MOODY'S
INVESTORS SERVICE

SECTOR IN-DEPTH
29 August 2017

Rate this Research

Click here to view the full infographic

TABLE OF CONTENTS

Contacts

Gersan R Zurita 55-11-3043-6097
Senior Vice President
gersan.zurita@moodys.com

Renzo Merino 212-553-0330
AVP-Analyst
renzo.merino@moodys.com

Anne Van Praagh 212-553-3744
MD-Gbl Strategy & Research
anne.vanpraagh@moodys.com

Atsi Sheth 212-553-7825
MD-Sovereign Risk
atsi.sheth@moodys.com

Political Risk - Latin America

Political risk poses major challenges to regional credit prospects

Summary

Political risk - the risk of credit negative political events which undermine the effectiveness of policy formulation and implementation - represents a major challenge for Latin American issuers. While the degree of political risk varies by country, its impact on economic growth, reform momentum and financing conditions, affect sovereign and corporate borrowers. This piece explores the different ways in which political risk manifests itself.

» **Latin America faces a range of sources of political risk.** In a number of countries, upcoming elections raise the prospects of credit positive reforms being halted or reversed, and of rising policy inertia. Political risk is also evident in contentious relationships between political parties, or among the executive and legislative and judicial branches of governments across the region.

» **At its severest, political risk threatens growth, structural reforms and financing conditions.** Political risk weighs on near- and medium-term economic growth prospects, reform momentum and financing conditions, and thus poses credit risks for sovereigns and other borrowers. It is transmitted by way of market confidence, investor sentiment, currency valuations and capital flows. Political conflict can stall reform momentum and, in turn, fiscal consolidation. Financing conditions can turn adverse, driving up the cost of funding and reducing market access.

» **Degree of political risk varies by country.**Chile (Aa3 negative), Colombia (Baa2 stable) and Mexico (A3 negative) all have upcoming elections that could affect policy direction and economic prospects in 2018 and beyond. Political risk is moderating in Brazil (Ba2 negative) despite lingering uncertainties surrounding President Michel Temer's incumbency and the outcome of next year's elections. The nation's institutions (including the central bank, the finance and planning ministries and the judiciary) are functioning, allowing the economy to start to recover after several years of recession. In Argentina (B3 positive), October legislative elections will determine whether continued progress will be made on reforms to combat inflation and stimulate the robust growth required to service growing levels of debt. In Venezuela (Caa3 negative), the credit impact of political risk is the most obvious and manifest leading to very high and rising probability of default by the sovereign and the national oil company Petroleos de Venezuala S.A. (PDVSA, Caa3 negative). The escalating crisis has led to violent protests, capital flight and the destruction of productive capacity, resulting in the worst economic crisis in the nation's history.

Latin America faces a range of political risks

Political outcomes are relevant to credit profiles of both sovereign and non-sovereign borrowers. They determine what policies the incumbent government will pursue, and the effectiveness with which those policies are formulated and executed. We define political risk as the risk of credit negative political outcomes that either result in the pursuit of policies that damage economic or fiscal strength, or that undermine government or policy effectiveness and hence institutional strength. Political risk may arise from: (1) election outcomes or leadership transitions which reverse - or halt - positive policy initiatives; (2) the contentious relationship between political parties - or between different branches of government - which encourage policy inertia; and (3) geopolitical or external events.

The Latin American political landscape is changing. New parties are being formed rising from relative obscurity and challenging the established positions of traditional players. Candidates regarded as unconventional, either because they are new to politics or because they hold views that are out of the prevailing consensus, are gaining ground. Voters are broadly dissatisfied by the lack of economic progress, whether real or perceived, and limited institutional development—elements that have led them to become more inclined to reject the establishment, at least in their declared voting intentions.

Political change, and related changes in policy objectives, is not inherently credit negative. However, since the pressure for change across Latin America is broad-based, the credit implications can be unpredictable and potentially credit negative.

Political uncertainty, which has negative implications for policy predictability, is also arising as different branches of government are turning more assertive. Opposition parties are exerting greater influence on policy agendas, a tilt away from the all-powerful “presidentialist” systems that were entrenched in the region. Moreover, as the judiciary is gaining increased independence in some countries, courts are more frequently voicing views — via injunctions — that are different from those of the executive on matters ranging from tax increases to various regulatory matters.

Even if such developments may prove to be credit positive over the longer term by enhancing checks and balances, as new institutional arrangements emerge the result can be greater instability of policy. Where, as in some Latin American countries, ongoing economic and fiscal reforms offer credit benefits, the emergence of instability which impede efforts is credit negative, whatever its benefits may be over the longer term.

A salient characteristic of institutions in Latin America is their comparative weakness, which explains much of the dissatisfaction voters have expressed in the elections. In some countries, such as Brazil, voters are beginning to reject corrupt practices and poor governance, demanding change. Still, progress on the prevention of illegal use of public funds and public official accountability has been modest and uneven across the region. To date, the region sits at the bottom of world rankings on institutional quality indicators.

Exhibit 1

Latin America sits at the bottom in the world ranking

Institutional quality indicators

Institutional Strength	Very High	High	Moderate	Low	Very Low
Political Risk	Very Low	Low	Moderate	High	Very High

	Government Effectiveness	Control of Corruption	Institutional Framework	Institutional Strength	Political Risk
Latin America	Low (+)	Low (+)	Low	Low (+)	Low (+)
Asia Pacific	Moderate (+)	Moderate	Moderate (+)	Moderate (+)	Low (+)
Eastern Europe & Central Asia	Moderate	Moderate	Moderate	Moderate	Moderate (-)
Middle East & North Africa	High (-)	High	High (-)	High (-)	Moderate
Sub-Saharan Africa	Low (-)	Low (+)	Low	Low	Moderate (-)
Western Europe & North America	Very High	Very High	Very High	Very High	Very Low (+)

Note: The assessments of Government Effectiveness and Control of Corruption use the Worldwide Governance Indicators (WGI) as inputs. The Institutional Strength and Political Risk scores are Moody's assessments that incorporate the WGI and other factors.
Sources: Worldwide Governance Indicators; Moody's Investors Service

Venezuela is turning into a stage in which competing economic interests could be at play. Large emigration into neighboring countries, Colombia, in particular, but also Brazil and beyond, is turning events in Venezuela into a crisis not seen in the region that is straining cross-border economic and political relations.

