Sovereign
Latin America
Special Report

Latin America's Populist Left: Beyond Commodity Prices

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Summary

In this special report, Fitch Ratings evaluates how well placed Argentina, Ecuador and Venezuela are to face the commodity shock. In Fitch's view, these countries fare quite poorly in terms of fiscal and external vulnerabilities, policy credibility and macroeconomic stability. As a result, the rating agency took negative rating actions on these three sovereigns in December 2008.

The economies of Argentina, Ecuador and Venezuela are likely to suffer real contractions over the forecast period, while their external and fiscal balances will deteriorate markedly. Moreover, the combination of high expenditure growth and heterodox monetary and exchange rate policies limits available options to adjust to the new reality. Finally, these governments' responses to the global financial crisis, such as the nationalization of pension funds in Argentina or the announcement of default in Ecuador, were politically motivated and eroded these sovereigns' fiscal and external positions even before they felt the impact of the crisis through real channels.

More importantly, the tough external environment will expose these countries' structural weaknesses. Political transformations have not only failed to reduce the potential for political and social instability, but also weakened the economic policy formulation process and increased the role of the state in the economy at the expense of the private sector. Despite its importance for these economies, production in key energy and agricultural sectors has been in decline due to capacity constraints and low investment. Moreover, Argentina, Ecuador and Venezuela have failed to increase macroeconomic stability because of excessive reliance on favorable terms of trade to provide a strong fiscal impulse, a confrontational stance with the private sector, and heterodox policies.

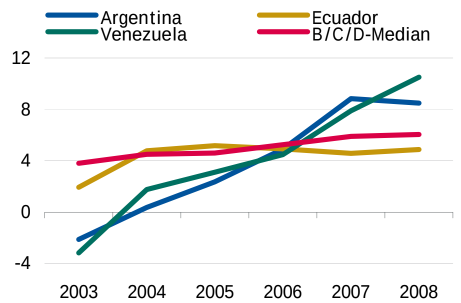
Even a partial recovery in commodity prices from current lows may not be sufficient to improve greatly either growth or external and fiscal balances. Building macroeconomic imbalances, combined with a high degree of policy uncertainty, limit the upside on these countries' ratings.

Reeling under the Commodity Shock...

After the "commodity boom" came to an abrupt end in mid-2008, commodity-dependent Latin American sovereigns face the challenge of adjusting m policies to soften the impact on external and fiscal accounts. A highly pro-cyclical fiscal stance and weak macroeconomic policy frameworks in Argentina, Ecuador and Venezuela are likely to result in economic contractions and deterioration in these countries' external and fiscal balances over the forecast period.

Real GDP Growth

%, 5-year Average

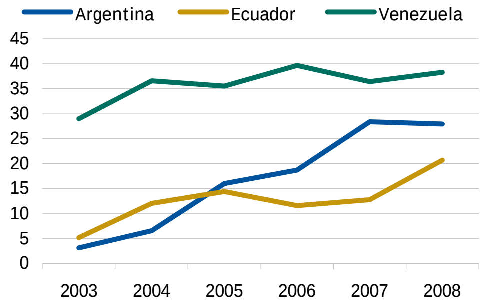


Source: IFS, National Sources, Fitch.

After reaching average growth rates between 8% and 10% over the past five years, Fitch expects the economies of Argentina and Venezuela to contract in real terms by 1.4% and 1.7%, respectively, in 2009 due to lower consumption, flagging investment and a lower fiscal stimulus. Ecuador's economy could contract by 1.6% after growing by 5.2% last year. However, the Andean country's growth, as seen in the chart, has underperformed that of Argentina, Venezuela and peers, in spite of record high oil prices.

Highly pro-cyclical and commodity-dependent revenues will decline, thus noticeably weakening fiscal balances. Oil revenues accounted for 42.2% and 51.4% of general government revenues in Ecuador and Venezuela in 2008. Given Argentina's lack of access to international capital markets, the government has relied to a great extent on higher commodity prices to reduce its financing needs. On the expenditure side, neck-breaking average fiscal expansions of 38% in Venezuela, 28% in Argentina and 21% in Ecuador over the past five years leave little room for counter-cyclical policies. Fitch estimates that central government deficits in Ecuador and Venezuela will then rise to 3.6% and 4.3% of GDP, respectively, in 2009, while Argentina's general government surplus will more than halve to 0.3%.

