

Rundt's World Business Intelligence

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There have been a number of encouraging signs, leading some to conclude that the economy is bottoming out, but we suspect that this observation is still premature. While the downturn will remain less severe than elsewhere in Europe, the French people appear to be in an increasingly angry mood, and President Sarkozy has become surprisingly unpopular.

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The economy's performance in the first quarter of this year was even worse than we had assumed in our assessment, and this definitely makes it impossible for the country to meet the conditions for its international loan package. We continue to believe that these will be eased. If not, a devaluation might have to be reckoned with.

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POLAND Page 10

For the first time, the Polish government seems to be seriously considering a significant delay of its plans to enter the country into the Eurozone and replace the zloty with the euro. Creditors of Polish companies need to look out for those facing big losses as a result of misplaced exchange rate bets.

SOUTH AFRICA Page 12

President Jacob Zuma chose his first Cabinet with the clear aim to reassure investors and businesses while vowing to help millions of poor people. What will now have to be seen is the extent to which he manages to resist the magnetic pull of the political Left in the ANC, which helped him rise to the top.

VENEZUELA Page 14

Signed contracts have no value in the Bolivarian workers' paradise and the regime has no compunctions about expropriating firms it can no longer afford to pay. More nationalizations must be expected so long as oil prices remain low and the parallel FX rate goes from bad to worse.

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International interest rates, spot and forward exchange rates, Euro, SDR, gold.

Trends You Should Know About

RUSSIA

After allowing the ruble to plunge by 35% from last August versus the US dollar, a period during which the Central Bank spent roughly one-third of its official international monetary reserves to brake the unit's slide, Bank Rossii was able to arrest the fall at the end of January by raising interest rates and curtailing the loans available to banks to bet against the currency. Since then, the ruble has gained 12% versus the USD thanks in part to a 30% rise in the price of Urals crude oil, the main export blend (to around USD 55.65 per barrel this week), which helped to lure investors back to Russia. Now, the CB says it may let the RUR strengthen a bit more, by at least another 6%-7% against the dollar-euro basket that defines the exchange rate, before it allows the currency to float freely – quite possibly well before the originally envisaged 2011 target date.

The authorities are encouraged by the fact that the current account of Russia's balance of payments was USD 11.1 billion in the black in the first quarter of this year, which fulfills one requirement of three that they have set for a ruble float. Russia does not yet have the developed financial system and technical conditions in place that are needed to manage inflation and monetary policy through interest rates, but the government is working on this. Official international monetary reserves were cited at USD 385.9 billion in the week of May 1, which was down from USD 598.1 billion last August, but still a handsome kitty.

SPAIN

Adding to stimulus measures valued at 2.3% of GDP earlier this year, the government has outlined new ones including tax incentives for companies to retain workers, subsidies for new-car purchases, and a program to shift resources away from the construction industry toward other sectors. According to Prime Minister Jose Luis Rodriguez Zapatero, the latest program has a dual objective, namely to stop job losses and prepare the economy for a recovery “with changes in our model.” The official national unemployment rate stood at a painfully high 17.4% of the labor force in March, according to the Eurostat agency.

UKRAINE

Moody's Investors Service has lowered the country's foreign and local currency government bond ratings from B1 to B2 with a negative outlook, putting them five levels below investment grade (Moody's defines all B-rated obligations as speculative and “subject to high risk”). It did so as Ukraine is facing a possibly 12% contraction of real GDP this year, dwindled demand for its exports, a pervasive lack of credit, a currency that has lost more than 40% of its dollar value since last September, and political instability that has slowed much-needed economic reforms.

Moody's says that “a supplementary reason for the downgrades is the uncertainty generated by a series of capital controls implemented by the National Bank of Ukraine to ration foreign currency.” This refers to new rules on currency trading which the Kiev-based ZAO Alfa-Bank blamed for having missed a payment on one-year 9.75% notes due May 4 because of a lack of dollars in the interbank market. Ukraine received the first USD 4.5 billion from its USD 16.4-billion IMF accommodation last November, when the facility was approved by the Fund, but the second tranche of USD 2.8 billion, originally expected in mid-February, was disbursed only on May 8, after being delayed by a disagreement about the permissible fiscal deficit.

China

The government's economic stimulus package is working well, so well that in fear of fuelling inflation and/or creating new bubbles Beijing has been cutting back loan growth. In a (minor) effort to protect its massive reserves against dollar risk, the CB has been diversifying into gold. In the US, meanwhile, lawmakers on Capitol Hill have launched a new attempt to punish the PRC for what they call “currency manipulation.”

While other countries are struggling to keep their official economic forecasts in line with still-deteriorating conditions and keep revising them downward, China's Central Bank says that the PRC's economy performed “better than expected” in the first quarter,

thanks to an easy-money policy and the government's big stimulus program. Real GDP grew by an annual 6.1% in January-March, down only slightly from 6.8% in October-December. The CB says the country is on track to register growth of about 8% this year, and some private forecasters have become more optimistic as well. There is a growing conviction that the economy, overall, has hit bottom and is on its way back up. Exports are still falling (they were in April down 22.6% from a year earlier), but the government's fiscal stimulus package of 4 trillion yuan (or USD 586 billion) has already driven investment back to pre-crisis levels, fuelled rebounds in electricity and steel production, and restored consumer confidence.

Driven By Investment

The ongoing recovery is driven by fixed asset investment with a focus on infrastructure. Urban fixed-asset investment soared in the four months through April by 30.5%, up from 28.6% in the first three months of the year. Housing sales jumped 35.4%, and new lending has been surging. The authorities are planning to provide 20 billion yuan this year in interest rate subsidies on bank loans to help steel, petrochemical and automobile companies upgrade technology. Overall, new lending skyrocketed sixfold to a record in March, as banks supported the government's stimulus efforts and responded actively to its call to open the credit taps and get the economy moving again.

So successful have these efforts been that there is now growing concern in official circles that, in the absence of measures to regulate the torrent of new bank lending more tightly, much of the credit surge could be diverted into the asset markets or bank deposits and could eventually fuel inflation and/or create asset bubbles. So, the government has put interest rates on hold since last December.

Brakes On Loan Growth

It has also noted that an unusually large portion of the new loans – CNY 1.48 trillion or about one-third – was in the form of short-term bill financing, usually used for businesses that need working capital quickly and giving rise to suspicions that companies may have been borrowing these short-term funds only to put them back on deposit and earn interest, or for speculation in the stock and property markets. Be that as it may, under the watchful eye of the authorities the state dominated banks gave out only CNY 592 million (USD 85 billion) in new loans in April, or less than one-third of what they had extended in March.

Reserve Diversification

Official international monetary reserves were valued at USD 1,954 billion as of end-March, a staggering amount even for a country as large as China. If one were to add to this what some call "hidden reserves," such as the holdings of the sovereign wealth fund China Investment Corporation and the "other foreign assets" of the People's Bank of China, one arrives at a grand total closer to USD 2.3 trillion.

Of these funds, the PRC has invested at least USD 1.5 trillion in US dollar assets, of which about half are in US Treasuries. Against this background, and even though China's reserve portfolio has held up well so far in the global crisis, it comes as no surprise that the authorities occasionally voice misgivings about the dollar risks they are facing.

The government has made some attempt at diversifying these assets and has, among other things, boosted its gold holdings by 76% since 2003, so that it now has the world's fifth biggest hoard, at 1,054 tons. But this is worth USD 31 billion at current prices, a relative pittance when stacked against the dollar assets. The fact remains that so long as the regime is determined to hold down the yuan's exchange rate versus the US dollar, it will have to buy up greenbacks in the market and add them to the official reserves.

Rising Anti-China Protectionism

This makes it noteworthy that a group of Democratic and Republican legislators in Washington this week revived a bill that threatens to raise import duties on Chinese goods to punish the PRC for what they call "currency manipulation." While the legislation would allow US companies to apply for protective tariffs on imports from any country deemed to be deliberately "undervaluing" its currency, the intended target is clearly China.

A Bill to Watch

The Obama Administration has deliberately refrained from calling the PRC a "currency manipulator," which would have forced it to take action, and a bill similar to the new one did not gain much traction on the Hill before. But the deep US recession and surging US unemployment raise the odds that the legislation will get more support this time around. It is being promoted by Representatives and Senators from states where especially large numbers of jobs have been lost, such as Michigan, Kentucky, Ohio, and Pennsylvania. (5/14/09)

France

There have been a number of encouraging signs of late, leading some observers to conclude that the economy is bottoming out, but we suspect that this observation is still premature. The government has run into limitations on what it can do fiscally to stimulate activity, and monetary policy is out of its hands. With unemployment continuing to rise, consumer spending will continue to suffer. While the downturn will remain less severe than in other leading European nations, the French people appear to be in an increasingly angry mood, and President Sarkozy has become surprisingly unpopular.

