Venezuela: In a Hole, and Still Digging

By RUTH KRIVOY

Introduction

Venezuela is not doing well. In the midst of a deep economic depression, the government has become increasingly authoritarian, militarized, and illegitimate. This is the result of two decades of economic mismanagement and a hunger to remain in power at any cost. With access to extremely high yet volatile oil income, the government opted for short-sighted macroeconomic populism over long-term responsible management. Key institutions were dismantled and basic principles of public administration thrown out the window. The public sector became a machine for distributing oil rents to cronies and political supporters. Fiscal and monetary anarchy ensued. Meanwhile, expropriations, over-regulation and weak rule of law scared away investment and destroyed the private sector's productive capacity.

Today, oil production and the rest of the economy have collapsed. By the end of this year, the economy will have shrunk by more than 50 per cent over five years. Inflation will reach almost 2 million per cent. The balance of payments has a gaping hole that Venezuela has neither the requisite foreign currency nor the needed access to financial markets to plug.

Things do not look good in the short term, either. Nicolás Maduro was reelected in a sham election on May 20, and his government is neither willing nor able to implement a stabilization program. Any such program would require drastic legal and policy changes that would hurt the interest groups that support him and—in the short term, at least—his political base. A Maduro government at best would carry out partial reforms that will act as Band-Aids. Moreover, the country has stopped servicing its debt, and formal restructuring of Republic and PDVSA debt worth over USD150 billion will begin soon. Yet the Maduro regime has neither the credibility nor the ability to negotiate an orderly default. Moreover, under current U.S. sanctions, several officials in the Maduro government lack the legal standing to negotiate, and the wave of sanctions and diplomatic pressures unleashed by the elections are bound to further constrain the government's room to maneuver.

The situation will prove unsustainable. Something will have to give; there will be regime change. There is no telling how or when it will take place, or who will end up in power. We know only that, to exit the crisis, any new government will need the political capital and skill set to reform key institutions and carry out corrective measures apt to cause short-term pain, as well as political and financial support from the international community.

The rest of this article details Venezuela's current situation and how it came about. We focus on Venezuela's oil industry, balance of payments and external debt crises and explain why Venezuela has used up all its lifelines—debt restructuring is inevitable.

We conclude by laying out pre-conditions for a successful turnaround.

More dependent on oil, but production is slipping

Ever since commercial oil drilling began early in the 20th century, Venezuela has built its policy framework on its oil industry. Reforms to open up the sector in the late 1990s provided lasting benefits, taking output to its 2008 peak of 3.2 million barrels a day. By then, however, the non oil industry was struggling under *chavismo*. As the domestic non-oil production shrank, Venezuela's economy became increasingly dependent on imports and on the oil revenue needed to purchase them.

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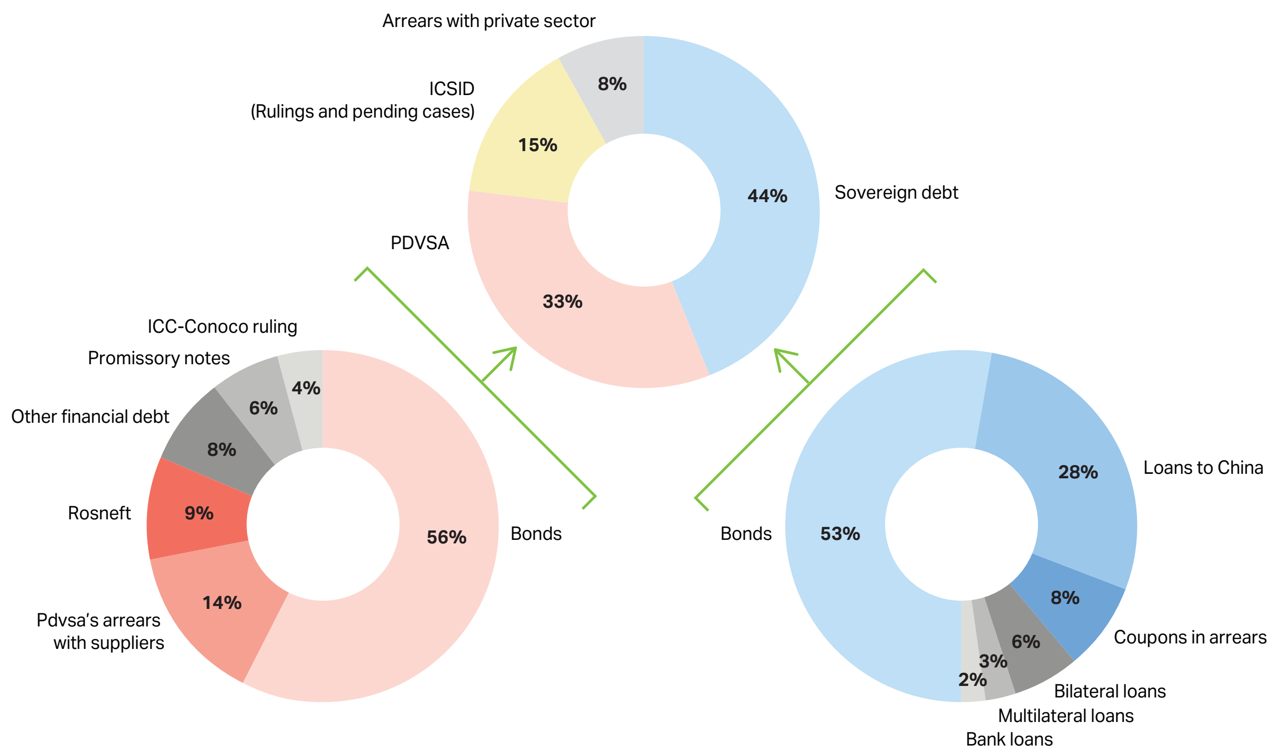
Despite its dependence on oil, the Chávez regime gradually reversed earlier reforms and eroded the oil industry's long-term productive capacity. Petróleos de Venezuela, S.A. (PDVSA), the state-owned oil company, was hit especially hard during the 2002–2003 political crisis, when over 20,000 well-trained professionals were fired and substitutes were hired based on their political loyalty rather than technical expertise. A decade later, operational capacity and investment were down, contractors and suppliers were not being paid, and business relations between PDVSA and its private partners were strained. Oil output began to fall in earnest. In recent months, U.S. sanctions and Maduro's firing of PDVSA's top executives (replacing them with military loyalists) have thrown even more sand in PDVSA's gears. Oil output now stands at a paltry 1.5 million barrels a day and heads toward 1 million next year. We expect no recovery in the foreseeable future.