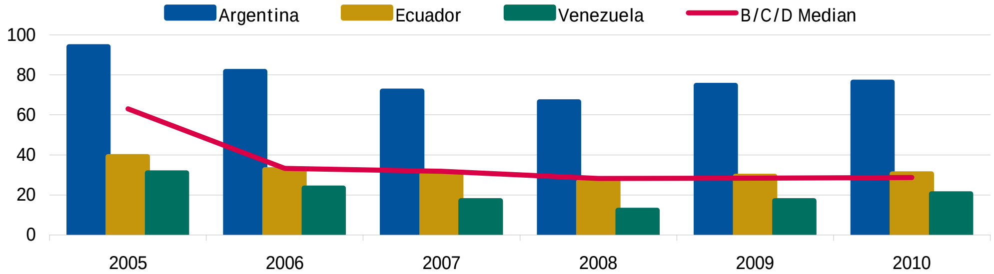
Government Expenditure Growth
%, 5-year Rolling Average



Source: National Sources, Fitch

After years of deleveraging, fiscal deterioration will result in heavier debt burdens; Argentina's general government debt at 74% is already the fourth-highest among all speculative-grade sovereigns. While Fitch expects debt levels in Ecuador and Venezuela to remain in line with the 'B' median, these sovereigns have also demonstrated a low debt tolerance in previous crises.

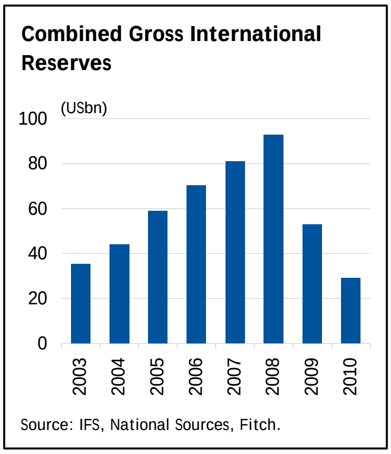
General Government Debt
% of GDP



Source: IFS, National Sources, Fitch

External balance sheets will also suffer in the forecast period. Gross international reserves in Argentina, Ecuador and Venezuela increased to a combined USD93.1bn in 2008 from USD35.5bn in 2003. Nevertheless, this record accumulation of FX assets will reverse due to an average drop of 28% in export revenues, limited sources of external financing and capital flight. Overall, Fitch expects these sovereigns' combined reserves to fall by USD40bn in 2009, with Argentina and Venezuela seeing the sharpest declines.

Current accounts in Argentina, Ecuador and Venezuela are likely to shift into deficit after at least five years of record surpluses. The sharpest reversal will take place in oil exporters: Venezuela's current account surplus, equivalent to 12% of GDP in 2008, will turn into a 1.5% deficit, and Ecuador's current account will swing from a surplus of 1.4% of GDP to a deficit of 5%. The impact of deteriorating current account balances on these economies will be magnified, most notably for Ecuador



due to its dollarization regime, in light of minimum foreign direct investment (FDI) and strained relations with international financial institutions. Policy initiatives such as the authorization to use international reserves for debt service in Argentina or continued reserve transfers to discretionary and opaque government funds in Venezuela will also likely weaken the sovereigns' external position.

The adjustment in external accounts also creates pressures for these sovereigns' exchange rate regimes. In the absence of significant capital inflows, Argentina's falling trade surplus and continued pressure on the ARS due low confidence of domestic actors could result in USD17bn in reserve losses, increasing the challenges for the central bank's "managed depreciation" policy. In spite of inflation running above 30%, pressures to devalue are likely to continue building in Venezuela due to the impact of lower oil exports on the supply of USD and fiscal accounts. Nevertheless, in light of the recent referendum results which eliminated term limits, the longer-term viability of Venezuela's macroeconomic framework, and thus the president's ability to continue winning elections, could outweigh the near-term political and economic costs of devaluation, particularly if oil prices do not stage a sustained recovery. As a result, Fitch forecasts a devaluation of at least 30% before year-end 2009 as its base case. Ecuador's dollarization regime will be severely tested, as the government's decision to default will increase the country's challenges in obtaining the necessary external financing to prevent a sharper economic contraction.

