique Capriles. In contrast with the past elections, Chavez should not take re-election for granted. After all, the heterogeneous opposition is now united and presents a single candidate, Mr Capriles, the 39-year old former governor of the most populous state, Miranda. He represents a real challenge to Hugo Chavez in view of the good opposition results in the 2010 legislative election. In addition, dissatisfaction caused by insecurity, high inflation as well as energy and food shortages is likely to further boost support for the opposition candidate. Moreover, President Chavez underwent treatment for cancer - the exact nature and the extent of his illness have not been made public – in June 2011 and February 2012. He claimed to have recovered fully, yet doubt remains whether he will be fit for a third term. Hence, if Mr Chavez wins the election, uncertainties surrounding his succession will remain high as nobody inside his party is likely to replace him due to internal division within the ruling party (PSUV) between moderate socialism and Cuban-style socialism.

If the opposition wins the election, it is uncertain whether Hugo Chavez will accept defeat. Henrique Capriles Radonski pledges to continue most of the popular social programs, but to end their politicisation. He is expected to reform the state, correct fiscal imbalances, dismantle price and exchange controls and adopt a more pro-business approach. His task will be extremely difficult as the national assembly is dominated by Chavista as well as most of the state institutions. After all, in most of the state institutions including the judiciary, the central bank, PdVSA, the state-owned oil company, and the army, technical ability is a secondary consideration, the most important hiring criterion is loyalty to the Bolivarian revolution. In this context, it is unclear how the military would react, so that a military coup cannot be excluded, with some army officials having already announced that they will not allow another candidate than Chavez to win the election.

Foreign policy is characterized by anti-Americanism, even if both countries have so far been pragmatic when it comes to business, particularly with regard to the supply of Venezuelan oil to the US. Nevertheless, to offset global US dominance and to create a multi-polar world, Chavez has deliberately increased relations with so-called pariah nations such as Libya, Syria and Iran, a strategy which has, of course, not been well received by the United States.

MLT political risk:
Venezuela: 6 /7
Brazil: 3 / 7
Colombia: 4 /7

Venezuela joined the Mercosur trade bloc in July 2012, which was a diplomatic and political victory for Chavez. Since 2006 the country has sought to join Mercosur but, despite the approval of the parliaments of Argentina, Brazil and Uruguay, the entry of Venezuela was blocked by the Paraguayan senate.

2012: marked by strong growth before presidential election

GDP expanded by 4.2% in 2011, after contracting by 3.2% in 2009 and 1.5% in 2010. GDP growth is likely to reach 4.7% in 2012 on the back of fiscal and quasi fiscal spending ahead of the presidential election and the high oil price. Growth will be disappointing in 2013 as it is still hamstrung by exchange and price controls, energy and input shortages, endemic corruption and arbitrary state interventions. If Mr Capriles wins the presidential election, he will not be able to reform the economy in the short run given high politicisation of all state institutions and his lack of a majority in the legislative assembly.

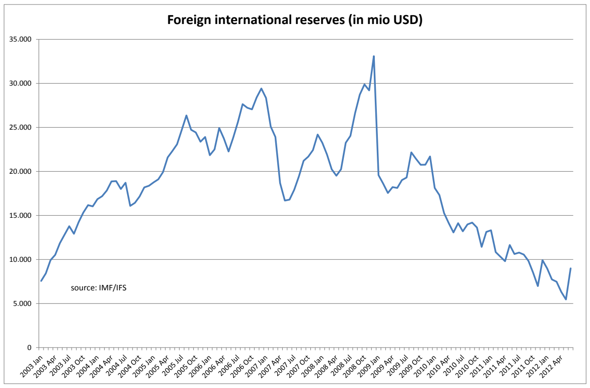
Commercial risk (A to C):
Venezuela: C
Brazil: C
Colombia: B