Exhibit 2
Weak institutions remain Latam's most stubborn challenge
Corruption is a key source of political risk

	Government Effectiveness	Control of Corruption	Institutional Framework	Institutional Strength	Political Risk
Chile (Aa3)	Very High	Very High (+)	Very High (+)	Very High	Very Low
Aa median	Very High (+)	Very High (+)	Very High (+)	Very High	Low (-)
Peru (A3)	Low	Low (-)	Low	Moderate	Low (+)
Mexico (A3)	Moderate (+)	Very Low (+)	Low (+)	Moderate	Low
A median	Very High (-)	High (+)	Very High	High (+)	Low
Colombia (Baa2)	Moderate (-)	Moderate (-)	Moderate (-)	Moderate	Low (+)
Uruguay (Baa2)	High (+)	Very High (+)	Very High (-)	High (-)	Very Low
Panama (Baa2)	High (-)	Moderate (-)	Moderate (+)	Moderate	Very Low
Baa median	High (-)	High (-)	High (-)	Moderate (+)	Low (+)
Guatemala (Ba1)	Very Low	Very Low (+)	Very Low	Low (-)	Moderate (-)
Paraguay (Ba1)	Very Low (-)	Very Low (-)	Very Low (-)	Low (-)	Low
Brazil (Ba2)	Low	Low (+)	Low (+)	Moderate	Moderate (-)
Costa Rica (Ba2)	High	Very High (-)	High (+)	Moderate (+)	Very Low
Bolivia (Ba3)	Very Low	Very Low (+)	Very Low	Low	Moderate
Ba median	Low	Moderate (-)	Moderate (-)	Moderate (-)	Moderate (-)
Dominican Republic (B1)	Low	Very Low (+)	Low (-)	Low (-)	Low
Honduras (B2)	Very Low (-)	Low	Very Low (-)	Very Low (+)	Moderate (-)
Nicaragua (B2)	Very Low (-)	Very Low	Very Low (-)	Very Low (+)	Low
Argentina (B3)	Moderate (-)	Low (-)	Low	Very Low (-)	High (-)
Ecuador (B3)	Very Low (+)	Very Low (+)	Very Low	Very Low (-)	Moderate
B median	Very Low	Low	Very Low (+)	Very Low (+)	Moderate
El Salvador (Caa1)	Low	Low (+)	Low	Low (-)	High (+)
Venezuela (Caa3)	Very Low (-)	Very Low (-)	Very Low (-)	Very Low (-)	High
Caa median	Very Low (+)	Low	Low (-)	Very Low (+)	Moderate (+)

Note: The assessments of Government Effectiveness and Control of Corruption use the Worldwide Governance Indicators (WGI) as inputs. The Institutional Strength and Political Risk scores are Moody's assessments that incorporate the WGI and other factors.
Sources: Worldwide Governance Indicators; Moody's Investors Service

Political risk threatens growth, reform and financing

Political events can raise credit risks through (1) conflicts that imperil policy continuity and progress in structural reforms, and (2) gridlock that leads to policy paralysis.

In the short term, heightened political risk raises investors' fears about negative policy outcomes affecting market confidence. Political-related uncertainty widens risk premiums, adversely affects equity and bond valuations, and generates exchange rate volatility. This creates credit risks for different types of borrowers, including sovereigns, financial institutions and corporates, because it increases the cost of funding and reduces market access.

Persistent political uncertainty, i.e. uncertainty lasting for instance more than one year, may affect confidence more broadly, impacting a wide range of activities as well as consumption and investment decisions. Currencies tend to experience steep depreciations that elicit sizable capital outflows. Overall, depending on the severity of the shock, political events tend to engender macroeconomic volatility.

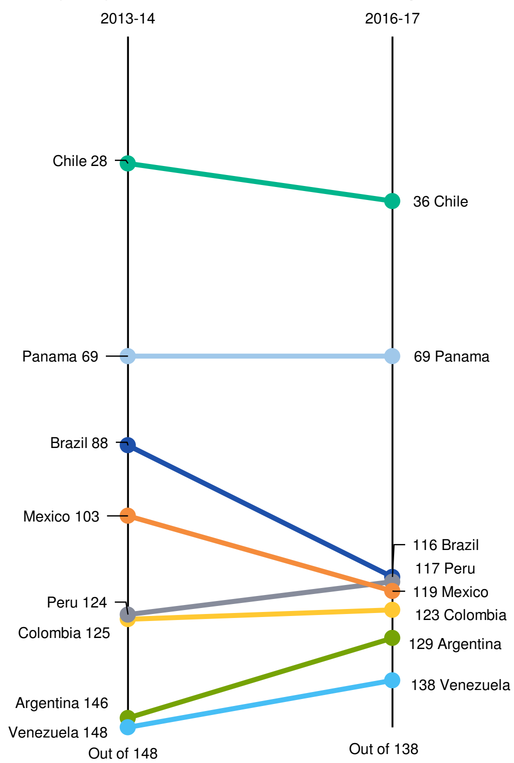
Political risk is also transmitted through the influence of government actions on private sector spending decisions—investment and consumption. Through changes in laws and regulations, politics can affect a wide range of sectors. Adverse regulatory changes, breach of contract, imposition of foreign exchange controls and, to a lesser extent, expropriation or nationalization are examples of risks that can have a high impact on individual credit prospects.