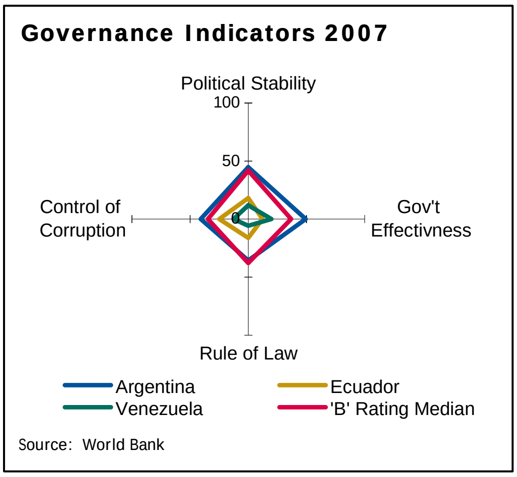
...And Possibly Beyond the Commodity Shock

Can Argentina, Ecuador and Venezuela resume high growth and improve their external and fiscal accounts in the unlikely event of higher international prices for oil and grains? In Fitch's view, the policies implemented during the commodity windfall years have structurally weakened these economies. Hence, the deterioration in fundamentals and macroeconomic imbalances built over the commodity boom years will likely weigh down on growth and creditworthiness independently of a partial recovery in commodity prices.

Continued Institutional and Policy Weaknesses

The commodity windfall provided the revolutionary governments with the necessary resources to engage in deep political and structural transformations. Nevertheless, these transformations have failed either to strengthen institutions or to eliminate the potential for political and social instability. In addition, powerful presidents have weakened the process of economic policy formulation and increased the role of the state in the economy at the expense of the private sector.

As shown by the World Bank governance indicators, Argentina, Ecuador and Venezuela compare unfavorably with the 'B' median in terms of government effectiveness and control of corruption. Moreover, the radical changes to the political structure in these countries have not increased their political stability, since they have taken place against the backdrop of increasing political polarization. Hence, the potential remains for episodes of political and social instability, witnessed in all three countries over the past decade, especially as the economic situation deteriorates.



The Correa administration in Ecuador is enforcing its new constitution approved in 2008. In Venezuela President Chavez has made use of referendums and presidential decrees, under an Enabling Law, to move forward with his vision of "socialism of the 21st century". In Argentina, after six years of historically high growth, the "economic emergency law," implemented first during the 2001 crisis, continues to be an important element in the formulation of economic policy. The common end result of these developments has been the centralization of power in the figure of the president, which weakens not only the system of checks and balances, but also overall policy quality and transparency. As formulation and implementation have been concentrated to a great extent in the office of the president, uncertainty about the future tack of economic policy has also increased with high economic costs. For example, the largely unexpected decision by Argentine government to nationalize the private pension funds (AFJPs) further dented the confidence of domestic actors and has permanently reduced liquidity in the domestic market.

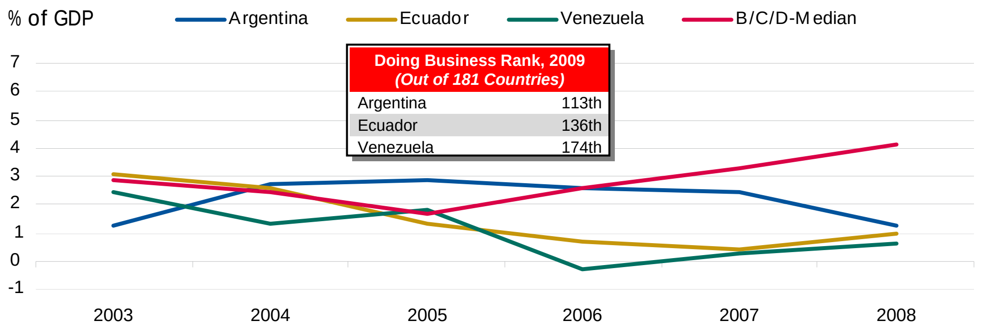
In terms of economic policy formulation, central bank independence has been greatly compromised as monetary authorities in Argentina and Venezuela have accommodated the policy goals of the government, either through low interest rates despite rising inflation or the direct use of reserves to finance infrastructure spending or debt payments[1]. On the fiscal front, expenditure over-execution through budget modifications has been the norm in Argentina and Venezuela, where governments also have a high discretionary power to determine the allocation and level of spending. Budget modifications in Argentina averaged 3.8% of GDP between 2006 and 2008, while Venezuela's over-execution above budgeted spending reached 30% on average in same period. Moreover, the transparency of fiscal spending has suffered due to use of quasi-fiscal vehicles (state companies and trusts).

