Barclays Capital Research

The Emerging Call

Focus: Venezuela's Willingness to Pay

Emerging Markets Strategy — April 3, 2003

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Key Markets	Yesterday	Month Ago
Dow Jones	8285	7838
NASDAQ	1397	1320
30-yr Treasury Bond Yield	4.92	4.67
EMBI (Spread)	640	708
C Bond Price	81.65	74.7
UMS12	208	264
Russia30	317	351
EUR	1.077	1.089
MXN	10.65	11.11
BRL	3.26	3.57

On Willingness and Elections

Summary

Venezuela's willingness to pay its external debt is tied both to the country's sharp financing constraint and to Mr. Chavez's ability to resolve the political crisis this year. The authorities' willingness to pay has dropped markedly after the sharp drop in reserves in Q1, and they are unlikely to be willing to lose much more in dollar reserves as the year progresses. In this setting, investor participation in a debt exchange should remain limited as long as the political crisis remains unresolved.

With or without elections, Venezuela's ability to pay will be greatly hampered by falling oil prices after a successful resolution of the Iraqi War, suggesting a high chance of debt default in Q4. Given the remarkable inability of the Venezuelan opposition to unify and present a sole candidate, Mr. Chavez does stand a chance to win and stay in office through 2007, assuming the Supreme Court rules that he can run. As long as Mr. Chavez perceives that he can win a presidential election, every effort will likely be made to avoid default. Regardless of the political outcome, the likelihood of default continues to grow in Venezuela (ability to pay). Its timing, however, remains underpinned by the government's ability to solve the political crisis (willingness to pay).

Divide et Impera ("Divide and Conquer") once Again

Willingness to pay is tied to oil revenues and therefore oil prices. As Venezuela's ability to pay declines due to rapidly falling oil prices following the end of the Iraqi war, the government's willingness to pay will also decline, underscoring a more limited tolerance to lose reserves. Not surprisingly, the government will attempt to pursue a voluntary exchange that reduces principal amortizations in exchange for somewhat higher interest payments. If the transaction is not successful, the likelihood of default will heighten significantly. The debt exchange is scheduled to occur in Q2, but it would likely be postponed if oil prices fall markedly and social pressures re-emerge. Still, as long as Mr. Chavez believes that he can resolve the political crisis in his favour, presumably via an election, Venezuela will continue to make external debt payments ahead of an election.

Mr. Chavez's ability to settle the political crisis once and for all will determine the government's willingness to continue honouring its external debt. First, in the event that he can get greater support for Venezuelans and a more united Venezuela by attributing the worsening economic crisis to a heavy debt burden, default would be a serious option. Because of the depth of the political crisis, it appears unlikely that calling for a default would generate any meaningful political support. As a result, this venue has a low probability. Second, and more importantly, Mr. Chavez's read of the political opposition to the government is crucial. To the extent that he perceives the opposition to still be in disarray and poorly organized, he would seriously consider bringing an end to the political crisis by negotiating a revocatory referendum that allows him to run in the subsequent presidential election.

Because the opposition may not unify behind a single agenda or vision for a new Venezuela, Mr. Chavez will again have a great opportunity to "divide and conquer." The Venezuelan opposition will likely run with several candidates, possibly as many as five. By so doing, it risks splitting the vote to the degree that Chavez could emerge as the winner, with only 25% of the vote. While diverging views and candidates should be welcomed, the opposition needs to come together, provide a clearly identifiable platform with a vision of the kind of country that they envision when they criticize Chavez. Furthermore, it would be a sign of political maturity for the opposition to unite as a single party and elect, through a primary process, a leader that will broadly represent them and end Mr. Chavez's term. Instead, it risks remaining as disorganized and uncoordinated as in the past; accordingly, Mr. Chavez could stay in office through 2007.

In this setting, Mr. Chavez may agree to a revocatory referendum that he knows he will lose if he is given the opportunity to run in the presidential election, on which the Supreme Court will rule after the election of the electoral council. An "independent" council would probably lead the Supreme Court to allow Mr. Chavez to run in a presidential election, in our judgment. In turn, Mr. Chavez would agree to hold a revocatory referendum as the country's financial situation worsens. An announcement of such a referendum, perhaps late in Q2, would cause the opposition to rally, with all the many divergent agendas running freely for a new election.