Consumer confidence rose in April, accompanied by indications that extended unemployment benefits and government incentives are lifting demand for cars and household appliances. Consumer spending on manufactured goods increased by 1.1% in March from February, when it had fallen by 1.8% from January, and was up by 0.6% year-on-year. Manufacturers' confidence improved in April for the first time in 13 months, suggesting to some observers that the economy hit its bottom during the final quarter of last year or the first three months of 2009 and is now in the early stages of a rebound brought on by a series of government stimulation efforts.

President Nicolas Sarkozy introduced last December EUR 26 billion (about USD 34 billion) in such measures, most of which were aimed at buoying investment and provided tax cuts for companies this year and next, as well as incentives for households that scrap old cars and buy new ones. In February, he pledged an additional EUR 2.6 billion in spending and new tax cuts for job seekers and the disabled. France, also, has spent EUR 1 billion more than planned on a stimulus measure to refund value-added tax to companies. Even so, the Paris-based "rich-country club" known as the Organization for Economic Cooperation and Development forecasts that real gross domestic product will shrink by 3.3% this year, which compares with OECD expectations of declines of 3.7% in Great Britain and 5.3% in Germany.

Left With Little Elbowroom

Industrial production in France fell in March by 1.4% from February, suggesting that the global slump

may have crimped growth more than anticipated and confirming that the first-quarter result for GDP will likely be disappointing. The problem is that the government of Pres. Sarkozy has pretty much reached the limits of what it can do to put more pep into business activity. The European Commission projects France's fiscal deficit for the current year at 5.4% of gross domestic product, or considerably more than the 3.0% permitted by Union rules over the longer run. The organization recently called on Sarkozy's government to cut spending on healthcare and local governance to help get the red-ink spill back under the prescribed threshold by the end of 2012.

Although the Elysee is not necessarily determined to follow such admonitions to the letter, it is constrained in its ability to deficit-finance its way out of trouble. As for monetary policy, this is in the hands of the European Central Bank, which sets policy in a one-size-fits-all fashion that is geared most heavily toward the needs of the largest economy in the Union, that of Germany. Mr. Sarkozy is under increasing pressure, not only from militant labor unions but also from the people at large, to raise taxes on the wealthy, but if he gives in at all on this score, he will do so only to a very limited extent. He strongly believes that he "was not elected to raise taxes" and wants to "reconcile France with the idea of success." While he needs, for political reasons, to avoid being viewed as siding with the rich so long as the economic crisis lasts, he is not likely to dismantle the "fiscal shield" that lets high-income households avoid paying more than 50% taxes on their overall income.

Mounting Unemployment Woes

This leaves the government now with relatively few options for any further stimulus efforts, while it is virtually certain that unemployment (a "lagging" indicator) will continue to rise. French companies shed more jobs than in any comparable period in at least four decades during October-December, when payrolls, excluding government employees, farm workers, and the self-employed, dropped by 117,300 or 0.7%. Joblessness is now close to 9% of the labor force, and is climbing as companies, from Sony France to Continental AG, announce new layoffs almost every day.

This trend has already brought hundreds of thousands of people into the streets to protest the government's "inadequate response" to the crisis. Fortunately, a law pushed through by Mr. Sarkozy in August 2007 limits the impact of such walkouts, especially by civil servants, since it requires "minimum service" to be guaranteed by workers and companies, particularly those in public trans-

port, schools, and the postal service. Interestingly, between 75% and 78% of those queried in recent public opinion polls agree with the labor unions and think the strikes have been justified.

Relatively Better Off

Actually, France entered the global crisis in a relatively good position. Since the days of Jean Baptiste Colbert, Minister of Finance and Industry under Louis XIV, the people have believed in a powerful, beneficent state, with heavy taxes, tight regulation, and protection for workers. The government has seen to it that the stimulus spending it has introduced is quick-acting and job-producing and that the financial support it is offering to specific companies such as the EUR 6-billion rescue of automakers Citroen and Renault goes to “national champions” that are large employers (the car industry directly employs some 700,000 in France and 2.5 million indirectly).

The economy is less dependent on exports than that of Germany and the French, who are great savers, have not taken out many unaffordable mortgages or spent excessively on credit. Household debt as a share of GDP is still less than half that in the United Kingdom or in the United States. French banks have largely kept their hands off the toxic assets that derailed so many of their US and UK counterparts, and the government to date has not had to rescue a single, big institution from collapse, let alone nationalize one. So, Pres. Sarkozy is not unreasonable when he stresses that in his view “the main feature of this crisis is the return of the state, the end of the ideology of public powerlessness.”

No Political Benefits

It does not follow, though, as one might expect, that the government gets the credit for keeping the country “relatively better off.” People have not forgotten that during his election campaign, Mr. Sarkozy had called for reforms to the “French model” which, he said at the time, produced less growth and more unemployment than elsewhere in Europe. The crisis exploded as he was in the midst of seeking to reduce the civil service, promote more competition, cut red tape, and loosen up the labor market. Now he is under intense pressure to reverse course and in one recent public opinion poll the respondents expressed more confidence in the ability of labor unions to soften the impact of the recession than in that of the government.

The anti-capitalist Left is on the rise politically, and the three far-Left parties, made up of Communists

and Trotskyites, have been forecast by some pollsters to win 16% of the vote in the upcoming European elections, or more than the Centrist party of Francois Bayrou. As for Mr. Sarkozy, his public approval ratings slipped by another two points in April, to 36% according to TNS-Sofres, which means his numbers are now far below the heights of popularity he enjoyed during his first six months in office.

The voters have grown wary of his making more promises than he can keep, his feverish pace of activity notwithstanding. As he begins his third year in office, he appears to be mulling a major Cabinet reshuffle in the Summer, but his personalization of policy making, which has undermined Ministers in his current official family, will not change and it remains to be seen how successful he will be in using the impending revamp to coopt many of the wavering constituencies.

No Serious Challenge

Prisons, hospitals, and utilities have already been hit by lengthy and disruptive strikes. Between 18 and 20 universities have been blockaded or partially blocked by students, professors, and civil servants even though the demonstrators face salary cuts and eviction by the police. We suspect that labor militancy will get worse as unemployment rises, and this cannot possibly help his standing with the public. Fortunately for him and his UMP party, the Socialists are more divided than ever, torn between their new leader Martine Aubry and the party’s defeated presidential candidate, Segolene Royal, who acts as if she were still campaigning. If any opposition party does well in the upcoming European elections, it will be either the Centrist party of M. Bayrou or the anti-capitalist hard Left of M. Besancenot. Either way, the UMP’s national position will not be seriously threatened. (5/14/09)
Latvia

The economy’s performance in the first quarter of this year was even worse than we had assumed in our assessment, and this definitely makes it impossible for the country to meet the conditions for its international loan package. We continue to believe that these will be eased, and in such an event Latvia should be able to hang on to its currency’s present euro FX rate, even though the target date for Eurozone membership will have to be further delayed. Were the IMF and the EU to be adamant concerning the loan conditions, a devaluation might have to be reckoned with.

The government has just released the latest statistics, which show an economic cave-in even worse than

that which was assumed in our report on this country in our issue of April 23. Real gross domestic product in January-March was a stunning 18% lower than in the like span of 2008, following a 10.3% contraction in October-December. Manufacturing was down 22% and retail sales plunged by 25%. Hotel and restaurant services contracted by 34%. Quarter on quarter, real GDP plummeted by an eyebrow-raising 28.7%, and considering that the base for calculating the second-quarter drop (i.e., GDP in April-June 2008) will be comparatively high, the measured result for this period could be even worse.

IMF Condition Cannot Be Met

Given the surge in social security payments (such as unemployment compensation) and the erosion of tax revenues this implies, it is now virtually a foregone conclusion that Latvia will not be able to meet the principal condition set in the IMF-EU loan of EUR 7.5 billion (USD 9.9 billion), namely that the nation must constrain its fiscal deficit in 2009 to no more than 5% of GDP. This criterion was set on the assumption that the economic contraction would be no worse than 5% for all of this year, whereas a much more likely outcome now is a fall by between 12% and 14% (the European Commission expects -13.1%).