Finally, Argentina, Ecuador and Venezuela have also pursued the reversal of structural reforms and increased state participation and intervention in the economy, which has further undermined the competitiveness of these economies reflected in rising imports and the growing importance of subsidies in recent years. Under President Chavez, the Venezuelan public sector has expanded through the nationalization the electricity, communications and oil sectors, as well as increasing its participation in the manufacturing sector. Ecuador has followed a similar path in increasing direct state participation in the oil sector, while Argentina has renationalized pension funds and Aerolineas Argentinas.

Killing the Golden Goose?

Fitch believes that the recent performance of these economies' "golden geese" exposes structural weaknesses that are likely to weigh down on growth, even if commodity prices were to recover from current lows. In light of increased state interventionism, much-needed investment and technical capacity to revert the declining trend in production of energy and agricultural products are unlikely to

Inward FDI



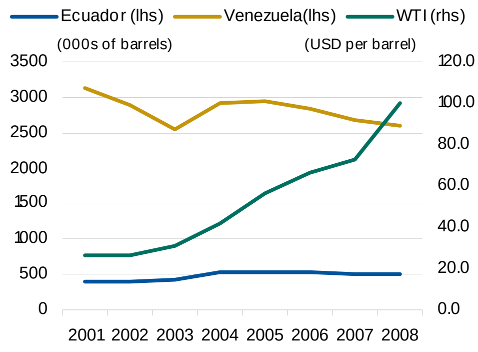
Source: IFS, National Sources, World Bank, Fitch

[1] Modifications introduced to Argentina's central bank charter through the 2009 budget law allow the government to make use of international reserves to service debt.

materialize due to the unfavorable business environment. Unlike other commodity-exporting peers, these economies have failed to attract FDI inflows necessary either to increase the productivity of their commodity-export sectors or to diversify their economies.

Venezuela's crude production fell by 2.5% in 2008 and it will continue to decline in 2009, thus falling for a fifth consecutive year, and with little prospect of returning to pre-2002 levels in the medium term, especially given coordinated OPEC actions. Petroecuador, Ecuador's state company, twice lowered its production target for 2008, and the country recorded a decline in crude production for the second consecutive year. It is noteworthy that these countries have not been able to revert the declines in production in spite of the exceptionally favorable international prices. In addition, both governments have not only increased their direct participation in the energy sector, but also repeatedly changed the regulatory framework through increased taxation and contract modifications, thus further discouraging private-sector investment.