Furthermore, it would lead Venezuelans to see the chance for progress and turn toward rebuilding the country, something that of course would benefit Mr. Chavez, as tax collection and public finances would strengthen somewhat. The government would benefit politically as it would show a "democratic" vocation well beyond doubt, while providing Mr. Chavez with his best chance to solve the political crisis once and for all. He would, of course, focus on the presidential election, while the opposition would focus on the revocatory referendum. The opposition would then hope that the Venezuelan electorate would be able to differentiate among many candidates and pick one. Because the campaign would probably last a couple of months, if not just weeks, the electorate could end up being seriously confuse and unable to identify the "likely" opposition winner. Accordingly, a heavily contested election could give him a victory, or as it's said in Venezuela: *A rio revuelto ganancia de pescadores* (Unsettle waters, benefit of fishermen).

In a heavily contested election with a short campaign, there is a greater chance that the votes are more closely split among five opposition candidates and Chavez. Because Mr. Chavez likely would receive 20-25% of the votes, the other five candidates may not be too far from each other at 15%. This suggests a Chavez victory, since in Venezuela there is no run-off election. The only hope for the opposition in such a scenario is that the Venezuelan people can differentiate between the candidates enough to vote for a single candidate. This would be by chance, rather than by a well-defined process organized by the political opposition that ensures this outcome, suggesting that political volatility will remain high.

As long as Mr. Chavez sees that he has a chance of resolving the political crisis in his favour, the government will remain willing to honour its external debt. Accordingly, should the government call for a revocatory referendum and a presidential election as the crisis deepens, any potential debt exchange would occur after the revocatory referendum, signalling the prospect of a resolution to the political crisis. This scenario will grow increasingly likely, as the military end of the war with Iraq – probably sometime in April or May – leads to a sharp drop in WTI oil prices to well below USD 25 or under USD 20 for the Venezuelan basket. WTI prices are now at USD 28.4 or about USD 23.4 for the Venezuelan basket, suggesting that average annual oil price likely will fall below our USD 22 assumption. At an average oil price of USD 22, daunting financing requirements suggest that the FIEM and the FOGADE funds will be exhausted by Q4 and that dollar reserves will fall markedly, likely reaching a minimum reserve level in Q4.

With debt service representing well over half of budgetary expenses, finding savings in this category whether voluntarily or not will become crucial for the government. While the setbacks appear to be liquidity, not solvency driven, that would only be true if the damage to business activity both oil and non-oil are temporary, rather than permanent. It can be argued, however, that some of the damage inflicted to Venezuela's industries throughout this crisis is indeed permanent. For example, with no investment in PDVSA and a depreciation rate of 15%, Venezuela's oil production capacity next year will likely be less than this year, which in turn is markedly lower than that in 2002. Also, thousands of businesses have gone bankrupt over the last few years, suggesting again that with no prospects of investment Venezuela's output capacity has indeed fallen markedly. In fact, GDP has dropped from USD 120bn just three years ago to about USD 72.5bn this year. As a result, debt will rise to about 40% by the end of this year from 29% in 2001, suggesting that solvency concerns are growing quickly.

In this setting, investor participation in a debt exchange should remain limited, suggesting that the willingness to default on debt will rise, especially into the fourth quarter. Venezuela's ability to pay will be greatly hampered, when large external debt payments come due in September, October, and December and the FIEM and the FOGADE funds will be exhausted. With or without an election, the chance of debt default in Q4 is sizable at about 70%. We assign an external debt default probability of 40% in June with an agreement on a revocatory referendum and election, which heightens to 55% without them. However, a presidential election would only postpone a default – should oil prices average below USD 22 – to the last month of the year, especially if Mr. Chavez perceives that he could win such an election. Otherwise, the default could ensue early in Q4.

Given the remarkable inability of the Venezuelan opposition to be more than just "opposition" and come together to present a candidate with unified support, Mr. Chavez has indeed a chance to win and stay in office through 2007. Regardless of the political outcome, however, the *likelihood of default* continues to grow in Venezuela (ability to pay), albeit its *timing* would be underpinned by the government's ability to solve the political crisis (willingness to pay).

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Latam Today

Key News

Argentina

Rating:

SD (S&P)
Ca (Moody's)

Market Call:

Underweight

- *Government announced that the primary fiscal surplus reached ARS 1.75bn in Q1, therefore above the IMF-set lower limit of ARS 1.50bn*.

  View: The number is preliminary but over-compliance was already expected given the high tax collection obtained in the period. Achieving Q2's indicative target of ARS 3.0bn will prove however more problematic. This target is quite ambitious in our view especially due to the fact that inflation and the level of USDARS were overestimated at the time the target was set. A stronger ARS means that collection from export-related taxes will come lower than expected (export taxes are based on USD amounts that are then converted to ARS amounts) while a lower inflation hurts tax collection in nominal terms. Furthermore, spending pressures should build ahead of the presidential elections which could further deteriorate Q2's results. But the stronger resolve from the government to curb tax evasion should offset some of that pressure.This suggests that a primary surplus of ARS 2.0bn is a more realistic goal.