The international bailout agreement also calls for the lats' exchange rate peg to the euro to remain in effect and for the country's international competitiveness to be safeguarded not by way of a devaluation but by cutting wages and lowering government expenditures. This is, in many respects, in the country's interest, since Latvia would have much more to lose than to gain from a currency debasement. It runs a sizeable foreign trade deficit, so the losses it would suffer on the import side of the ledgers would be greater than the gains on the export side. Most local credits (by households as well as companies) were taken up in euros, meaning that a devaluation would make the indebtedness much more difficult to cope with. The peg is supported by the IMF, and it is giving the government credibility and the financial system stability at the national level.

Devaluation Not a Tenable Option

The administration has made it quite clear that it does not want to devalue. In fact, the Cabinet is expected to pass a second round of budget and wage cuts in June. But Prime Minister Valdis Dombrovskis and his people are worried that going down this road without substantial help from abroad will make the recession even worse, and they have asked the IMF to permit a fiscal deficit of 7%

of GDP this year, given the changed circumstances. The IMF delayed the payout of a USD 266-million installment from its facility in March because the government did not rein in spending as promised. We continue to believe that it will give its nod to a larger fiscal shortfall, aware that the alternatives could be grim for Latvia. If so, the target for joining the Eurozone would have to be postponed beyond the envisaged January 1, 2012 deadline, but Riga should be able to preserve the lats' euro peg.

A Path to Worse Problems

If not, it would become questionable how long the authorities would then be able to hold the currency stable. Assuming that the cave-in of domestic demand and a much faster decline of imports than of exports this year will pare the current-account BoP deficit to under 4% of GDP from 13.5% in 2008, the red-ink spill should be manageable, with some run-down of official foreign exchange reserves, even alongside a relatively high rollover ratio of bank debt, provided the IMF and the EU maintain the disbursement of funds from their bailout accommodation. But Latvia has already had to spend money from reserves, on and off, to defend the lats against downward pressure in the markets. The signals remain set for a continued outflow of capital. And if the IMF and the EU began to pull their purse strings tight, it would not take Latvia long to run into growing international-liquidity difficulties. (5/14/09)

Nigeria

With government revenues falling woefully short this year, the authorities are looking high and low for sources of funds with which to plug the widening fiscal gap. The country needs very large amounts of money for urgent infrastructure work, especially on projects to improve electricity supplies. While the local banking industry is facing a liquidity crisis, the government has vowed that it will not let a single institution go under. But it has, to date, stabilized conditions only with stopgap measures that offer no solutions for the longer run.

With receipts from crude oil making up more than 80% of government revenues and some 95% of foreign exchange earnings, the fiscal accounts

have been in trouble ever since world market prices for petroleum started to plummet last July. To boot, Nigeria is now having to cope with reduced capital inflows due to the global credit and economic crisis, a reduction in the availability of trade finance, and a decrease in the foreign exchange sent home by expatriates living and working abroad. Revenue from oil has slumped to less than USD 1 billion a month from an average of USD 2.2 billion last year. Companies, institutions, and departments are said to owe the government at least 260 billion naira in unpaid taxes and the first-quarter tax collection was 124 billion naira (USD 830 million) below target.

A Huge Need For Money

Finance Minister Mansur Muhtar indicated recently that, as a result, Nigeria will post a wider budget deficit of 3.02% of GDP this year, but it seems to us that this estimate is wildly optimistic. The government says that it will need USD 10 billion annually over the next decade to develop infrastructure (roads, rail service, and utilities) to support economic growth, and only a fraction of this will come from private industry. The government has granted a concession for the construction of an expressway linking the cities of Lagos and Ibadan. It is also working on the concessions for two other highways, the Benin-Ore-Sagamu road and the Kano-Kaduna-Abuja expressway. A railway development program is being worked on involving the rehabilitation of – and the purchase of rolling stock for – the country's single-track railroad. Nigeria is also renegotiating a contract with China to build a railway line from Lagos to Kano that was suspended last year.

Above all, there is an urgent need for a revamp of the country's power sector, for which the government recently allocated more than USD 5 billion from the so-called excess crude oil account, a rainy day fund of which the total value has already dropped to USD 13.5 billion from over USD 20 billion at end-March. The problem is that the large majority of Nigerians, over 70% of whom live on less than a dollar a day, frequently go without reliable access to electricity, and that companies running their own generators to provide power for their operations incur costs that are between 10% and 20% higher than they would be in neighboring countries. Numerous foreign investors have pulled out of the country, citing high energy costs as one of the principal reasons.

Finding It Will Be a Challenge

Rectifying this will not prove easy. Under former Pres. Obasanja, the government spent between USD 10

billion and USD 16 billion on the power sector in eight years, without much in the way of tangible results, as most of the money went unaccounted for. Late last month, seven senior officials from the National Electricity Regulatory Commission were arrested and charged with fraud, accused of diverting USD 33 million in state funds for their personal use. But aside from corruption, the administration of Pres. Umaru Yar'Adua also has to find a way of raising the needed money, and this is proving to be even more of a challenge.

Nigeria's external debt is not the problem. These IOUs fell to USD 3.5 billion in 2006 from USD 36 billion in 2004 after Abuja paid off arrears and the creditor nations under the Paris Club umbrella wrote off most of their loans. But official foreign currency reserves declined to USD 45 billion in April from USD 53 billion in January. Standard & Poor's in March cut the outlook on Nigeria's BB- credit rating to negative from stable as oil prices stayed low and the government refused to curtail spending. The currency controls introduced this year (see our Briefs of February 12 and 19) and the cap on bank deposit and lending rates (at 15% and 22%, respectively) have stabilized the naira's official exchange rate, but they are temporary measures that will create growing distortions if they are kept on the books too long.

To make ends meet, the government will continue to take money from the excess crude oil account. It is now also seeking to withdraw USD 200 million from the USD 330-million Nigeria Trust Fund, which it established in 1976 at the African Development Bank, when oil earnings were flowing profusely, to help development projects on the continent and to increase its influence in the AfDB. Abuja, furthermore, is in "urgent talks" with the World Bank on a loan to help finance its budget deficit, since it had to abandon a plan last year to sell a global bond of USD 500 million as the international credit markets seized up.

Interest Rates and Inflation

The economy is forecast by the Finance Ministry to grow by 5%-6% this year, which is short of the 8.9% the President had predicted as recently as in December, but which may still be substantially too optimistic. The AfDB anticipates a gain of only 4%, following one of 6.1% in 2008. The Central Bank cut its benchmark interest rate by 1.75 percentage points to 8.0% in early April to boost lending and ease the economic slowdown, but it needs to be careful in loosening its grip since inflation, despite an improved harvest that lowered food costs, was still at 14.4% in March, after 14.6% in February.

Problems In the Banking Sector

The CB is also mindful of problems in the local banking sector, from which investors have been fleeing by the droves since regulators allowed financial institutions to delay booking losses on so-called margin loans backed by shares. The lack of disclosure made it impossible for investors to identify potential losses. It is widely assumed that lenders may be holding as much as USD 10 billion in “toxic assets,” which would be about half their capital.

In late-March, the Central Bank announced it would carry out a “rigorous” examination of the commercial banks to detect “early warning signals” about possible failures. It also vowed that it would not allow any lenders to fail and that banks in distress may be given loans, have their management restructured, or be forced to merge. The average capital adequacy ratio of Nigerian banks stands at roughly 22%, which is a handsome cushion. But there is not much trust among investors, who know that the banks are facing a liquidity crunch as the global crisis curbs lending by foreign banks and as economic growth in Nigeria grinds down.

A Lawsuit to Pay Attention To

In an unrelated matter that is, however, worth keeping an eye on, Royal Dutch-Shell Plc faces a trial in a Manhattan Federal court on May 26 that could have far-reaching implications for other investors in Nigeria. It is based on a lawsuit by three alleged victims of attacks and by the relatives of seven activists killed between 1990 and 1995 in what the plaintiffs describe as a campaign of terror by Nigerian security forces in Ongoni in the Niger Delta that culminated in the hanging of Ken Saro-Wiwa. The plaintiffs allege that they or their relatives were jailed, tortured, and killed by Nigeria’s government at the company’s instigation, in reprisal for their attempts to interfere with Shell’s operations. Shell says that the accusations are false and that the company actually appealed to the government for clemency for Saro-Wiwa.