The Odebrecht corruption cases illustrate the institutional weaknesses that are present in a number of countries. Multiple infrastructure projects have been canceled or delayed as a result, affecting not only those directly involved but also general economic and fiscal conditions.

Exhibit 3

Public institutions; weak, becoming weaker

Country rankings; higher values indicate lower (worse) position

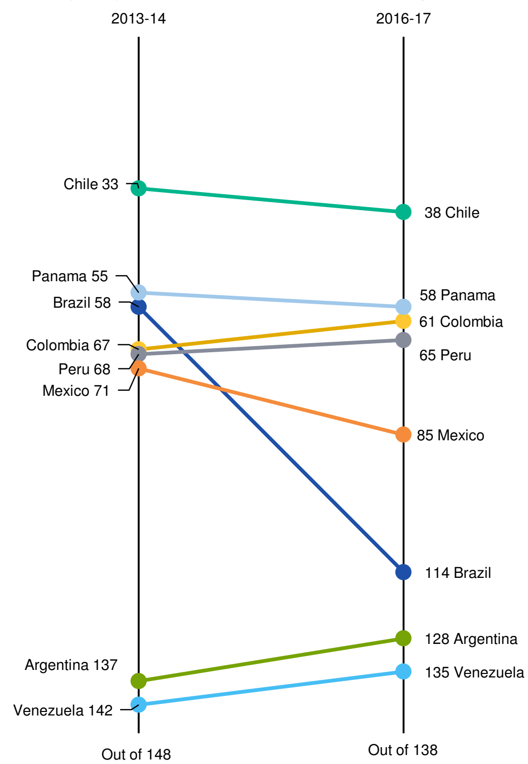


Sources: World Economic Forum. The Global Competitiveness Index dataset 2007-2016; Moody's Investors Service

Exhibit 4

Private institutions; corporate scandals weighing on rankings

Country rankings; higher values indicate lower (worse) position



Sources: World Economic Forum. The Global Competitiveness Index dataset 2007-2016; Moody's Investors Service

Potential consequences of adverse political developments in the global context

Events in the domestic political sphere can undermine a nation's economic, institutional and fiscal strength. Domestic risks stemming from political uncertainty can engender instability and result in:

- **Slower economic growth.** Structural economic changes, shocks to confidence, or loss of productive capacity that undercut economic resilience and medium-term growth. A weaker economy will in turn adversely affect other borrowers domiciled in the nation**.**
- **Weaker institutions.**Adverse changes to the institutional framework (legislative or regulatory). Policies that reduce transparency and policy predictability. Corruption, a common manifestation of weak institutions, affects corporates in industries prone to bribery.
- **Fragile public finances.** Politics can bring about gridlock and unbending opposition to structural reforms and changes to fiscal policy that reduce the authorities' ability to adjust expenditures.

Manifestations of domestic political risk include:

- Transition risk (e.g. uncertain political transition in an authoritarian regime)
- Regime change that could lead to political instability, or to policies that undermine the credit strength of the sovereign and other issuers in the country
- Abrupt structural breaks that have a major impact on underlying conditions (e.g. the UK's decision to exit the European Union)
- Secession/independence movement for a region that is a material part of the country's GDP (e.g. Catalunya's independence movement in Spain)
- Emergence of political movements that can cause a radical shift in policy direction (e.g. Greece's Syriza party, Podemos in Spain)
- Internal civil strife or war risk (e.g. the decades-long conflict between guerilla groups and the government of Colombia)
- A deliberate decision to refuse to honor debts (e.g. President Correa's 2008 decision to default on Ecuador's bonds.)
- Use of force and violence by non-state actors motivated by political, economic, or religious considerations

Degree of political risk varies by country

Chile, Mexico and Colombia all have upcoming elections that could materially affect policy direction and, consequently, medium-term credit prospects.

Political risk is moderating somewhat in Brazil, despite lingering uncertainties surrounding President Temer's incumbency and the outcome of next year's elections. The nation's institutions are functioning, allowing the economy to begin to recover after several years of recession.

In Argentina, October legislative elections will determine whether continued progress is likely on reforms that, if implemented, should contribute to sustained economic growth and lower inflation.

Adverse political developments are most acute in Venezuela, where the likelihood of a bond default by the sovereign and/or the national oil company PDVSA is very high and rising. The escalating crisis has led to violent protests, capital flight and the destruction of productive capacity, resulting in the worst economic crisis in the nation's history.

Argentina: October legislative elections to weigh on President Macri's reform agenda

Sources of political risk: Argentina (B3 positive) will hold mid-term legislative elections in October 2017.

Political risk channels: The government does not have a majority in Congress. A strong showing in the October election by President Mauricio Macri's party (Cambiemos) would allow the administration to consolidate its economic policies and increase the likelihood of passing legislation during the second half of his term in office.

Susceptibility to Political Event Risk score: High (-)

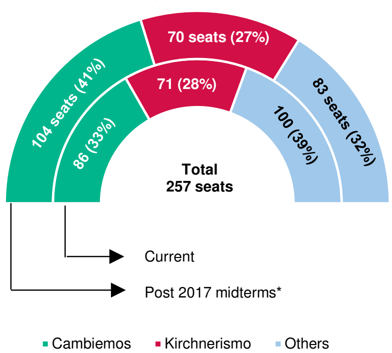
We assess Argentina's susceptibility to political event risk as "High (-)." The likelihood of political event risk impacting the sovereign credit profile remains latent due to the possibility of policy reversal. October's congressional elections can be seen as a referendum on President Macri's economic agenda.

The outcome of the elections will strongly influence the extent to which the government can make additional progress advancing its economic agenda. The outcome of the elections will also affect business confidence and, consequently, the outlook for investment. This is important as lowering the fiscal deficit and stabilizing government debt ratios is contingent on improving Argentina's medium-term growth prospects.