Brazil

Rating:

B+ (S&P)
B2 (Moody's)

Market Call:

Overweight

- *Amendment to Article 192 of the Constitution passed with great margin*.

  View: The news was already expected and did not generate much market reaction. Nevertheless the high number of votes (442 against 308 needed) brings optimism regarding the future advancement of the congressional agenda in Congress. Also, despite speeches decrying the possibility of independence of the central bank, there were no defections from government's support-base suggesting that the government was successful in its attempt to control its allies. There were just 13 votes against and 17 abstentions. A second round Lower House vote, to take place possibly next week, is still needed to finalize the amendment's approval. Although there is no official position on the issue, we find it very unlikely that a complementary law establishing the independence of the central bank will be discussed by Congress in 2003. Given the resistance from a great part of the government's support base to the measure and the likely resistance by the same group to the other more pressing reforms (Social security and Tax) we think the government will not push too hard here. It will prefer to advance on the other reforms and leave the independence of the central bank for later, after the other reforms are approved.

- *FIPE inflation for March came lower than expected this morning at 0.67% down from 1.61% last month and 2.19% in January.*

  View: Market expectations were around 0.8-0.9%. Number bodes well for a lower IPCA inflation number for the same period which is going to be released in a week.

Bond Trading

Market Volume (MM):

Total: 1066

C Bonds: 376

Russia 30: 161

EMBI+: 640bps, -17bps

Brazil

Brazil EMBI+:

967 bps,
-36 bps

- The rally continued yesterday as C bonds traded as high as 82.25 and spreads were much lower due to the UST sell-off.
- With last night's vote we think that most of the good news, in the short term, is priced in and expect the market to trade around current levels for a few sessions. The big question now is when we will see a new issue by the Sovereign.

— Ronaldo Lyrio (212) 412-3412

Mexico

Mexico EMBI+:

269 bps,
-16 bps

- Spreads significantly tighter as prices held up very well in the face of the strong UST sell off. A lot of the demand seems to be coming from local demand as local rates and the peso are also doing extremely well.

— JP Alvarado (212) 412-3118

Andeans

Venezuela EMBI+:

1360 bps,
-7 bps

Colombia EMBI+:

569 bps,
-30 bps

- Venezuela was tighter although performance was disappointing if compared with other LATAM markets. If Venezuela has been unable to rally in this environment we are worried about what might happen if the broader market turns negative.
- Colombia spreads were tighter significantly although there was better local selling. Most of the gains came very late in the day with little volume and trading.

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Emerging Europe & Africa

- In Russia, bonds closed well bid yesterday on local demand following coupon payments on 10s and 30s at the end of March. Both bonds outperformed the rest of the curve yesterday with 30s trading at an all time high of 87.625 into the NY close. The overnight weakness in USTs put pressure on bonds at the open. 30s initially traded at 87.50 but spent the rest of the day tracking USTs lower, with 30s closing at the lows of the day at 87.00. The EMBI+ Russia still closed at a new post 1998 low of +354 on the back of weaker Treasuries. As we have said previously, Russian bond prices are at risk of further downside if rates continue to rise in the US going forward, but spreads should continue to tighten as fundamentals remain positive.
- Trading in Turkish bonds remains thin with most volume concentrated in the 30s. 30s opened weaker, trading a low of 87.25 ahead of Powell's speech from Ankara. Nothing new was said during the speech. Headlines later in the day that Denktash had offered Greek Cyprus land concessions in hopes of reaching a final agreement, led to some buying of 30s with a high trade of 90.00 before bonds closed 1/2 point higher on the day at 89.25-89.75.

— Rupesh Hindocha (44-20) 7773-9112

FX & Interest Rates Trading

Brazil

- For the third consecutive day, the interest rate curve moved to the left. The interest rate market is following the bullish trend of the FX market and is indicating a cut on the SELIC rate for the next semester. The BRL gained ground against the dollar for the fourth day yesterday. This movement came on the back of the expected Congressional passage of the constitutional amendment reforming the country's financial system. The dollar closed at 3.263 (-1,56%).

— Noel Zanoni (55-11) 5509-3208

Mexico

- Big rally in the MXN markets took the peso to 10.6350 intraday closing a bit lower at 10.6500 yesterday. Trading continues to be dominated by events in Iraq and the euro. The 10.6100 support area is very important technically and a close below will bring back the old 10.3500/10.5500 range into play. Resistance comes in at 10.6750 and 10.7300 thereafter.

— Carlos Cervetti (212) 412-2015

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