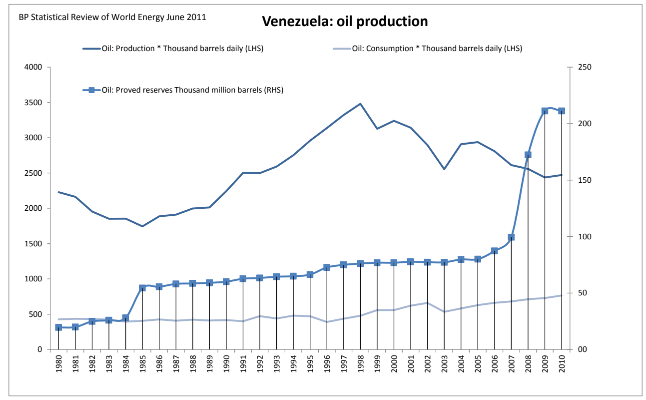
Despite the strong growth, inflation moderates somewhat in 2012 to 21% compared to 27.1% in 2011 as the government introduced in July 2011 further price controls by adopting a “Law of Costs and Prices”, which authorises the government to establish the “fair” price of basic goods and services. In case of non-compliance, the government is authorised to impose fines, sanctions and

Head of the State and the government:
Hugo Chavez (since 1999)
Description of electoral system:

- presidential: 6-year term;
  next election: 7 October 2012
- legislative: 5-year term;
  last election: 26 September 2010

Structural features:
Population: 28.4 mn
Per capita Income (USD): 11590 USD
Income group: Upper middle income
Main export products: Petroleum (90.4% of current account receipts), factor income credits (2%), manufactured goods (4%) and ores and metals (1.8%).





even nationalize businesses.

Current account surplus maintained thanks to controls

Reliance on oil as a source of foreign exchange is high and has increased from 68.7% in 1999 to 90.4% of current account receipts in 2011. The performance of the non-oil sector is weak, owing to the overvaluation of the Bolivar and the uncompetitive manufacturing sector that represents a mere 4% of current account receipts. Despite the poorly performing non-oil sector and increasing reliance on imports for food and other basic needs, the current account surplus has been maintained as imports have grown more slowly than exports due to foreign exchange controls imposed in 2003 when the government put in place the CADIVI (Comision de Administracion de Divisas), an administration that grants authorization for releasing foreign exchange at a preferred exchange rate.

High risk of devaluation in 2013

In 2005, the Bolivar (VEB) was pegged at 2.15 per US dollar. The fixed exchange rate could only be obtained through the CADIVI. A parallel legal FX market that supplied hard currency at a higher rate had emerged. In 2010, Hugo Chavez devalued the Bolivar to 2.6 per US dollar for imports of ’priority’ goods such as food and medicine and to 4.3 per US dollar for ’non-essential’ products. In addition, the government shut down the parallel FX market and created a new system: the SITME (Sistema de Transacciones con Titulos en Moneda Extranjera), which is monitored by the central bank and provides hard currency under very strict conditions at a floating exchange rate (5.3 VEB per USD in September 2012). Late December 2010, the government decided to further devaluate the Bolivar by abolishing the dual exchange rate system, fixing the exchange rate at 4.3 Bolivar per USD for all goods through the CADIVI.

Regardless of who wins the presidential election, further devaluation is likely in 2013 as foreign exchange reserves are depleting (as shown by the graph). Moreover, tighter foreign exchange controls are likely to be imposed to protect foreign exchange reserves. Indeed, given the surplus on the current account, the depletion of reserves reflects the high level of capital flight.

High liquidity risk amid low level of foreign exchange reserves

The level of foreign exchange reserves has fallen sharply despite the high oil prices and exchange controls. The level of reserves reached nearly a decade low in May 2012. The depletion of reserves is due to high private capital outflows (capital flight) and the transfer of "exceeding" FX reserves to the development fund FONDEN. As a result, the FX reserves covered only 1.1 months of import in June 2012 which is extremely low compared to international standard and the historical level of Fx reserves of Venezuela.