The case could be groundbreaking if the court ruled in the plaintiffs’ favor. A verdict against Shell would undoubtedly prompt numerous investors to dump its shares since they do not want to be affiliated with an enterprise found responsible of human-rights violations. More than likely, though, the plaintiffs will find it impossible to offer evidence for their allegations, while Shell can offer plenty of the programs it runs to benefit the people. Juries hearing cases under the Alien Tort Claims Act (as this one) do not readily blame companies

for the wrongdoing of government security forces, even if these are called in to protect the enterprises against terrorist acts. And if the jury were to rule against the company, any damage award could still be overturned by judges. More than likely, the only thing the plaintiffs will get out of their lawsuit is publicity, but the proceedings will, nonetheless, be worth watching. (5/14/09)

Pakistan

Faced with a national catastrophe, many Pakistanis appear to have come around to the view that the battle against the Taliban is one for national survival, not just for US interests. Even so, it is far from certain that the military will bring the confrontation to a successful conclusion. Worries about the security of Pakistan’s nuclear arsenal will persist. So will concerns about the stability of the hard-pressed local economy. Noteworthily, in the midst of the national emergency the authorities plan to introduce a new insolvency law designed to permit workouts rather than standard bankruptcy by troubled companies.

In order to understand the war against militant Islamists that is currently being conducted by the Pakistani military in the Northern part of the country one needs to go back to the mid-1990s, when the cleric Sufi Mohammad took up arms to impose Sharia law in the Swat valley (formerly a beautiful, well-known tourist spot) and neighboring areas of the Malakand region. He was arrested after he returned to Pakistan, having led thousands of fighters to Afghanistan in 2001 in a failed effort to help the Taliban resist US-backed forces there. But the Pakistani authorities released him in 2008 in an attempt to defuse another uprising, spearheaded by Mohammad’s son-in-law Fazlullah after a military assault on the Red Mosque in Islamabad in mid-2007, where an armed movement had barricaded itself seeking spread Islamic law to the capital

Meaningless Promises

Fazlullah, also a cleric, has ties with various Pakistani Taliban forces and with al-Qaeda. Using FM radio to spread his message, he became known as Mullah Radio. Then, in October of 2007, the army deployed troops in Swat, using artillery and gunship helicopters in an attempt to reassert control. But the civilian government that

came to power last year tried to reach a negotiated settlement. It thought it had clinched a peace accord, but this pact fell apart in May 2008. Following that, militants unleashed a reign of terror in Swat, beheading politicians and others they deemed to be opponents, killing singers and actors practicing arts they disapprove of, banning female education, and destroying nearly 200 girls schools.

A Skewed View of the Problem

Even then, only about 10% of Pakistanis saw terrorism as their biggest worry. For the vast majority economic issues such as inflation, unemployment, and poverty were much more pressing problems and people felt that the military, by fighting the Taliban, was conducting an “American war” strictly in America’s interest. Many Pakistanis thought the Taliban were amenable to negotiations and would keep their word if they signed on to a peace deal. So did the government, which also believed it could replicate in the Swat Valley the successful pacification of Fallujah in Iraq, where agreements with more moderate elements opened up a rift between them and al-Qaeda fanatics. So, the administration of President Asif Ali Zardari offered on

February 16 of this year to allow the Taliban to impose Islamic law in the Swat valley and neighboring areas in exchange for an indefinite cease-fire and an end to all hostilities.

The Taliban, however, refused to give up their guns and instead pushed into Buner and another district adjacent to Swat, clearly determined to use their momentum to spread their rule. This brought them to within 60 miles from Islamabad. It not only raised deep concern in the US and many other countries about the increased risk of Pakistan seeing its democratic institutions collapse under the onslaught of the militants and, conceivably, nuclear weapons falling into terrorist hands, it also, apparently, convinced many Pakistani’s that the jihadists do, indeed, pose an existential threat to the country. It was then that the government gave the go-ahead and the military launched an offensive to expel the militants from Buner and, perhaps, from Swat.

The Critical Question Now

This would be great news if the military now proved willing and able to achieve a quick and total victory, since only the complete destruction of the religious extremists can bring a return of peace and order. For one thing, though, the army so far has committed only 15,000 troops to the fight against the Taliban, out of a total defense establishment of one million men in the armed

forces and paramilitary rangers. A 1.5% commitment does not exactly bespeak a convincing resolve. For another, as on similar occasions in the past, the army so far has relied mainly on air strikes and artillery to battle the militants. It was not until this week that helicopter-borne soldiers swooped into a far corner of Swat to conduct search and destroy missions. The heavy-weapons strategy involves a high number of civilian casualties and alienates the people when the authorities should be winning “hearts and minds.”

It also allows the Taliban to withdraw into remote valleys and use guerrilla tactics to strike at military convoys, posts, and camps. It raises the question whether the government, this time, will fight on until it has decimated the Taliban, or whether it will again call off the fight prematurely, declaring victory while the Taliban regroup. An inconclusive campaign with heavy civilian casualties and more bomb attacks would undoubtedly undermine public support and be grist on the mills of critics world-wide who claim that military force won’t work and will only alienate the population, even though the people in Swat and Buner clearly want the Taliban gone and would argue that their main problem has been too little involvement of the army, not too much.

The Insurgency Can Still Spread

There is also a serious risk of al-Qaeda and the Taliban seeking revenge by unleashing suicide bombers throughout Pakistan, the more so as the fighting in Buner and Swat has already driven an estimated 1.3 million civilian refugees out of the region and there is no way of preventing jihadists from melting into the crowds and thus infiltrating other parts of Pakistan. There is also a continuing risk of the military splintering under the pressure, since many Pakistani officers and members of the ISI security apparatus are subject to radical influences. Under the circumstances, one would be premature to say that the threat of a collapse of the constitutional government and/or a fragmentation of the military (often called the steel backbone of the country) has disappeared. And this also means that the US Government and other interested parties would be naive to accept blanket assurances from Islamabad that the nuclear weapons “are safe.”

The international community has reason to worry not only about this, but also about the risk that a failure by the conventional offensive against the Taliban (rather than a counter-insurgency campaign) may endanger the mission in Afghanistan, with NATO depending heavily on supply routes through Pakistan. The economic situation in Pakistan gives additional grounds for worry, even though

the IMF, which approved a USD 7.6-billion facility for Islamabad last November, has just agreed to relax the country's budget deficit target in order to help boost growth.

Economic Challenges

The government now predicts that the economy will gain by 2.5% in the current fiscal year, which would be the slowest pace of expansion in eight years and would compare with average annual growth of 6.8% in the past half decade. The State Bank of Pakistan last month cut its key lending rate by one percentage point to 14%, encouraged by the fact that inflation eased in April to a 13-month low of 17.19% from 19.07% in March, but further interest rate cuts will now, presumably, have to await a further significant decline in inflation. While in the US Democratic Congressional leaders have agreed to step up action on a USD 83.4-billion war-spending bill that includes more than USD 400 million in counterinsurgency funding for Pakistan and USD 1.4 billion in economic assistance, a recent international donors' conference in Tokyo raised USD 5.3 billion in aid pledges, but it is not clear where, or on what, the financial aid could be usefully spent.

Also, one has to wonder how deeply engaged the political classes in Pakistan are with the problems the country faces if the President, in this time of a crucial battle against an existential threat to the country and a mounting refugee crisis, chooses to be absent. As these lines are being written, Mr. Zardari has yet to return home from a visit to Washington last week to meet Pres. Obama. Following his trip to the US his itinerary called for a stop-over in Libya, then a visit to the United Kingdom, and finally one to France. But if Mr. Zardari views the confrontation in Swat as a fight for the survival (and the "soul") of Pakistan, as he claims, then this is no time for him to be out of the country.

A New "Chapter 11" Law

Curiously, Pakistan's corporate regulator has picked this time of "national emergency" to announce plans to introduce a new insolvency law by July to enable companies hit by the economic downturn to be revived or taken over, rather than collapse. But for the Security & Exchange Commission of Pakistan the "emergency" consists of "growing closures in the industrial sector and increasing non-performing loans in banking." Especially hard hit are the country's textile factories and engineering companies, as domestic economic growth is slowing to a crawl and global demand declines. Non-performing loans at Pakistani banks rose to 30% or the equivalent of USD 4

billion in the six months ended last December 31, and this is a level that is giving the regulators nightmares.