President Macri's party does not hold a majority in Congress. Even under a best-case scenario this is unlikely to change after the 22 October election. A strong showing by Cambiemos would make it easier for Macri to make additional progress on the implementation of his economic agenda during the second part of his five-year term in office.

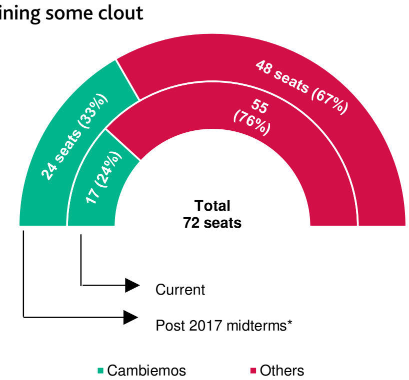
Despite having a minority representation in the Chamber of Deputies and the Senate, the Macri administration has implemented various policies to address multiple macroeconomic imbalances (see Exhibit X). The measures include liberalizing the exchange rate, reducing energy subsidies, increasing central bank independence and improving the quality and transparency of economic data.

Exhibit 5
Chamber of Deputies
Governing coalition to hold the largest share of seats



*Assuming the midterm results are identical to the 14 August primaries.
Sources: Argentine Congress and media reports; Moody's Investors Service

Exhibit 6
Senate
Macri's allies gaining some clout



*Assuming the midterm results are identical to the 14 August primaries.
Sources: Argentine Congress and media reports; Moody's Investors Service

The economy is now showing signs of recovery and inflation has been declining since the adoption of economic measures at the beginning of the Macri administration. The elimination of price controls and removal of energy and transportation subsidies initially drove up inflation and contributed to social discontent, but these have since subsided. We expect growth to average 3.3% in 2017 and 2018, driven by higher public investment and a strong performance of the agricultural sector. We also expect inflation to decline to about 22% in 2017 and move towards a still-high 15% by 2018.

Brazil: Recent corruption scandal and the future of pension reform may impact credit profile

Sources of political risk: Ongoing corruption investigations involving current and former government officials and presidential elections scheduled for October 2018.

Political risk channels: There are lingering uncertainties surrounding the potential consequences of ongoing corruption investigations and the implications of that for next year's elections. The political fallout from bribery charges against Temer may affect the final outcome of pension reform, a key component of the government's reform agenda.

Susceptibility to Political Event Risk score: Moderate (-)

In May, we changed the outlook on Brazil's Ba2 rating to negative from stable because of increased political risk and our assessment of diminished likelihood of passing key structural reforms. Temer was formally charged in June with corruption for allegedly taking bribes, but the lower house of Congress voted in August to block the corruption trial against him.

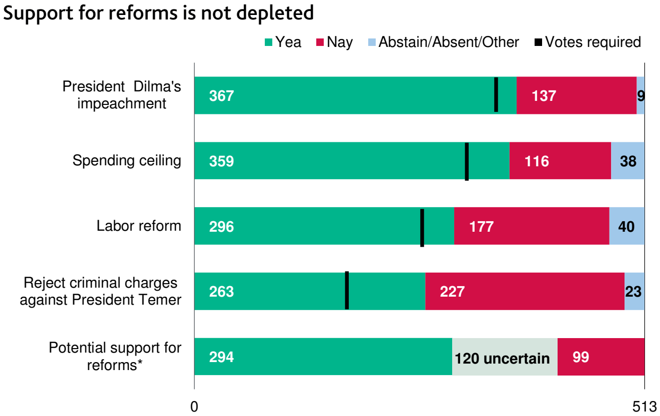
Even though this was a victory for the embattled president, getting enough congressional support to approve pension reform—two rounds in both houses with a three-fifths majority—remains a major challenge for the Temer administration. Achieving this is fundamental as pension reform is required to arrest growth in social security spending and assure compliance with the spending ceiling that was instituted last December.

Political risk has been affecting business confidence and investment sentiment, contributing to delay in the economic recovery after a prolonged recession. The fiscal deficit remains high at about 9% of GDP, and government debt ratios have been on an upward trend. The negative outlook assigned to Brazil's rating captures both political and macroeconomic policy challenges.

After a two-year recession, we expect the economy to stabilize this year. Inflation continues to decline, allowing the central bank to reduce interest rates. Lower interest rates have a positive effect on government debt affordability and debt dynamics.

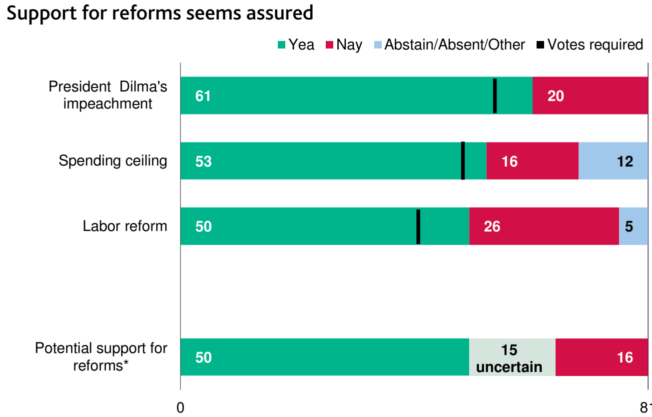
The Brazilian judiciary has shown a high degree of independence in the face of multiple corruption scandals, some of which have involved high-profile politicians, including current and former presidents.

Exhibit 7
Landmark votes in Chamber of Deputies
Support for reforms is not depleted



*Assuming the potential support is composed by the 263 deputies that rejected criminal charges against President Temer plus 31 deputies from pro-reform parties such as PSDB and DEM.
Sources: Brazilian Congress; Moody's Investors Service

Exhibit 8
Landmark votes in Senate
Support for reforms seems assured



*Assuming the potential support is identical to the labor reform
Sources: Brazilian Congress; Moody's Investors Service

Chile: Political consensus to support stable economic policies, but growth remains weak

Sources of political risk: Chile (Aa3 negative) will hold presidential and congressional elections in November 2017.

