Venezuela

Economics

Political Environment

After leading a failed military coup in 1992, current President Hugo Chávez was democratically elected for his first term in 1998. Since then, Chávez has significantly increased the government's control over strategic matters. He has rewritten the constitution and considerably expanded the powers of the executive over the legislature, the judiciary, the military, the Central Bank and the domestic economy, especially in the oil and gas industry. His authoritarian tendencies have 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 shifting environment for private investors and concerns about economic stability over the medium to long term.

In the December 2005 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. Going forward, Chávez could conceivably seek to amend the Constitution to enable him to remain in power indefinitely.

Chávez's anti-American rhetoric has magnified over the past year and he is seeking new allies both within South America and abroad. In addition to his strong ties with Cuba's President Fidel Castro, Chávez is strengthening ties with other leftist South American leaders. Beyond Latin America, Chávez has developed alliances with Russia, Spain, China and Iran aiming to expand his network of allies, diversify the country's oil market and acquire new military equipment.

Investment Environment

The business climate is turbulent and uncertain, and the Chávez administration has an ambivalent attitude towards the role of private capital and foreign direct investment. His unfriendly behaviour towards foreign investors causes some to reconsider their involvement in the market and may discourage the arrival of new investment.

Chávez has caused investor disquiet with his expropriation and breach of contract initiatives. Investors in the oil and gas sector were forced to renegotiate their agreements to incorporate higher taxes and royalties and to enter into joint-venture structures with the state-owned oil & gas company, PDVSA.

The government introduced currency controls in 2003, administered by the Foreign Exchange Administration Commission (CADIVI). The most recent updates to the system were implemented in February 2007, and increased the administrative burden for exporters to Venezuela in certain circumstances. The process serves to increase governmental supervision of the national economy. The illicit exchanges law heavily punishes those that violate the process.

As demonstrated through Venezuela's ranking in the 2006 World Bank's control of corruption index, the judicial system has problems with corruption and is subject to political interference.

Canada and Venezuela have signed a Foreign Investment Promotion and Protection Agreement (FIPA) and a double-taxation agreement.

Political Violence

Fears of major street demonstrations in the context of the presidential elections proved unfounded, but large protests emerged in the 2nd quarter of 2007 following the government's decision not to renew RCTV's license to broadcast on public airwaves.

Occasional incursions by Colombian guerrillas do not pose a broad security threat to the state.

Political

Political Structure
Federal Republic

President
Hugo Chávez

Vice President
Jorge Rodríguez

Legislative Body
National Assembly – 167 members

Major Parties
Chavez's alliance:
- Movimiento Quinta (V) 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: December 2010
Presidential: December 2012

Press Freedom Survey:
- 2006 Score: 72 Not Free

(0: Free; 100: Not Free)
freedomhouse.org

Control of Corruption Index:
- 2006 Score: -1.05

(-2.5: Worst; +2.5: Best)
worldbank.org

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Political Outlook

Chávez appears set to maintain a strong focus on social programs which are dependant on windfall oil revenues. He is expected to use broad powers to rule by decree, granted in January 2007 for a period of 18 months, to increase the government's role in the private sector and tighten the regulatory environment, which together will serve to further undermine the investment environment. In the medium term, political instability could be instigated by the opposition's desire to remove Chávez from power. Alternatively, economic mismanagement leading to shortages of basic foodstuffs could lead to widespread popular unrest.

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Economic

Credit Ratings:
Moody's: B2
S&P: BB-
Fitch: BB-

Nominal GDP (2006):
USD 181.9bn

Population (2006e):
26.9mn

Total Trade / GDP (2006):
53.6%

Currency:
Bolivar

Exchange regime:
Pegged at VEB2,150/USD

Merchandise Imports from Canada (2006):
CAD785.4mn

Main sources of Foreign Exchange (excl. FDI):
Petroleum

Largest Merchandise Trading Partner:
United States
Colombia

Main imports:
Consumer goods
Intermediate goods

Risks to the Outlook:

Continued oil price strength.

Further policy and infrastructure erosion.