PDVSA: political engine of Chavez?

Since Chavez's came to power in 1999, Venezuela's oil production has gradually decreased due to lack of investment in oil producing capacities. Chavez has replaced PdVSA's labour force with loyalists following the 2002-03 protests and used PdVSA cash for social spending, leading to underinvestment. As a consequence, the maintenance work is sloppy and infrastructure suffers from repeated failure and multiple stoppages due to accidents, the biggest one been the explosion at Amuay refinery in August 2012. In addition, the investment climate has deteriorated under the Hugo Chavez' administration, which acts on social ideals, an anti-business agenda and its ambition to control strategic sectors, deterring crucial foreign investment. For instance, in 2007, President Chavez nationalised oil joint ventures with ExxonMobil and ConocoPhillips. In April 2011, the government raised taxes on oil income. In January 2012, the government withdrew from the International Centre for the Settlement of Investment Disputes (ICSID), which implies that, since July 2012, investors no longer have the right to recourse to an international arbitration. On the positive side, Venezuela's proven oil reserves are among the biggest in the world and have risen recently.

Given the high political polarisation of the country and PdVSA, widespread social unrest might occur in case the opposition wins the election. Under these circumstances, disruptions of oil production cannot be ruled out.

Venezuela commits, under the Petrocaribe scheme, to sell oil under preferential financing terms to countries in the region. The participating countries (from the Caribbean and Central America) purchase oil from PDV Caribe, a subsidiary of PdVSA, on conditions of preferential payment. The alliance was launched in June 2005. The payment system allows to buy oil at market value but only a part is paid up front; the remainder (5 to 50% of oil bill) can be paid through a 17- to 25-year financing agreement at 1% interest with a grace period of up to two years. In addition, it allows for nations to pay part of the cost with other products provided to Venezuela, such as bananas, rice, and sugar. This agreement places a large financial burden on PdVSA and is likely to be reconsidered in case of opposition victory.

Deterioration of public finance

Public debt has more than doubled between 2008 and 2011. As public spending surges in 2012, the budget deficit is likely to deteriorate further and public debt to increase further despite the high oil prices. As a result, a devaluation of the

Bolivar will be welcomed as it will increase oil revenues in domestic currency terms.

In view of Venezuela's deteriorating public finances, PdVSA has become a key source of funding for the government as the company is a large contributor to social programs but is also increasing debts through loans in exchange for future oil shipments. Ahead of the presidential election, these loans provide needed funding for strategic social government projects such as housing construction or electricity infrastructure but weaken the financial position of PdVSA and restrain its capacity to invest. If Chavez is re-elected, pressure on PdVSA to step up government financing is likely to continue, which would deteriorate further the financial position of the company.

On the positive side, Venezuela's external debt remains at a moderate level as well as external debt service, which mitigate somewhat the high MLT political risk. Nevertheless, if the country continues to rely on PdVSA as a source of external funding, external debt is likely to increase deteriorating the ability of the country to pay off its external debt.

Risk outlook

Uncertainties surrounding the political scene are high in the run-up to the presidential election. Compared to the 2006 presidential election, Chavez's re-election is far from certain as the opposition is united and population disapprobation is rising amid insecurity, high inflation and shortages of food, energy and housing. Uncertainty surrounding the presidential election already has an impact on the external accounts of Venezuela as private capital outflows are high, leading to the depletion of foreign exchange reserves, which are at a very low level. If foreign exchange reserves continue to follow their downward trajectory, the ST political risk which reflects the liquidity of the country, will be revised downward ceteris paribus. ONDD classified the commercial risk at the highest level due to the difficult business environment and risk of further devaluation in 2013.

Strengths	Weaknesses
Important oil reserves	High uncertainty surrounding presidential election
Moderate external debt and debt service	Economy is highly reliant on oil
	Price and foreign exchange controls
	Endemic corruption, arbitrary state interventions, lack of transparency and high risk of devaluation