Political risk channels: The outcome of the elections will affect business sentiment and economic prospects.

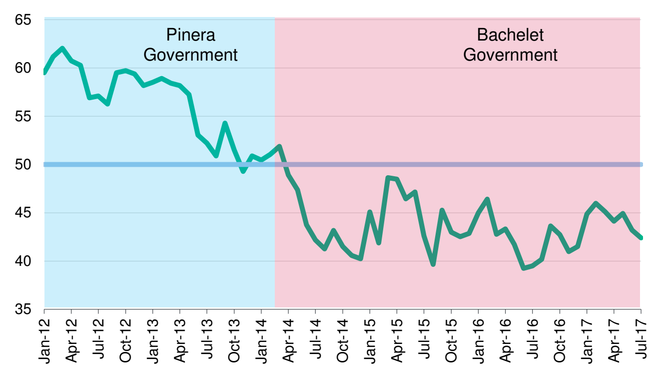
Susceptibility to Political Event Risk score: Very Low

Political event risk remains very low despite President Michelle Bachelet's low approval ratings. Despite evidence of fundamental political differences in some areas between the government and the opposition, we think there is strong consensus across political parties on the importance of preserving stable and predictable macroeconomic policies. We expect this consensus to remain in place and see it as a structural feature of Chile's credit profile.

Chile's strong fiscal position, robust government liquidity position and a healthy banking sector provide support to the sovereign's credit standing. Some of Bachelet's policies—i.e. higher corporate taxes and labor reform—have not been well received by the business community, negatively affecting investor confidence.

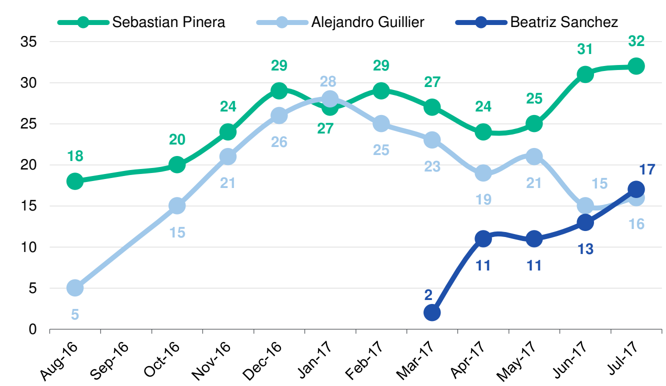
Depending on the outcome of the November presidential elections, important changes in policy priorities could materialize. Former president Sebastián Piñera, a center-right candidate, is the front-runner. Alejandro Guiller, a senator and former journalist who espouses views that are more left-of-center, has surged to second place in recent polls. A victory by Piñera, who has a pro-market stance, would likely lead to improved market and investor sentiment.

Exhibit 9
Business confidence - expectations
Index (optimism > 50 > pessimism)



Sources: Icare and Universidad Adolfo Ibáñez; Moody's Investors Service

Exhibit 10
Pinera is leading as the favorite candidate
But undeclared voter preferences remain high (22% as of July 2017)



Sources: GfK Adimark. Encuesta De Opinión Pública: Evaluación Gestión De Gobierno, July 2017; Moody's Investors Service

Chile's economic growth has slowed markedly since 2014. Real GDP growth was 1.6% in 2016 and we expect growth to remain below 2% in 2017 because of weak private investment and the slow recovery in commodity prices. Higher government spending in the face of sluggish growth and low copper prices has negatively affected the fiscal accounts. We expect debt ratios to increase to 25% of GDP this year and 27% in 2018 from 11% in 2011. Given a marked deterioration in the government's financial position, the new administration may look at lowering social spending, a difficult move from a political standpoint.

Colombia: Increased political polarization; peace agreement commitments could complicate fiscal consolidation efforts

Sources of political risk: Colombia (Baa2 stable) will hold legislative elections in March 2018 and a presidential election in May 2018.

Political risk channels: Increased political polarization and contentious campaigns ahead of legislative elections next March and a presidential election in May could weigh on consumer and investor sentiment. Colombia's fiscal outlook could be affected by government commitment incorporated in the peace agreement reached with the Revolutionary Armed Forces of Colombia (FARC).

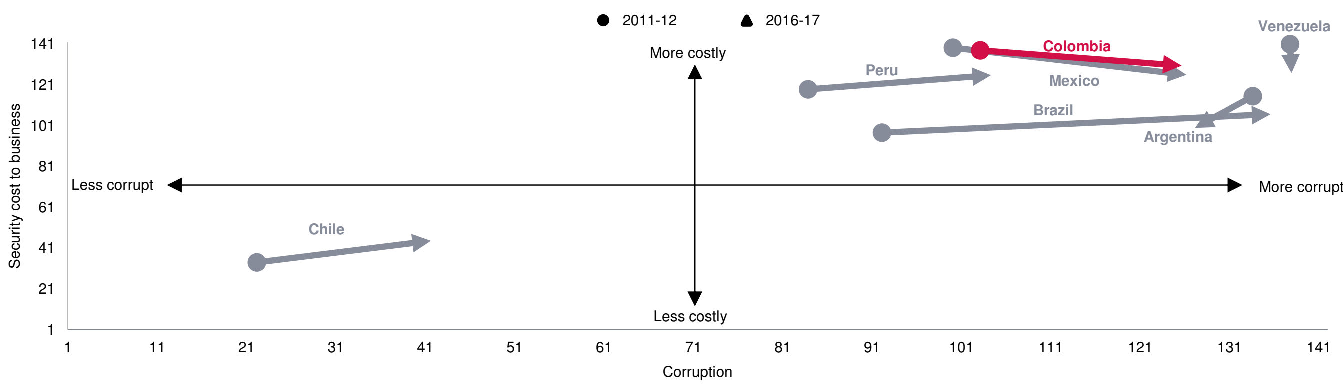
Susceptibility to Political Event Risk score: Low (+)

Political risk has eased after the government and FARC signed a peace agreement in November 2016 to end a decades-long armed conflict. In line with this, domestic security threats and repeated attacks on oil pipelines have declined. The authorities estimate that commitments reached as a result of the peace agreement will amount to about 15% of GDP and that various peace-related projects will be distributed over a 15-year period. Before it was approved, the peace agreement polarized the population and political parties, introducing an additional risk factor that may limit President Juan Manuel Santos' ability to push forth additional reforms in the last year of his administration.

