



The Impact of the Bolivar Devaluation...

The political antics of “self-styled” Venezuelan President, Hugo Chavez, are both renowned and expected by market players worldwide. To this ever expanding list, we can add the recent sharp devaluation of Venezuela’s Bolívar currency by the Chavez government, setting two rates of 2.60 and 4.30 against the United States dollar (dollar), representing a weakening of the currency by 17.30% and 50% respectively from the previous 2.15 fixed rate, on 8 January 2010. According to Chavez, the 2.60 rate is a preferential rate for essential imports like food, health and machinery whilst the 4.30 “petro-dollar” rate is for other things. Admittedly, the Chavez administration has long been pressured to make an adjustment to the over-valued exchange rate; however, this move has heightened speculation about Chavez’s intentions in light of elections for a new National Assembly in September of this year and his sliding popularity.

For those who are unfamiliar with the Bolívar currency, the following are some brief facts. During the 1970s when oil prices were high and the economy was booming, the currency was one of the strongest in the Latin American region. Amidst problems in the financial sector in the 1990s, the value of the currency fell rapidly with measures to curb this including bands, fixed rates and a free float all proving unsuccessful. In 2003, currency controls were introduced in an attempt to prevent capital flight when political turmoil heightened in Venezuela. At that time, Chavez fixed the Bolivar at 1,600 to the dollar and limited foreign currency purchases. The devaluation on 8 January marks the third such occurrence since 2003 with the currency weakening to 1,920 per dollar in 2004 and 2,150 in 2005. Further to this, in 2008, the government dropped three zeros from the currency and new bills and coins were subsequently issued. The currency’s history of instability is further exacerbated by the “tolerated, semi-legal black market” in which the Bolívar is traded.

According to Kevin O’Rourke, a Professor of Economics, “...the textbook solution is for governments to tackle their fiscal problems by raising taxes and cutting expenditure, and to simultaneously tackle their unemployment problems by devaluing their currency. Devaluation is essentially a confidence trick, and - although some economists are reluctant to admit it – it works.”

In a statement by Chavez, he indicated that the devaluation has several objectives, “to revive the productive economy, strengthen the Venezuelan economy, slow imports that are not strictly necessary and at the same time ... stimulate production for exports.” This comes at a time when the Venezuelan economy is in a recession. The oil-rich economy shrank 4.5% in the third quarter of 2009, after posting a 2.4% decline in the previous quarter. According to analysts’ reports, Venezuela’s negative growth numbers reflect dwindling oil revenue, as global crude prices are well off their July 2008 record highs, coupled with the Chavez government’s push toward socialism. To counter this, Chavez alleged that the weak economic growth numbers are mostly the result of “capitalist calculations” that don’t give proper credit to economic

activity in a socialist setting in addition to Venezuela's decision to voluntarily cut oil production as a way to reduce supply amid slackening demand and thus, avoid a sharper drop in oil prices. Venezuela took the decision to reduce production with other members of the Organization of Petroleum Exporting Countries after the global economy began to weaken in 2008 and energy prices began to fall. With Venezuela's weak growth numbers and global oil prices hovering around USD80 a barrel, Venezuelan officials have indicated they will consider reversing the production cuts and start ramping up output to churn the local economy.

The Venezuelan government continued its expansionary fiscal policy in late 2009 which resultantly pushed public spending to USD90.7 billion at the previous 2.15 fixed rate. With the adjustment to the foreign exchange and the subsequent increase in oil revenues, the government should be able to maintain its planned expenditure amidst lower tax contributions in light of the country's economic downturn. Analysts argue that the devaluation is a bid to shore up government finances as the "weaker currency helps narrow a growing budget shortfall by instantly giving his oil-rich government more local currency to spend per barrel of oil exported by the state petroleum company, PDVSA.