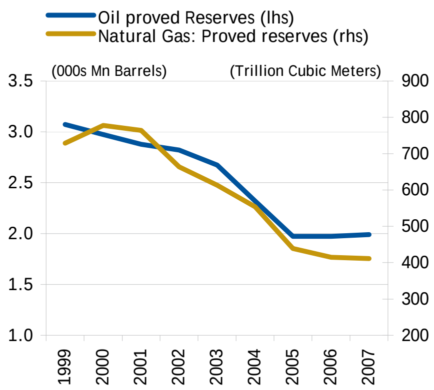
Price vis-à-vis Production



Source: National Sources, Bloomberg, Fitch estimates

In Argentina, export taxes and continuous government interventionism have exchanged short-term fiscal gains for lower productivity in the commodity sector. The decline in hydrocarbons production and export volumes is a result of limited investment in the sector due to export taxes, export caps and tariff freezes for the domestic market. As a result, oil production has fallen consistently since 1999, while oil and gas reserve levels have not increased since the late 1990s. High international prices provided an incentive to invest and develop the production of soy beans in Argentina, but price controls and export taxes and restrictions have taken a toll on Argentina's traditionally strong grain, cattle and dairy industries, which is reflected in declining production and stock levels. In spite of high international prices, Argentine staple beef exports declined in 2008, in volume terms, for a third-year in a row, and exports as a percentage of total beef production fell to levels similar to 2002. Wheat exports are estimated to have dropped 10.9% in 2008. Moreover, commercial partners such as Brazil have sought to diversify away from Argentine products due to the unreliability of export shipments. The current drought affecting Argentine farmers will certainly compound structural weaknesses of the sector.

Argentina Hydrocarbons Sector

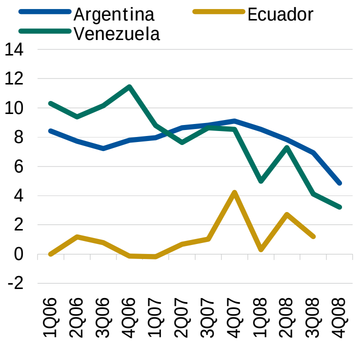


Source: National Sources, Fitch estimates

Government Spending Not a Panacea

An excessive reliance on favorable terms of trade to provide a fiscal impulse, a confrontational stance with the private sector and heterodox policies have failed to either sustain growth or increase macroeconomic stability. In spite of a strong fiscal stimulus supported by rising commodity prices, the revolutions' economic models began to show signs of fatigue in H207. On the domestic demand side, private consumption declined as a result of rising inflation, reduced credit availability and, more importantly, dwindling consumer confidence. Increased risk aversion and

Slowing Economies
(%, YoY Change in Real Terms)

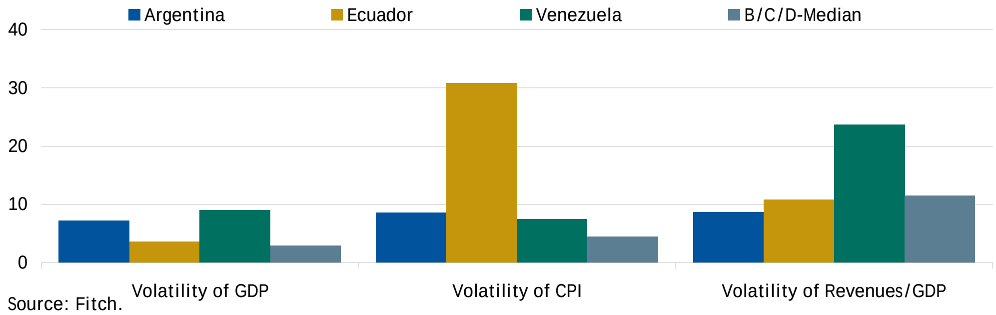


Source: DNCN, BCE, Fitch

state interventionism in the economy also discouraged private-sector investment, thus eroding medium-term growth prospects and contributing to inflationary pressures.

Economic and/or financial crises have taken place in Argentina, Ecuador and Venezuela during the last decade, and the combination of fiscal profligacy, inconsistent exchange rate regimes, an excessively accommodative monetary policy (in Argentina and Venezuela) and confrontational relations with the private sector have failed to increase macroeconomic stability. As a result, the sovereigns' GDP remains among the most volatile of all sovereigns rated by Fitch, increasing the risk that forecasted real GDP contractions could be sharper than anticipated.

Continued Macroeconomic Instability
10-year rolling STDV as of 2007



Source: Fitch.

Inflation volatility in these economies is also likely to remain among the world's highest, due to accelerated expenditure growth in recent years and the heterodox policy responses implemented to control inflationary pressures. Despite price controls in place since 2002, Venezuela has the highest inflation rate of all sovereigns rated by Fitch, and could rise further even as economic activity contracts due to shortages of basic products, the spread between the official and parallel market rates, and a potential devaluation. Argentina's actual inflation is estimated to be significantly higher than the levels presented by INDEC, which not only discourages investment but also creates inflation inertia due to salary demands in line with "perceived" inflation.