"Instead of resorting to a default culture," says SEC Chairman Salman Ali Shaikh, "we need to have structures that enable troubled companies to get a soft landing." Under the so-called Corporate Rehabilitation Act, which is patterned after the US Chapter 11 procedure and Mexico's Insolvency Law 2000, the judiciary can approve plans filed by debtors or their creditors for a troubled company to survive in difficult conditions. The legislation also calls for the setting up of a resolution trust corporation. It was developed after consultations with textile producers, cement companies, car makers, engineering companies, and industrial units in the Northwest Frontier Province, and all those owed money by Pakistani customers should try to get a look at it before it goes into effect. (5/14/09)

Poland

For the first time, the Polish government seems to be seriously considering a significant delay of its plans to enter the country into the Eurozone and replace the zloty with the euro, a move that had been targeted for 2012. The Finance Ministry still holds that January 1 of that year is "realistic," but this is no longer credible, given the prospects for the fiscal deficit. The zloty has stabilized in the FX markets, especially since Warsaw signed up for a big credit line from the IMF, but creditors of Polish companies need to look out for those facing big losses as a result of misplaced exchange rate bets.

Before a country can join the Eurozone, its currency has to spend some time in an antechamber of sorts, the so-called ERM-II arrangement, in which it is firmly tied to the euro while the authorities in charge of it prove that they can keep the relationship stable. The Polish government wanted to have the zloty join the ERM-II in the first half of 2009 and then be ready to adopt the euro with effect from January 1, 2012. Until fairly recently, while the administration was ready to concede that it might not be able to meet the ERM-II requirements in the first semester of this year, it still insisted that it would be able to do so before the end of 2009, so that, in the words of Finance Minister Jacek Ros-

towski, “the first of January 2012” for Eurozone membership was “still realistic.” Lately, however, the authorities have begun to admit that such plans may have to be postponed for at least a year.

A Pillar of Official Policy

The Center-Right government of Prime Minister Donald Tusk retains joining the common currency as one of the lynchpins of its anti-crisis policy. It feels strengthened by the notion that the Polish economy is fundamentally much more stable and resilient than are those of some of the most troubled nations in the region, such as Hungary and Latvia. But, while the administration last year had predicted that real GDP in 2009 would grow by more than 3.0%, following a 4.8% expansion in 2008 and one of 6.7% in 2007, such expectations have since been geared back to 1.7%, and the European Commission, perhaps more realistically, reckons with the possibility that GDP will contract by 1.4%.

Also, whereas Mr. Rostowski says that he will not increase spending from the public till and predicts that the fiscal deficit will not come to more than 4.6% of GDP, the Commission foresees a shortfall of 6.6% in 2009 and one of 7.3% in 2010. The criteria for joining the Eurozone call for a red-ink spill no greater than 3.0% of GDP, and this makes the 2012 deadline unrealistic. To complicate the issue further, to give up the zloty for the euro Warsaw would also have to change the country’s constitution, and the Monetary Policy Council is quite correct in maintaining that the pertinent amendments should be legislated prior to the currency switch to avoid the political tensions that would inevitably be caused by disagreements about the plan. Poland is due to hold a presidential election in 2010 and a parliamentary one in 2011. The terms of a majority of the Monetary Council’s members expire at the start of 2010, which is another reason why a postponement of the euro timetable appears essential.

Business Wants the Euro

This is not to say that the government will find opposition to the step difficult to overcome. Quite to the contrary, there are few business people in Poland these days who would not like to see the country embrace the euro as quickly as possible. The zloty has been on a roller coaster ride for the past year, which has made it all but impossible for them, whether they are exporters, or importers, or both, to plan for even the medium-term, let alone for the long run. While many on the export side may have benefitted from the fact that the PLN has

dropped by one-third from its peaks in July last year, they suffered when the cost of their imports of raw materials and parts skyrocketed.

Risky Derivatives Gambles

Many, moreover, sought to protect themselves against the ravages of the zloty’s volatility and the weakness (at the time) of the US dollar by entering into currency derivatives contracts, which turned sour when the greenback began to recover and the zloty went into a tailspin. The financial services regulator in Warsaw said recently that from 80% to 85% of the affected Polish companies will not suffer any losses because their currency contracts are true hedges and their export sales are sufficient to cover the payments, but those that used derivatives to speculate and bet on the zloty as it climbed against the USD and the euro last year lost out when the trend reversed and are now staring in the face of contracts that may cost them as much as 18 billion zlotys (about USD 5 billion), a loss that quite a few may not be able to stand. Polish banks, in any event, had created, by end-2008, a reported 1.34 billion zlotys of provisions for derivatives contracts with local companies out of concern that many may not be able to fulfill their obligations under these contracts.

Steadier Zloty

Fortunately the zloty seems to have stabilized, thanks at least in part to a just-approved arrangement with the International Monetary Fund under which Poland has the right for one year to borrow up to USD 20.6 billion from the Fund’s new flexible credit line, which is extended to countries with sound economic fundamentals using such a line merely as a provisionary facility on which they do not intend to draw except in the event of an unforeseen emergency. The accommodation does not carry the stigma or conditionality of other IMF programs. But it has beefed up Poland’s available official international monetary reserves by almost one-third, following a steep decline that – due largely to intervention on behalf of the ailing zloty – took such assets from a peak of USD 81,930 million at end-July last year down to USD 59,306 million by end-December and produced a loss of 28% by end-March.

Mixed Signals

Still, while Poland is better off than most of its neighbors, mainly because it suffered a tough cyclical downturn already in 2001-2002, credit is tight and borrowers are under pressure. The number of corporate in-

solvencies is on a rise and will continue to climb for the foreseeable future. Central Bank officials estimate that the share of non-performing loans in the total could easily double from 4.5% at end-2008. Industrial production dropped only 2% in March following a 14.6% plunge in February, but one would be premature to interpret this as a signal that the economy is already turning. The improvement resulted primarily from increased sales of automobiles made in Poland on growing demand from European Union clients who are taking advantage of government subsidies for purchases of new vehicles. The weak zloty has made Polish cars cheaper and the country produces the small, fuel-efficient cars that right now are sought-after.

Domestic demand is holding up because of still-robust real wage growth, but this will gradually peter out over the course of this year. While unemployment appears to have stabilized at around 11% of the labor force, further increases down the road cannot be ruled out, especially as more expatriate workers are likely to return home after losing their jobs in host countries. Producer prices in March were 5.6% higher than a year earlier and were up 0.1% from February. The Finance Ministry has suggested that consumer price inflation probably increased to 3.9% in April from 3.6% in March, which would mean that the rate surpassed the targeted 1.5%-3.5% substantially for the first month in four.

Temporary Hold On Interest Rates

While the pick-up was probably only temporary, as slowing economic growth, a rising unemployment rate, and ebbing consumer demand weigh down the rate of monetary erosion in the months ahead, it was sufficient to persuade the Central Bank to put interest rate cuts on hold for the first time in six months and leave its benchmark seven-day reference rate at a record low of 3.75% last week. The Central Bank will now probably take no action on the rate front until June or July. But it will then, probably, go ahead with one more cut this year, to get Polish interest rates into better alignment with those prevailing in the Eurozone. (5/14/09)

South Africa

Sworn in after a convincing election victory, President Jacob Zuma chose his first Cabinet with the

clear aim to reassure investors and businesses while vowing to help millions of poor people. What will now have to be seen is the extent to which he manages to resist the magnetic pull of the political Left in the ANC, which helped him rise to the top. He takes over at a difficult juncture for the economy, which will test his abilities as a pragmatist as it is about to go through its first real recession in 17 years.

Predictably (see our Briefs of April 16) the ruling African National Congress (ANC) won the April 22 general and provincial elections by a landslide, garnering 65.9% of the vote and, thus, 264 of the 400 seats in parliament. This leaves it just three mandates shy of the two-thirds majority it would have needed to be able to change the constitution at will and to govern totally unopposed. The main opposition party, the Democratic Alliance, received 16.6% of the ballots cast and 67 seats in the legislature, while Cope, the upstart Congress of the People formed by disgruntled ANC members who left the party late last year, garnered only 7.4% of the vote and will take 30 seats in parliament.

With this, the former guerrilla and (since December 2007) leader of the ANC, Jacob Zuma, was sworn in last Saturday as South Africa's new president. Keenly aware that many in the financial and business sector had watched his rise to the top with misgivings, he moved quickly to let his domestic audiences know that he intends to be a President for all South Africans, and to reassure international investors that under his administration there would be no big lurch to the Left. At the same time, he tried to generate hope that the country's poor will benefit from a better performance by the government and by what he says will be a greater commitment to the fulfillment of the promises of the past 15 years to tackle widespread poverty, crime, and AIDS.

Thoughtful Appointments

At first blush, it may seem alarming when the darling of international bankers is replaced at the helm of the Finance Ministry by a former Communist. But the new man to hold the portfolio, Pravin Gordhan, while little known outside South Africa, has a good reputation inside the country. Mr. Gordhan, of South Asian descent, not only played a leading role in drafting the present Constitution, he also earned himself laurels as the Chairman of the World Customs Organization for an unprecedented five terms and as head of the South African Revenue Service since 1999, as which he broadened the tax base to

28% from 24% of national income and became arguably the most respected civil servant in the country.