Exhibit 11

Business costs of security and corruption weaken competitiveness

Higher rank values indicate lower (worse) position



Sources: World Economic Forum. The Global Competitiveness Index dataset 2007-2016; Moody's Investors Service

If an opposition candidate is elected next year, a new administration could put the peace accord back on the negotiating table, a situation that would introduce additional uncertainty, diverting attention from a focus on the need to pass fiscal reforms to support debt sustainability.

The risk of increased political polarization and a contentious electoral campaign ahead of legislative and presidential elections will likely weigh on consumer and business confidence. In June, the Ministry of Finance presented its Medium Term Fiscal Plan (MTFP) for the next 10 years. The government intends to narrow the fiscal deficit to 1.6% of GDP by 2020 from 3.6% this year. The MTFP incorporates higher government revenues based on somewhat optimistic growth projections and the authorities' estimate of the effect of recent tax reforms, in addition to cuts to public investment in the coming years.

Achieving the MTFP's targets will be challenging. We expect economic growth of about 3% in 2018 and 2019, lower than the government, which contemplates growth rates that will exceed 4% starting in 2019.

Mexico: Elections pose a risk, but NAFTA renegotiation unlikely to significantly affect medium-term trade prospects

Sources of political risk: Mexico (A3 negative) will hold elections in July 2018. North American Free Trade Agreement (NAFTA) renegotiations with the US.

Political risk channels: A contentious election campaign may stall the reform agenda. NAFTA renegotiations with the US are unlikely to affect medium-term trade prospects.

Susceptibility to Political Event Risk score: Low

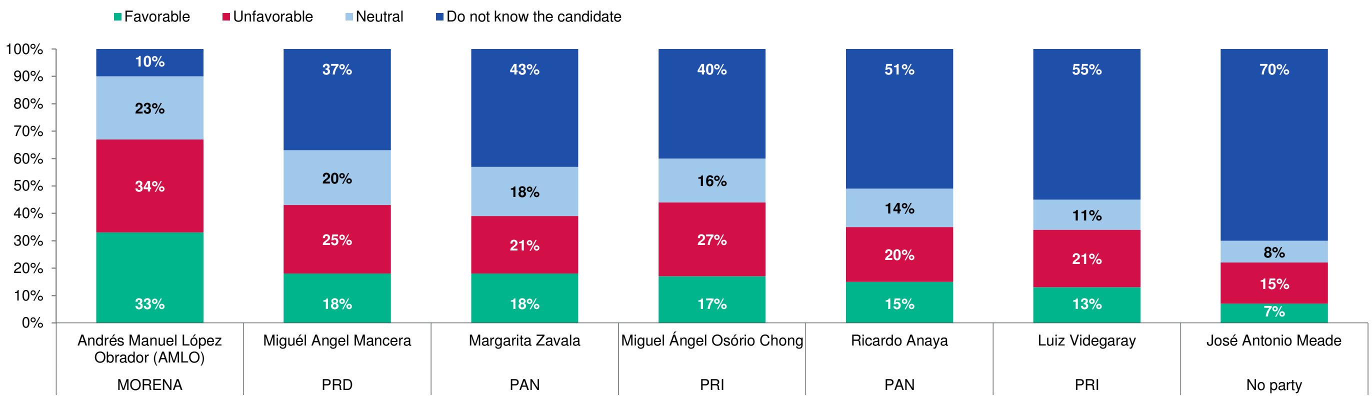
Over the next year Mexico will be exposed to two sources of political risk. Presidential elections are scheduled for July 2018. President Enrique Peña Nieto of the Partido Revolucionario Institucional (PRI) has seen his approval ratings decline partly due to corruption allegations. The president's unpopularity may weigh on the PRI's electoral prospects next year. The latter increases the probability of a victory by left-of-center candidate Andrés Manuel López Obrador of the Movimiento Regeneración Nacional (MORENA) party, who is leading the polls. López Obrador is known for his opposition to reforms that were passed during the Peña Nieto administration.

The composition of Congress will have an important effect on the next government's ability to carry out its economic agenda. As with previous legislatures, we expect no single party will have a majority, with seats divided among the ruling PRI, the conservative Partido Acción Nacional (PAN) and the leftist parties Partido de la Revolución Democrática (PRD) and MORENA (MORENA is an offshoot of the PRD). The PRI had the support of PAN to push forth the reform agenda, including energy reform that opened the oil sector to private sector investment. Even though a López Obrador presidency is unlikely to be able to reverse the reforms, as it would lack sufficient votes in Congress to do it, his administration could delay the implementation of ongoing reforms, particularly in the oil sector.

Exhibit 12

Voters' opinions of leading prospective candidates

AMLO is the best known of all potential candidates; unfavorable opinions exceed favorable ones



Sources: El Financiero-sponsored survey as of late June 2017; Moody's Investors Service

In August, the government released its review of second-quarter 2017 economic and fiscal performance, which showed economic growth above market expectations. The outperformance is due in part to a more benign view of NAFTA renegotiation, which has led to improved consumer and business sentiment. In June, we revised Mexico's economic growth forecast upward to 2.1% in 2017 from 1.4% previously, and to 2.5% in 2018 from 1.9%. Exports will provide additional support to growth in the second half of 2017 as sustained expansion of the US economy drives demand for Mexican exports, and uncertainty over changes to NAFTA continues to decline.

