



A Case of “Chávez” Intervention

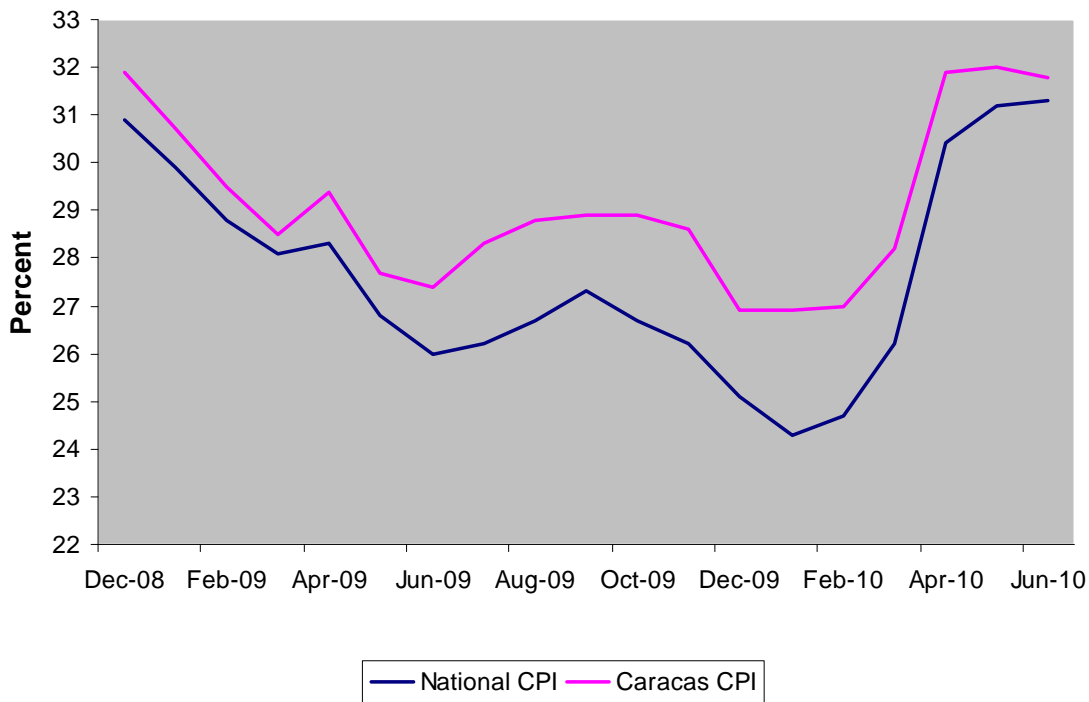
The Venezuelan economy has recently been referred to as the worst performing economy in Latin America by some analysts and is set for another recessionary year, following a poor performance in 2009. Like most countries around the world, the global economic and financial crisis of 2008 has negatively affected the South American state. It recorded negative growth in the first quarter of 2010 of 5.76%, following four consecutive quarters of negative real GDP. Despite the economic recovery experienced by many of the Latin American countries in the second half of 2009, and in some cases in the first quarter of 2010, Venezuela continued its economic hardships and is forecasted to grow at a rate of -3.6% in 2010. There are a few reasons for this dismal performance: Venezuela is plagued with excessively high levels of inflation, which is being fuelled by a rapidly depreciating exchange rate, and this is compounded by President Hugo Chávez continuing to exert his political pressures across various sectors of the economy. For this reason, many argue that it is Chávez's policies that have the economy in its current state of distress.

Venezuela is one of the world's largest producers of oil and as such, is a member of the oil cartel OPEC. Given its heavy production of petroleum products, oil constitutes approximately 95% (as at December 2009) of its total exports, thus providing a significant source of foreign exchange. Oil prices have been relatively subdued given the slow down in demand worldwide. Prices have been significantly lower than the USD120 per barrel region seen in 2008 and the forecast is not as high, ranging between USD85 and USD87 per barrel in 2011. In addition to the lower oil prices, the domestic production within the petroleum sector has been on the decline recently, and the Chávez administration's policies have not been of any consolation to the situation. At the end of June, the administration announced that its plans to nationalize 11 oil rigs belonging to US company Helmerich and Payne and a further 5 rigs operated by Chevron have been earmarked as expropriation targets. Over the last three years, Venezuela has nationalized much of its oil sector in a move to strengthen control of the national economy. This however is not a positive sign for the country's business environment, since investment revenue will fall as evidenced by the decline in investments of 27.9% (year-on-year) in the first quarter of 2010. Additionally, this accounted for roughly 8.6% of GDP in the first quarter; indicating its importance to the growth of the economy. Furthermore, under-investment in the sector can contribute to structural economic problems, further constraining growth.