He will bring a proven record in project management and efficiency to the job. Moreover, his well-known and well-respected predecessor in the Finance job, Trevor Manuel, will not leave the government but will become the head of a new Planning Commission to oversee all Ministries, including Treasury, and coordinate the implementation of all government programs as well as spending and budgets. According to Pres. Zuma, his switch from the Finance Ministry was in no way aimed at "limiting his power," but he will now control "a very powerful structure that is going to work out a national plan of government." Mr. Manuel is a favorite among investors for his management of the economy over the past 13 years and for presiding over market-friendly policies.

An Emphasis On Competence

Mr. Zuma retained 12 Ministers from Pres. Thabo Mbeki's outgoing government in his official family, which counts 34 members, 14 of whom are women. He named Ebrahim Patel as head of a newly created Economic Development Ministry. His choice for Minister of International Relations and Cooperation (formerly the Foreign Ministry) is a relative unknown, Maite Nkoana-Mashabane, which bespeaks a desire to downgrade this particular portfolio. Barbara Hogan, who used to head the Health Ministry, is now at the helm of the Public Enterprises Ministry, which oversees the big state companies. Former Foreign Minister Nkosazana Dlamini-Zuma, the President's ex-wife, who had embarrassed South Africa by openly backing governments with dubious human-rights records, has been shifted to Home Affairs.

In an attempt to appeal to Afrikaansers, Mr. Zuma appointed Pieter Mulder of the Freedom-Front-Plus as Deputy Agriculture Minister. Susan Shabangu is the new Mining Minister and Tokyo Sexwale, a businessman and one of the richest in the country, is Human Settlements Minister. Aaron Motsoaledi is Health Minister with a brief to get serious about tackling the country's AIDS problem. Siphwe Nyanda takes over Communications, with oversight over Telkom. The only appointment that looks distinctly like a payback for election help rendered is that of Blade Nzimande, the General Secretary of the Communist Party, who was made Minister of Higher Education and Training. On the whole, this is an impressively technocratic Cabinet put together, it seems, much more on the basis of qualification than that of political loyalty.

Promises to Keep

Jacob Zuma himself, who hails from the rural village of Nkandla in the Eastern KwaZulu-Natal province, lost his father (a policeman) at the age of five. Since his mother was too poor to send him to school he tended his uncle's livestock as a child. Friends taught him to read and when he, later, during Apartheid rule, was imprisoned on Robben Island, he found more opportunity to study. By the time he was released, he was reading Tolstoy without any formal education. He is a political survivor who overcame being fired as the nation's Deputy President and becoming the target of charges of rape and graft. He has vowed to create jobs and improve health and education for the millions of poor South Africans who voted for him, as well as to woo foreign investment.

It is now 15 years since the ANC came to power. But five million adults in a population of 49 million are still illiterate and 34% of them live on less than USD 2 a day. Unemployment was most recently measured at 23.5%. Mr. Zuma has promised to change all this. He plans to outline his new government's program in a state-of-the-nation address on June 3. But he insists that there will be "no surprises," that economic policy will remain conservative and responsible, so that investors putting money into South Africa will have nothing to fear.

The Critical Factor

If this is, indeed, his wish, then the acid test of his administration will be the extent to which it proves able to resist the efforts of key special interest groups that were instrumental in getting him elected – particularly the labor unions and the Communists who form an integral part of the ANC – to dominate his politically diverse coalition.

For the foreseeable future, the economy will continue to go through hard times. While the ANC has promised a massive infrastructure spending bill, real GDP is almost certain to wind up with a loss for 2009 as a whole. In last year's fourth quarter, the economy experienced a contraction (by an annualized 1.8%) for the first time in a decade. Prices for many of the country's commodities have fallen steeply and the mining and manufacturing sectors have been hit hard by dwindling export demand. Crime remains a serious problem, especially in big cities such as Johannesburg, and education and health care are in dire need of an overhaul. Manufacturing contracted in April for a 12th consecutive month. Retail sales have been falling.

The South African Reserve Bank has been cutting interest rates aggressively. Its most recent reduction of its benchmark repurchase rate, by one percentage point to 8.5% on April 30, was the fourth since December, encouraged by the fact that the escalation of consumer prices had receded in March to 8.5% from 8.6% in February. The downtrend has proven to be “sticky,” according to CB Governor Tito Mboweni, but the March decline was the sixth in seven months and the Reserve Bank is fairly confident that it can hit its target of getting headline inflation to within its 3%-6% target band, anticipating an average of 6.1% for 2009 and one of 5.6% for 2010.

Credit demand has slumped, but it may pick up now that the CB has pared interest rates by a total of 350 basis points since December. Fortunately, the country’s banking industry, which is dominated by four institutions (Standard, First Rand, Absa Group, and Nedbank), between them accounting for 84% of the industry, has not become deeply involved with US-generated toxic assets and its exposure to now-contracting economic sectors at home, such as mining, manufacturing, and real estate, is quite limited (together, these sectors account for about 13.2% of total credit extended to the private sector).

While financial conditions are expected to remain “fragile,” to use the term preferred by the Reserve Bank, local banks have maintained levels of capital well in excess of the (already prudent) regulatory requirement, and the Reserve Bank says that their degree of leverage as well as off-balance-sheet risk exposures is much lower than those of “the failed banks in other countries.” Granted, bad debts as a proportion of total loans, which increased to 3.9% last December from 3.6% in November and from 2.9% in July last year, will undoubtedly rise further. Also true, consumers have been showing signs of financial distress lately and their indebtedness will pose a threat to the financial system if the recession becomes much deeper than currently anticipated, and lasts much longer. But at this point we see no reason to disbelieve Reserve Bank assurances that there is “no major systemic threat.” (5/14/09)

Venezuela

It came abruptly, but not as a big surprise, when the government moved last week to take over the oil service companies that had been supplying the in-

creasingly insolvent PdVSA. It has been amply clear for some time that signed contracts have no value in Hugo Chavez’ Bolivarian workers’ paradise and that the regime has no compunctions about expropriating firms when it can no longer afford to pay what it owes them. More nationalizations must be expected so long as oil prices remain relatively low and the exchange rate on the parallel market goes from bad to worse. Interestingly, Chavez sees enemies not only in private enterprise, but also in the labor unions.

The handwriting had been on the wall. The state oil company Petroleos de Venezuela SA (better-known as PdVSA), used as a cash cow by President Hugo Chavez and long short of investment capital, began to run into increasingly serious cash flow problems when world market prices for oil started to plummet last year. The company almost immediately started to fall behind in its payments to suppliers, so much so that it is now estimated to owe them upwards of USD 12 billion. For a while, it was offered relief in the form of an increased ability to sell dollars it earned on the parallel market, where it received much more in bolivars than the official exchange rate. But this reduced the flow of greenbacks to the government and to Cadivi (the exchange control agency) and ultimately forced more & more demand for hard currency onto the parallel market, where the rate recently fell to as low as VEB 7.00 per USD 1.00, compared to the official 2.1475.

Troubled Creditors

This has been driving up inflation, which is now close to 30%. Besides, it did not offer PdVSA nearly as much support as the company needed. Helmerich & Payne, Inc. recently became the second company in two days to question publicly whether PdVSA would ever repay its debts, saying that it may not collect USD 116 million owed to it. Prior to that, Oklahoma-based Williams Cos. said it had written off USD 241 million for uncollectible Venezuelan payments. Enesco International Corp. had stopped booking revenue in January because of a payment dispute. Some service companies had abandoned rigs, while others threatened to suspend operations if PdVSA continued to refuse to pay them.

Troops Seizing Assets

So, last week Pres. Chavez, in his inimitable style, mobilized troops to seize the assets of 20 companies on the Eastern side of Lake Maracaibo in the oil heartland

of the Western state of Zulia. He did so on the day on which the legislature approved a law to pave the way for the state to increase its control and only about a fortnight after PdVSA President Rafael Ramirez had declared “we are not going to pay the contractors that have tried to speculate and aren’t at all concerned for the future of our business.” PdVSA apparently did not give the companies any indication of plans to withhold payment. It just went ahead and did so.