The US intentions regarding NAFTA negotiations, as formalized in a memo made public this past July by the Office of the United States Trade Representative, are likely to result in stronger—more strict—rules of origin, while leaving the core of the free trade agreement virtually intact. To date, there is no indication that negotiations could lead to higher tariffs or quantitative trade restrictions, as initially thought. Domestic and foreign investors have reacted favorably to indications of limited changes, helping support positive investor sentiment. Trade negotiations, which will take place through early 2018, could become a contentious feature in next year's electoral campaign.

Peru: Low risk of political instability and strong policy framework support credit profile

Sources of political risk: A tense relationship between various branches of the government in Peru (A3 stable), including Congress. Corruption scandal involving Brazilian construction company Odebrecht (Caa2 negative).

Political risk channels: While a noisy political environment remains a challenge for the government and has been a constant on the credit profile, the risk of major political instability is low.

Susceptibility to Political Event Risk score: Low +

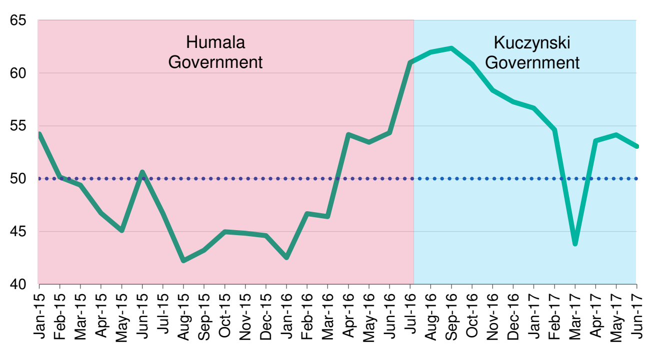
We assess Peru's susceptibility to political event risk as "Low (+)" to reflect that the likelihood of a candidate who pursues unorthodox policies coming to power and significantly altering Peru's decades-long track record of prudent macroeconomic management has materially decreased over time. Nevertheless, Peru remains susceptible to bouts of political noise stemming from confrontations between political parties and also from social protests.

Peru held general elections in 2016. The presidential runoff election saw Pedro Pablo Kuczynski win with 50.1% of valid votes over Keiko Fujimori. The president's party is a minority in Congress, while Fujimori's party, Fuerza Popular (FP), holds a majority. Legislative initiatives require the administration to negotiate with FP. While there is broad consensus on key measures, political differences have led to frequent confrontations between the opposition and the government. This condition has weighed on domestic investor confidence even though Kuczynski has been actively seeking to improve relations with Fujimori and her party. If those efforts prove effective, reduced political noise should improve investor sentiment.

Exhibit 13

Business confidence - expectations

Index (optimism > 50 > pessimism)

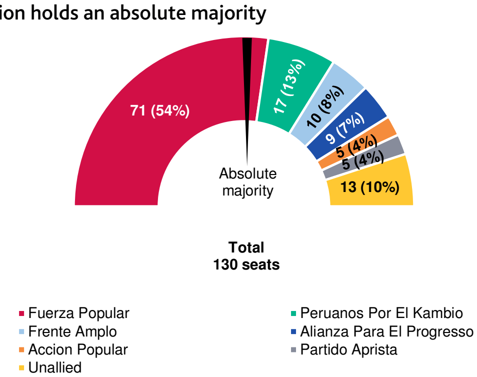


Sources: Central Bank of Peru; Moody's Investors Service

Exhibit 14

President's allies in the minority

The opposition holds an absolute majority



Sources: Peruvian Congress; Moody's Investors Service

The Odebrecht corruption scandal is a source of risk to economic growth. Odebrecht participated in several infrastructure projects. Peru's government has canceled or postponed some of these projects due to investigations related to allegations that Odebrecht bribed former government officials. The government annulled the contract for the Gasoducto Sur Peruano (GSP), a $7.3 billion (4.1% of GDP) gas pipeline public-private partnership project that was being developed by a consortium in which Odebrecht was a shareholder. We estimate the delay of the GSP reduced growth by 0.5% in 2017. Other projects where Odebrecht was involved have been affected as well.

Along with the negative spillover effects from the El Niño climate phenomenon in early 2017, we now forecast growth this year of 2.6%, down from our initial forecast of 4.5%. While reconstruction efforts scheduled to start during the second half of 2017 will help the economy recover, private investment will be needed to boost growth. The government is adopting measures to reduce the administrative burden on investors.

A weak institutional framework, particularly involving political institutions as well as elements pertaining to government effectiveness, rule of law and control of corruption, have long remained a credit constraint. However, strong economic institutions, including an independent central bank, and fiscal prudence have enabled the country to weather several shocks without a material deterioration in its credit profile.

Venezuela: Political, economic and social crises pose challenges to sovereign creditworthiness

Sources of political risk: Venezuela's (Caa3 negative) domestic politics are characterized by heightened polarization and widespread, sometimes violent, civil unrest.

Political risk channels: Venezuela is facing a political and economic crisis, which is highly likely to result in a debt restructuring.

Susceptibility to Political Event Risk score: High

We assess the sovereign's susceptibility to political risk events as "High" to reflect the ongoing economic, financial and social turmoil. In March 2017, the Supreme Tribunal of Justice assumed the National Assembly's duties, effectively dissolving the legislature. Even though that move was later reversed, to consolidate power, President Nicolas Maduro issued a decree in May to convene a National Constituent Assembly that would rewrite the constitution. The government also postponed regional elections until December 2017.