On the flipside, there is the gamble that the consequences of a weaker currency will be to stoke inflation. The Finance Minister has indicated that it may add 3%-5% to the country's stubbornly high inflation rate, which averaged over 25% on an annual basis in 2009. This forecast is moderate compared to market players who suspect that the effect will be more pronounced and forecast headline inflation to reach 40% by year-end. The benchmark consumer price index rose 26.9% in 2009 (the highest in Latin America), down from a 32% increase in 2008, according to the central bank. Even at the new peg, "higher inflation will also keep chipping away at the value of the Bolívar."

Trade dynamics with Venezuela is also anticipated to be negatively impacted by the devaluation. Indeed, trading partners including Argentina, Bolivia and Colombia are all discouraged with the government's recent move. According to an Argentine research firm, the devaluation of the Venezuelan Bolívar will adversely affect exports from Argentina amounting to USD500 million. Bolivian exporters have called on its government to intervene in order to prevent a negative effect. Bolivia's exports to Venezuela amounts to USD270 million annually. In July 2009, Venezuelan President Hugo Chavez pledged to end imports from Colombia in response to a deal to allow the U.S. armed forces access to seven Colombian military bases. Colombia stands to lose as the drop in the value of the Bolivar adds further to the pain caused by Venezuela's trade blockade. Colombian exports to Venezuela fell 70% in October from a year earlier while total exports fell 5.5%, according to Colombia's statistics agency.

Devaluation is generally not favored by the population, as no one likes a lost of purchasing power. However, this move was viewed generally as a positive move from the financial community. Indeed, Standard & Poor's upgraded Venezuela's outlook from negative to stable whilst Fitch ratings speculated that the economic benefit from the devaluation would be limited. Despite the mixed views on the devaluation, the currency move sends a strong signal on the affect of the global downturn on the Venezuelan economy and only time will tell if the benefits will outweigh the obvious costs.

FINANCIAL & ECONOMIC INDICATORS

As at 21 January, 2010

Exchange Rate/US\$	Closing Value	Previous Week
Yen	90.43	91.21
Euro	1.41	1.45
Jamaica	89.67	89.65
Guyana	204.70	204.70

Commodity Prices	Closing Value	Previous Week
Crude oil (US\$/bbl)	76.08	79.39
Natural Gas (US\$/mmbtu)	5.52	5.78
Gold (US\$/Troy Ounce)	1,093.95	1,142.85

Eurobond Indices (As at 21-01-10)

Lehman Brothers Global Aggregate Index (Return % YTD)	0.72
JP Morgan EMBI+ (Basis points)	296
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	1.10

Policy Interest Rates (%)	Closing Value	Previous Week
United States	0.10	0.11
Euro Zone	1.00	1.00
Japan	0.11	0.09
Brazil	8.75	8.75
Trinidad	5.25	5.25
Jamaica	12.50	12.50
Barbados	2.50	2.50

Market Interest Rates (%)	Closing Value	Previous Week
US 90-day T-Bill	0.04	0.06
US 10-Yr Treasury	3.59	3.74
3-month UK Libor	0.62	0.61
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	9.17	9.12
TT 90-day T-Bill	1.34	1.34
Jamaica 90-day T-Bill	15.34	15.34
Barbados 90-day T-Bill	3.40	3.43

Sources: Bloomberg, J.P. Morgan, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

DISCLAIMER

The information contained in this documentation is for your information only. All information contained in this documentation has been obtained from and is based on sources, including but not limited to, newspaper and magazine articles that CMMB believes to be accurate and reliable. However such information, facts, calculations, methodology, assumptions and estimates contained in this documentation have not been verified by us. All opinions and estimates constitute the Author's judgment as of the date of the documentation which are subject to change; however neither its accuracy and completeness nor the opinions based thereon are guaranteed. As such, no warranty, express or implied, as to the accuracy, timeliness or completeness of this documentation is given or made by CMMB in any form whatsoever. Consequently, CMMB assumes no liability for the accompanying information, which is being provided to you solely for general information.