Ramirez had demanded in February that the companies cut their fees by 40%. In the takeover, Energy Minister Ramirez presided over the seizure of 300 boats, 61 diving boats, and 21 terminals, docks, and other assets, saying that PdVSA will “absorb” 8,000 employees from sub-contractors. John Wood Group Plc, based in Aberdeen, Scotland, said that PdVSA had taken over one of its contracts. Boots and Coots International Well Control said it had suspended operations in the first quarter because of past-due payments. The new law allows PdVSA to pay the companies for their expropriated assets with bonds rather than in cash, and at book value rather than market value.

Oil Production Will Suffer

One of the early consequences of the move and the law, which puts the state in charge of providing a range of services including gas & water reinjection, marine transport in Lake Maracaibo, and dock control, which PdVSA does not have the ability to operate as efficiently as the service providers, will likely be a further decline in Venezuela’s oil production. Liftings dropped from 3.18 million barrels per day in 2007 to 2.36 million bpd in 2008, according to the International Energy Agency, while the Venezuelan government insists that the company increased its production to 3.27 million bpd last year. Between these two sources, we clearly have more confidence in the estimates of the IEA.

Of course, according to Minister Ramirez “a sector as important as oil cannot be subject to the whims of private companies. It must be subject to the control of the state.” Problem is, output now is down about 8.4% from last year, and there are private forecasts that it may fall below 2 million pbd in 2009 for the first time in two decades. So far, it seems, the move has been targeted primarily at oil companies which themselves ran into severe cash flow problems because of PdVSA’s non-payment. But the representatives of larger companies such as Halliburton and Schlumberger have reason to worry that the measure will eventually extend to them as well. The way the law is written, the state can take their assets whenever it wants.

A Broader Assault On the Private Sector

PdVSA announced earlier this year that it is cutting its investment budget for 2009 to USD 14 billion from a previously planned USD 24 billion, while Chavez insists that his regime will maintain spending on social programs that provide food, health care, and housing to the poor, upholding his political support. In this context, the seizure of the oil service companies has been, and is seen as, part of a broader assault on the private sector, which is routinely blamed by Chavez as the country slides deeper and deeper into economic difficulties.

It sends a loud warning signal to companies that may still be considering investing in Venezuela, such as those which have expressed interest in an auction to develop the Carabobo block in the Orinoco belt, which has drawn attention because it is the first oil investment opportunity in Venezuela in the past decade and represents the country’s biggest hope for reviving production. The foreign enterprises that do take the invitations seriously better keep in mind that, once signed, contracts in Venezuela are not worth the paper they are written on and legal security is practically nil.

An “Internal” Bond Issue

This is a consideration that should be of concern also to those tempted to invest in the USD 2-billion worth of bonds PdVSA is expected to issue this month to ease its financial problems. It is now beyond doubt that both PdVSA’s ability to pay contractors and the government’s ability to satisfy demand for dollars even under the cover of the exchange controls imposed in 2003 have been seriously weakened. The bonds are likely to be denominated in dollars, but payable in bolivars at an implicit exchange rate about double the current official exchange rate, benefiting PdVSA but hurting investors from the get-go.

Investors may be lured by the fact that many advisers consider an all-out debt default by Venezuela improbable, but they should keep in mind that the country is already going through a progressive currency devaluation by shifting more & more demand for dollars to the parallel market, and that this will heat up inflation considerably more than has already been the case. As devaluation and inflation get worse, importing will become more difficult and shortages will become more generalized. Ultimately, there are no guarantees that the state will not formally default on its debt, as other Latin American nations have already done in the recent past. Simply put, the regime is now turning to desperate measures to keep its (financial) head above water as it is scrambling to dam in seas of red

ink that are spreading as a result of its overspending and the global collapse of oil prices.

Forced Gold Sales to the CB

Meanwhile, probably with an eye on reducing the overwhelming portion of US dollars in official international monetary reserves in anticipation of a decline of the greenback in the foreign exchange markets, the Finance Ministry has ordered that henceforth 70% of the gold produced in Venezuela will have to be sold domestically and 60% (previously 20%) must first be offered to the Central Bank. Up to 30% can still be exported. Also, ending a year-long price dispute Ternium SA, Latin America's second-largest steelmaker, and the Venezuelan government agreed that the latter, through the state holding company Corp. Venezolano de Guayana (CVG) will acquire the former's Sidor unit for USD 1.97 billion.

The Story of Sidor

This dispute had begun in 2007, when Chavez' regime accused the company of refusing to supply the local market and operating a monopoly. Ternium at the time promised to sell more discounted steel within Venezuela. But then it was hit by months of work stoppages to underscore union demands in contract talks, and when these talks stalled, the government in April 2008 ordered the company nationalized. Chavez' people accused the enterprise of maintaining "slave-like" conditions for the workers and of owing as much as USD 700 million in back-taxes. Then, in the second half of 2008, against the backdrop of crashing world market prices for oil, Chavez decided to soften his stance.

He had met with Argentine President Cristina Fernandez de Kirchner in late June to discuss compensation negotiations. Last week, CVG paid USD 400 million in cash for Ternium's 59.7% stake in Sidor and said it will pay the rest in two separate installments. Initially, Ternium had sought USD 4 billion for the stake, while Chavez had offered only USD 800 million after seizing the company. Some say that Ternium, thus, wound up with "a good deal" in the end, but what now remains to be seen is whether the government will hold up its end of this deal.

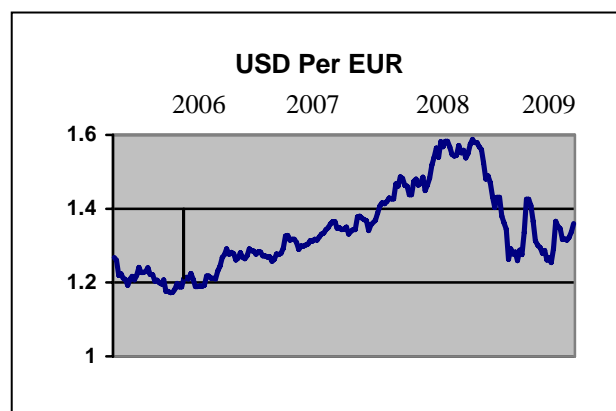
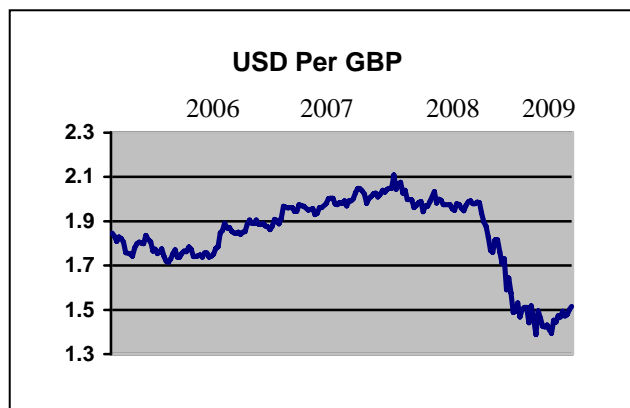
No Liking For Labor Unions

Interestingly, while in Argentina, for instance, Peronism has historically relied heavily on support from the labor unions, Chavez 21st Century Socialism would like to do away with the unions entirely because they are "corrupt vestiges of the capitalist past." Chavez, the auto-

crat, wants to replace unions with "workers' councils" that are, in effect, mere branches of the ruling Unified Socialist Party of Venezuela. What seems to trouble Chavez, among other things, is the fact that workers, and their unions, realize that not only the rich have been paying the price for his programs for the poor and the country's mounting economic problems, but that inflation, shortages of goods, and the many other ills are affecting them very directly.

Labor unrest has been growing, as 46 strikes in January were followed by 59 in February and 113 in March, according to compilations by the Catholic University in Caracas. The regime has been erratic in its attempts to deal with this problem, at times giving in to the pressure, at times threatening military intervention, and at times renegeing on promises made (and then calling the workers "corrupt" for insisting that they be kept). The powers that be are also doing their best to "divide and conquer." For instance, on May Day, when the unions staged two separate marches (as they have been doing for some time), one supporting the government and the other protesting its actions, the latter was broken up by national guard troops with tear gas and water cannon, while the former was treated to presidential exhortations of how Socialism could not exist without the working class... (5/14/09)

Exchange Market Trends



Short-Range Outlook

US DOLLAR, GENERAL: The USD has fallen to seven-week lows against the euro as rising oil prices and other indications that the global crisis may be easing lessened its safe-haven attractions. More dollar selling is likely over the coming weeks, although we do not expect the greenback's decline to be steady or dramatic.

BRITISH POUND: Sterling has been showing considerable strength versus both the USD and the euro, but this is a trend that is not likely to last.