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Market Spotlight: In efforts to drain excess liquidity, PDVSA floated a US$7.5bn USD bond in April, bringing the *bolivar* up to 3,580/USD in parallel markets. ■ Consumer prices fell 0.7% in March as a result of a rebound in supply at government stores and a reduction of the VAT. ■ CADIVI approved US$5.3bn for importers and US$8.2bn total in Q1 – up 20%y/y and 57%y/y.

Real Economy: Venezuela's economy expanded by 10.3% in 2006, despite a decline in the oil sector. Growth was fuelled by runaway government spending, which increased the size of the public sector and pushed domestic demand up 18.8%. Demand could only be met by foreign producers, due to the overvalued *bolivar* and weak domestic investment. Imports rose 26.8%. Going forward, a heterodox policy bent and increasingly confrontational approach toward the private sector will foster weak investment, low incentive for diversification, and increased dependence on commodities. As oil prices moderate, the government will be unable to maintain spending, pulling growth down to 6.3% in 2007 and 3.9% in 2008.

External: Venezuela's current account reached 16.2% of GDP in 2006, but is projected to come in under 10% of GDP this year. With oil accounting for 90% of export earnings, expected price declines and weak production portend continued deterioration. As PDVSA's profits continue to be diverted and foreign investment dries up, capacity constraints and an overvalued exchange rate will lead to the decay of both the oil and non-oil sectors. Given existing import and non-oil export growth trends, oil prices below $50/bbl could turn the country's current account surplus into a deficit within a few years. In anticipation, access to FX is already tightly controlled by CADIVI, under a process that is likely to become even more rigid and politicized. Reserves now cover 8.5 months of current account outlays and almost 4 times the country's external debt servicing obligations for this year. Total external debt is expected to rise to around USD38bn this year, or 56% current account receipts.

Monetary: Expansionary fiscal and monetary policies, as well as inadequate sterilization efforts in the face of rapid capital inflows, pushed M2 up 66.7% y/y in February. This, together with strong domestic demand, is keeping annual inflation high, despite a range of price controls, a fixed exchange rate, reductions in the VAT rate, and a broadening of the government's reduced-price food distribution network (MERCAL). Annual inflation jumped to 18.5% in March, from 12.1% a year earlier. Going forward, prices are expected to accelerate through year-end, as the government makes new adjustments to the official exchange rate and price controls become less effective.

Fiscal: Government spending is budgeted to top $54bn for 2007, from US$50bn in 2006. Pro-cyclical spending, together with a 50% reliance of fiscal accounts on oil, will threaten newfound wealth going forward. But even in a sub-$50/bbl oil price environment, total collapse could be avoided by turning to debt financing and dipping into accumulated oil savings. Ambitious reforms, however, are needed over the medium- to long-term. But while spending on regional allies would be easy to cut, new budget rigidities are also now in place. Wages and other social-related expenditures now account for approximately 50-60% of government outlays. And with almost half of the Venezuelan economy directly dependent on public spending, the necessary changes would be neither swift nor smooth.

Outlook: *EDC Economics is concerned that the current policy mix may result in a rapid drawdown of FX reserves, resulting in a deterioration of the country's external position. Further, opaque financial management is adding to concerns over the vulnerability of public finances. Venezuela must also prepare itself for lower oil prices. Restoring productivity in the non-oil sector is crucial for economic growth and access to foreign currency. This will necessitate a more conciliatory approach toward foreign participation.*

Economic Indicators

	01-05 avg.	2006	2007	2008
GDP (% growth, real)	2.6	10.3	6.3	3.9
Inflation (%chg, pa avg.)	20.6	13.7	20.0	17.0
Fiscal Balance (% of GDP)	-2.5	-1.8	-5.0	-4.0
Exports (%, comp. annual growth)	10.6	17.6	-7.0	2.0
Imports (%, comp. annual growth)	7.0	36.0	15.0	14.0
Current Account (% of GDP)	11.1	14.9	7.2	5.2
Reserves (months of curr. debits)	7.0	7.7	7.2	6.7
External Debt (% of GDP)	33.3	20.5	16.4	16.7
Debt Service Ratio (due)	20.7	7.4	11.6	11.3
Exchange Rate (to USD; eoy)	1565.5	2147.0	2300.0	2600.0