Inflation is also a major problem within the Venezuelan economy. Historically the economy has had high levels of inflation and this has steadily trended upwards, reaching as high as 31.8% at the end of June. A number of factors have contributed to this ludicrous rate, namely Chávez's political influences and a rapidly depreciating exchange rate. The latter has been driven by the government's policy decisions. The Venezuelan exchange rate is a very complicated system,

consisting of three official exchange rates and a parallel black market exchange rate. The black market rate however, is the more reflective rate as it mirrors the performance of the economy. In January, President Hugo Chávez devalued the Bolívar against the US dollar in an effort to boost the economy out of recession. The devaluation in effect resulted in a two-tier exchange rate system – one rate for priority imports (VEF2.6/US\$) and the other for ‘non-essential’ imports (VEF4.3/US\$). The rate had traditionally been pegged at VEF2.15/US\$ since 2005. In spite of the devalued rate, the parallel black market rate was still proliferating, driven by the shortage in foreign exchange. To combat this, Chávez decided to regulate private brokerage trading. These private brokers traded dollar-denominated securities and provided a method of avoiding currency controls, thus meeting the domestic demand for foreign currency. Chávez accused these brokerage houses of deliberately manipulating the parallel exchange rate through speculation and fraudulent trading, contributing to its downward spiral. With the regulation of these companies, the government can now exert an influence over the “parallel black market rate,” introducing a third-tier rate for trading (band of VEF4.2/US\$ and VEF5.4/US\$).

Figure 1: Inflation Rates in Venezuela



Source: Bloomberg

Despite the government’s intention to regulate the exchange rate in an attempt to tame the inflation levels, Chávez’s economic policies have proven to be counterproductive. A regulated exchange rate creates the problem of a shortage of foreign currency in an environment where demand is extremely high. Importers will thus have to resort to illegal means to continue trading, or may be forced to restrict trading altogether, both of which are problematic for the economy. In the first instance, illegal sources of foreign exchange create yet another parallel exchange rate which the government is trying to control. It is believed by some analysts that this rate may be as low as VEF 7.8/US\$ (as at May 2010). This rate however cannot be easily monitored given the tighter regulations and restrictions imposed by government authorities. As such the true rate cannot be accurately determined. In the second instance, with the reduced supply of goods through imports, domestic demand will be severely constrained, further slowing the growth within the economy. There is also the possibility

of a shortage of consumer goods, which is further worsened by government-imposed price caps. This poses further threats to the already sliding exchange rate.

In light of the economic struggles facing Venezuela, the economy has a fairly grim outlook. Growth is expected to further decline, fuelled by lower private consumption, foreign direct investment and even government consumption. Government consumption has always been a main source of growth for the Latin America's largest oil producer. However, given the decline in oil production compounded by structural inefficiencies in the sector, consumption has fallen for the first time since 2002. On a positive note though, the net exports balance has improved. Despite the fall in oil production, oil prices have remained relatively high, stabilizing the level of exports. It is the import side that had the major change with the implementation of stricter exchange controls and the high levels of inflation plaguing the economy. Thus the improvement in the net exports has not necessarily been an increase in exports but a significant fall in imports.

Adding to the frustration of the economy is Chávez's increased nationalization policies. His administration continues to impose restrictions on various areas including the media, brokers and oil producers. This has added to the recessionary spiral of the economy, spurring the inflation rate further. Furthermore, the economic data which is supplied by the government has been questioned in terms of reliability. Many believe that the information may not be fully reflective of the country's performance, and may have been doctored by the administration. Going forward, it is forecasted that the economy will continue to experience negative growth and high inflation levels, even experiencing stagflation. The unpopular policies by the president are also adding to these hardships. Legislative elections are set for September this year, so this may be a means for the population to voice its opinion, possibly indicating a sign for Chávez to change his ways. However, given Chávez's history, this may seem unlikely.

FINANCIAL & ECONOMIC INDICATORS

As at 22 July, 2010

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	86.95	87.40
Euro	1.29	1.30
Jamaica	86.48	86.32
Guyana	204.20	203.90

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	79.30	76.62
Natural Gas (US\$/mmbtu)	4.68	4.41
Gold (US\$/Troy Ounce)	1,194.95	1,208.25

Eurobond Indices (As at 22-July-10)

JP Morgan EMBI+ (Basis points)	294
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	N/A

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	0.25	0.25
Euro Zone	1.00	1.00
Japan	0.10	0.10
Brazil	10.66	10.16
Trinidad	5.00	5.00
Jamaica	9.00	9.00
Barbados	2.50	2.50

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	0.15	0.15
US 10-Yr Treasury	2.94	3.00
3-month UK Libor	0.74	0.73
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	11.23	10.90
TT 90-day T-Bill	0.97	1.00
Jamaica 90-day T-Bill	8.52	8.52
Barbados 90-day T-Bill	3.26	3.26

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados,

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