RUSSIAN RUBLE: We expect further appreciation of the RUR (see country entry on Russia in the body of this issue).

CANADIAN DOLLAR: The loonie has been quite volatile in recent trading sessions, responding to a mix of good and bad economic news from the United States and the waxing and waning of expectations that the global crisis is bottoming out. The volatility will persist.

MEXICAN PESO: The MXN is probably headed for more weak spells in line with concern that the Mexican economy is following trends in the US with a time lag.

EURO: Right up to the ECB's next policy meeting on June 4 speculation will persist as to whether the Bank will cut interest rates further. This will keep the EUR volatile, but firm on balance.

Medium-Term FX Forecast – Miscellaneous

Currency	5/13/09	End-Jun 2009	End-Sep 2009	End-Dec 2009	End-Mar 2010	End-Jun 2010
Euro	1.3598	1.3800	1.4000	1.4500	1.4500	1.4500
British pound	1.5158	1.5000	1.5200	1.5500	1.5500	1.5500
Canadian dollar	0.8521	0.8500	0.8600	0.8800	0.8800	0.8800
Rand	8.5225	8.7500	9.0000	9.3500	10.000	10.250
Turkish lira	1.5750	1.5950	1.6000	1.6800	1.7200	1.7500

World Currency Tables

Foreign Units Per US\$

Country	Unit	5/14/09	12/31/08	%	Country	Unit	5/14/09	12/31/08	%
Algeria	DZD	72.3501	71.0299	-1.82	Kenya	KES	77.3290	77.6555	0.42
Angola	AOR	77.8060	75.2000	-3.35	S. Korea	KRW	1250.985	1339.505	7.08
Argentina	ARS	3.7252	3.4510	-7.36	Kuwait	KWD	0.2907	0.2761	-5.02
Australia	AUD	1.3278	1.4461	8.91	Lebanon	LBP	1501.89	1502.55	0.04
Bangladesh	BDT	69.010	68.869	-0.20	Malaysia	MYR	3.5448	3.4785	-1.87
Bolivia	BOB	7.0200	7.0200	0.00	Mexico	MXN	13.3415	13.7610	3.14
Brazil	BRL	2.1099	2.3308	10.47	Morocco	MAD	8.2995	8.0199	-3.37
Brunei	BND	1.4658	1.4369	-1.97	N. Zealand	NZD	1.6878	1.7310	2.56
Bulgaria	BGL	1.4506	1.3959	-3.77	Nicaragua	NIQ	20.1906	19.8350	-1.76
Burma	MMK	6.4100	6.4350	0.39	Nigeria	NGN	149.250	139.505	-6.53
Canada	CAD	1.1736	1.2160	3.61	Norway	NOK	6.5218	7.0114	7.51
CFA-Franc	CAF	486.455	466.989	-4.00	Pakistan	PKR	80.3950	79.2050	-1.48
Chile	CLP	568.805	642.555	12.97	Paraguay	PYG	5055.95	4945.90	-2.18
China	CNY	6.8225	6.8303	0.11	Peru	PEN	2.9565	3.1470	6.44
Colombia	COP	2259.559	2248.585	-0.49	Philippines	PHP	47.1295	47.5180	0.82
Costa Rica	CRC	573.595	557.555	-2.80	Poland	PLN	3.2755	2.9605	-9.62
Czech Rep.	CZK	19.8470	18.8650	-4.95	Romania	ROL	3.0765	2.8513	-7.32
Denmark	DKK	5.4780	5.2897	-3.44	Russia	RUR	32.0410	29.3755	-8.32
Dom. Repub.	DOP	35.65605	35.2770	-1.06	Saudi Arabia	SAR	3.7501	3.7528	0.07
Ecuador	ECS.	1.000	1.000	0.00	Singapore	SGD	1.4658	1.4369	-1.97
Egypt	EGP	5.6265	5.5275	-1.76	Slovakia	SKK	22.1594	21.3950	-3.45
El Salvador	SVC	8.7480	8.7520	0.05	South Africa	ZAR	8.5225	9.4600	11.00
Europ. Union	EUR	0.7354	0.7098	-3.48	Sweden	SEK	7.9188	7.5729	-4.37
Fiji	FJD	2.1675	1.7805	-17.85	Switzerland	CHF	1.1073	1.1555	4.35
Guatemala	GTQ	8.0515	7.7355	-3.92	Taiwan	TWD	32.879	32.527	-1.07
Honduras	HNL	18.8950	18.8950	0.00	Thailand	THB	34.5155	34.585	0.20
Hong Kong	HKD	7.7504	7.7502	0.00	Trin. Tobago	TTD	6.2779	6.3065	0.46
Hungary	HUF	210.325	190.111	-9.61	Tunisia	TND	1.3828	1.2326	-10.86
India	INR	49.715	48.465	-2.51	Turkey	TRL	1.5750	1.5360	-2.48
Indonesia	IDR	10393.55	10960.00	5.45	U.A.E.	AED	3.6730	3.6725	-0.01
Iran	IRR	9908.05	9835.05	-0.74	Ukraine	UAH	7.8065	7.5625	-3.13
Israel	ILS	4.1390	3.7579	-9.21	Uruguay	UYU	23.9505	24.3990	1.87
Jamaica	JMD	88.5258	79.8550	-9.79	Venezuela	VEB	2.1473	2.1473	0.00
Japan	JAP	095.425	090.280	-5.39	Vietnam	VND	17775.9	17472.9	-1.70
Jordan	JOD	0.7084	0.7078	-0.08	Zimbabwe	ZWD	319.13	80808.20	n.a.

Selected International Interest Rates

As of 5/14/09

	USD	GBP	CAD	EUR	CHF	JPY
CB Rate	0.50		0.50			0.50
Prime Rate	3.25	0.50	2.25	1.00	0.53	1.48
Euro-Currency Deposit Offered Rates						
	USD	GBP	CAD	EUR	CHF	JPY
1 Month	0.59	0.92	0.65	0.84	0.29	0.26
3 Months	1.06	1.17	0.80	1.28	0.52	0.67
6 Months	1.30	1.43	0.90	1.49	0.80	0.59
1 Year	1.55	2.19	1.65	1.65	0.86	0.92

NEW YORK		LONDON		TORONTO	
Federal Funds	0.16	Interbank/Sterling		Treasury Bills	
Commercial Paper		1 Month	0.77	1 Month	0.12
30-59 Days	0.33	3 Months	1.41	3 Months	0.18
60-89 Days	0.25	6 Months	1.66	6 Months	0.27
90-179 Days	0.43	1 Year	1.95	1 Year	0.43
Bankers Accept.		Sterling CD's		Corporate Paper	
60-89 Days	1.00	1 Month	0.75	1 Month	0.64
150-179 Days	1.55	3 Months	1.25	2 Months	0.65
Certif. Of Deposit		6 Months	1.54	3 Months	0.64
30 Days	0.30	1 Year	1.82	Bankers Accept.	
90 Days	0.60			1 Month	0.27
180 Days	1.18			3 Months	0.31
Treasury Bills				FRANKFURT	
1 Month	0.16			EURIBOR	
3 Months	0.19			1 Month	0.95
6 Months	0.30			3 Months	1.35
1 Year	0.54			6 Months	1.58
5 Years	2.02			1 Year	1.71
10 Years	3.17				

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Exchange Cross Rates

5/14/09	USD	CAD	JPY 100	GBP	SEK	CHF	AUD	EURO
USD		1.1736	0.9542	0.6597	7.9188	1.1073	1.3278	0.7354
CAD	0.8521		0.8131	0.5621	6.7476	1.0025	1.1314	0.6266
JPY 100	1.0481	1.2299		0.6914	8.2989	1.1605	1.39151	0.7707
GBP	1.5158	1.7789	1.4464		12.004	1.6784	2.0127	1.1147
SEK	0.1263	0.1482	0.1205	0.0833		0.1399	0.1677	0.0929
CHF	0.9031	1.0599	0.8617	0.5958	7.1515		1.1991	0.6641
AUD	0.7531	0.8838	0.7186	0.4968	5.9636	0.8339		0.5538
EURO	1.3598	1.5959	1.2975	0.8971	10.768	1.5057	1.8055	

LdnGold	\$926.00	Silver		14.055	SDR	1.51981
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5/14/09	CAD	JPY	GBP	SEK	CHF	AUD	EUR
2009 Hi	1.1728	088.81	1.5175	7.8044	1.0966	1.3278	0.7321
2009 Lo	1.2907	100.42	1.4681	9.3143	1.1862	1.5851	0.7975