Failure to increase macroeconomic stability leaves limited options for the revolutionary governments to soften the blow of the global financial crisis. As expenditure growth on average outpaced revenue growth in recent years, the room to implement counter-cyclical fiscal policies is rather limited. In addition, high inflation (in Venezuela) and flagging confidence of domestic actors (Argentina) limit the extent to which monetary easing can be used to spur domestic activity.

Limited Financing Options

Argentina, Ecuador and Venezuela virtually "closed" their economies to external financial inflows, most notably non-debt-creating ones, during years of abundant global liquidity. Although this policy should have protected them from the capital reversal in Q408, politically motivated policy decisions during that period have further reduced not only external but also domestic sources of financing for the government and the private sector.

In Argentina, the stalemate between famers and the government over export taxes, and then the nationalization of the AFJPs in October, caused a "confidence crisis" among domestic economic actors. Hence, pressures on the ARS could partially be controlled through a sharp rise in domestic interest rates, which is likely to further squeeze credit availability. Moreover, the disappearance of pension funds as providers of long-term financing will reduce the depth of the local market, as financing to the private sector will be conditioned to the needs of the public sector.

After liquidating the country's oil savings funds in 2008, the drop in oil revenues has forced the Correa government to issue approximately USD1.2bn in debt to the Ecuadorean Social Security Institute (IESS), thus weakening the country's USD liquidity and signaling that the government will likely compete with the private sector for resources to fund its financing needs. In Venezuela, the decision by President Chavez to hold a referendum to amend the constitution in February 2009 effectively delayed fiscal adjustments. As the government used its deposits in the financial system to maintain the pace of expenditure growth in light of lower oil-derived revenues, the system's liquidity has declined and interbank interest rates have risen noticeably.

In the absence of a credible and sustainable shift in economic policy adjustments, capital inflows to fund current account deficits and external obligations are likely to remain low. As part of their ideological discourse, relations with multi-lateral institutions such as the IMF and World Bank remain strained. The ongoing default on Argentine bonds not tendered in the 2005 exchange and the Ecuadorean government's decision to stop servicing external bond debt not only constrain the public sector's access to international market, but also increase the financing costs for the private sector. Finally, as mentioned above, FDI inflows are likely to remain low in the absence of significant adjustments to economic policy and overall business environment.

Implications for Creditworthiness

A recovery in commodity prices could help Argentina, Ecuador and Venezuela alleviate pressures on fiscal and external accounts. However, there would be very limited room for creditworthiness to improve due to their weak policy frameworks and fragile macroeconomic stability. In addition, political calculations and ideology will likely continue to weigh heavily on future policy choices, as Fitch expects these governments to continue focusing on short-term political gains rather than long-term policy objectives that would reduce their economies' vulnerabilities and volatile macroeconomic performance. The recent proposal by the Argentine government to move forward congressional elections originally scheduled for October illustrates precisely that calculation.

Downward pressures on Argentina's Local Currency IDR could intensify if fiscal slippage is greater than anticipated. Conversely, liability management operations such as voluntary debt exchanges, Paris Club repayments or a potential reopening of the debt exchange for holdout creditors could ease Argentina's financing prospects and stabilize its Local Currency IDR.

If Venezuela fails to address its mounting macroeconomic pressures — underpinned by the rapid decline in oil prices, high inflation and an overvalued official exchange rate — there could be a severe and disorderly economic adjustment. In this scenario, the sovereign's capacity to service its debt could be adversely affected. Additionally, a greater–than-anticipated deterioration of the country's fiscal and balance of payments position could also put downward pressure on Venezuela's ratings. Venezuela's creditworthiness could improve if a sustainable and coherent policy response were implemented to reduce its vulnerability to oil price fluctuations and thus the volatility of overall macroeconomic performance.

Argentina's and Ecuador's Foreign Currency IDRs remain at 'RD' until these sovereigns can successfully conclude the restructuring of their defaulted debt. Nevertheless, even if they were to complete successful exchanges, their ratings would likely remain low due to the vulnerability of their fiscal and external accounts and weak macroeconomic policies. In addition to capacity, concerns about willingness and transparency are likely to continue to weigh on investors' perceptions, thus possibly maintaining high financing costs for these sovereigns.