As political instability ticks up, the economy remains in deep recession. GDP will contract for a fourth consecutive year by some 6.5% in 2017, after an estimated contraction of 12% last year. Violent and widespread protests since the beginning of the year have exacerbated political tension and the economic recession. The government has curbed imports to preserve foreign currency to pay Venezuela's dollar-denominated bond debt amid a decline in oil prices. This has led to shortages in basic goods including food and medicine. We expect scarcity of goods and civil unrest to continue, and triple-digit inflation to persist (estimated at 420% in 2016) as a result of the monetization of fiscal deficits.

Maduro's very low approval has been further eroded by the government's plans to rewrite the constitution, a decision that has been criticized by several countries in the region and the US. In July and August, the US imposed sanctions against members of Venezuela's ruling party, including President Maduro. These sanctions have further undermined Venezuela's credit prospects. If the US were to restrict Venezuelan oil exports, this could precipitate a credit event and a series of events that could eventually open the door for regime change.

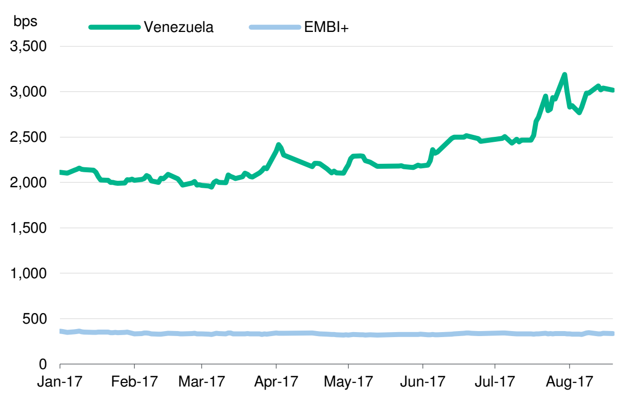
Although the current regime has remained committed to servicing sovereign bond debt, current policies in the context of a low oil price environment have significantly reduced foreign currency availability, increasing the likelihood of a debt restructuring. Given tight external liquidity, we estimate the government may be able to generate sufficient foreign exchange to service sovereign bond debt this year, but only if it reschedules large upcoming payments in November by PDVSA, the national oil company.

Some investors believe that a regime change could bring about a shift in economic policies that would support debt payment sustainability. We do not think this to be the case. Although a change in government has the potential to introduce more coherent, pro-market policies, that shift is likely to be accompanied by a debt renegotiation.

Exhibit 15

Venezuela deteriorates while other emerging market countries improve

Venezuela's country risk spread is 9x the EM average

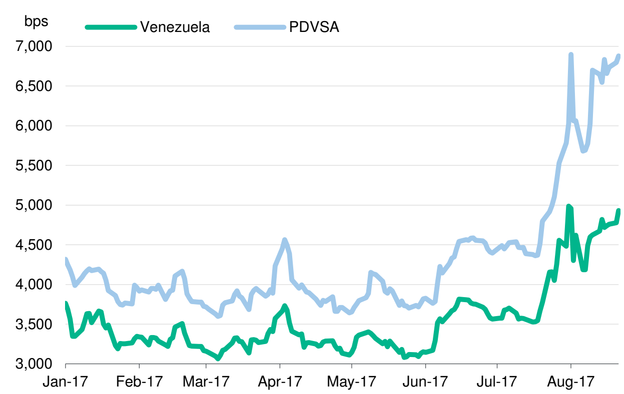


Sources: JP Morgan via Valor; Moody's Investors Service

Exhibit 16

Heading toward default?

5-year CDS spreads point to imminent default



Sources: Bloomberg; Moody's Investors Service

Moody's Related Research

Credit Opinion

- Credit Opinion: Government of Argentina – B3 Positive, 27 June 2017
- Credit Opinion: Government of Chile – Aa3 Negative, 25 August 2017
- Credit Opinion: Government of Colombia — Baa2 Stable, 29 June 2017
- Credit Opinion: Government of Peru - A3 Stable, 27 June 2017
- Credit Opinion: Government of Venezuela – Caa3 Negative: Regular Update, 1 June 2017

Issuer Comment

- Government of Argentina – Economic Recovery is Underway, But Medium-Term Growth Prospects Hinge on Business Confidence and Investment, 3 April 2017
- Chance of Brazil's Social Security Reform Wanes after President Is Charged with Corruption, 3 July 2017
- Government of Colombia – Medium-term fiscal plan envisions lower deficits and higher growth, but reaching targets may be challenging, 24 July 2017
- NAFTA Renegotiation Is Unlikely to Significantly Alter Trade Deal, a Credit Positive for Mexico, 24 July 2017
- Government of Peru – The Odebrecht Effect: Lower Near-Term Economic Growth Amid Gas Pipeline Project Cancellation, 6 February 2017
- Government of Peru – Government Outperforms 2016 Fiscal Target, Allowing for a Slower Pace of Consolidation in 2017, 17 January 2017
- Issuer Comment: US Sanctions Against Venezuelan Officials Have Little Credit Relevance, 31 July 2017

Issuer In-Depth

- Government of Brazil – FAQ on current political turmoil, prospects for social security reform and sovereign credit risk, 18 July 2017

Rating Action

- Moody's changes outlook on the Government of Argentina's B3 rating to positive from stable; ratings affirmed, 6 March 2017
- Moody's changes outlook on Brazil's Ba2 issuer rating to negative from stable, 26 May 2017
- Moody's affirms Mexico's A3 issuer rating; negative outlook, 27 April 2017

Sector In-Depth

- Cross-Sector – Chile Low Economic Growth Will Offer Little Improvement for Most Sectors, 14 June 2017

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

REPORT NUMBER 1084917

Contacts

Henrique S Ikuta 55-11-3043-7354
Associate Analyst
henrique.ikuta@moodys.com

Aaron Freedman 52-55-1253-5713
Associate Managing Director
aaron.freedman@moodys.com

Mauro Leos 212-553-1947
VP-Sr Credit Officer/ Manager
mauro.leos@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

MOODY'S INVESTORS SERVICE