A balance of payments crisis years in the making

Venezuela's balance of payments has been precarious for years but is now in full-blown crisis, owing to plunging oil revenue, low foreign assets and the lack of external sources of financing. Export revenue, hit by falling prices and output, fell 70 per cent from 2014 to 2016. The government responded by cutting imports by 75 per cent in that same period.

Non-oil imports per capita are now at historic minimums. Even without adjusting for chronic over-invoicing provoked by currency controls, imports per capita amounted to merely USD362 in 2016 and USD245 in 2017, down from USD1,450 in 2013.

Despite low imports, now stable at around USD11-12 billion, the foreign exchange deficit has widened; we project a USD1.4 billion deficit this year, even assuming that neither the government nor PDVSA service their debt (except the PDVSA 8.5% 2020 bond which is secured by 50.1 per cent of Citgo Holding). By any definition, the government is in default. Overdue bond coupon payments since October 2017 add up to USD4.5 billion. Litigation might begin soon.



No more lifelines from China or Russia

For years, China and Russia were important sources of funding for Venezuela. Not anymore. They both appear wary of elevating their exposure to a country with a collapsed economy, minimal government management capacity, and little to show for large sums of money already loaned. And they, too, deem a regime change to be inevitable. If they decide to put any money into the country it will most likely go to the joint ventures in which they partner with PDVSA, not to fund the balance of payment gap.

China made its first big loan to Venezuela in 2007, financing Chávez's government as part of its global oil-for-loans strategy. Over eight years, it lent Venezuela around USD60 billion through a system of revolving credits for specific projects and imposed increasingly strict control over the use of proceeds of such loans. China stopped making new loans in 2015, and outstanding debt owed to China has remained under USD20 billion since then. Venezuela has sent several emissaries to China to secure new funding, but they have all come back empty-handed. And last January, China's Development Bank decided not to renew a USD1.5 billion line of credit for PDVSA.

While it stopped lending new money, China did help by easing the terms of repayment and allowing loans earmarked for projects to be used to purchase imports from China. Until recently, we assumed that China had awarded a two-year grace period for amortizations of its loans to Venezuela and that it would renew this period in mid-2018 (we've been forced to make assumptions because both governments have been cagey about these deals). We recently learned, however, that the grace period was only 18 months (expiring last November), that such grace period did not cover the Large-Volume Long-Term loan, and that it was not renewed. This means that Venezuela will owe USD5.3 billion in amortization payments and USD8.4 billion in total debt service to China this year.

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At today's prices, Venezuela can cover debt service to China by sending about 428,000 barrels per day. Shipments to China barely exceed that amount—they remain at about 500 million barrels per day and generate some free cash after debt service. This money is deposited in the account that Venezuela's development bank (Bandes) has in the China Development Bank and to which Venezuela's government has access.[1]

Reliable information on loans from Russia is scarcer still. We estimate total outstanding debt at USD7.6 billion (the Venezuelan government owes USD3.1 billion and PDVSA USD4.5 billion). Major financing from Russia began in 2006, when Chávez bought USD11.0 billion worth of Russian arms for credit. After partial repayment of this loan, outstanding debt in November 2017 was USD3.1 billion, which was restructured for ten years, with minimal payments in the first six years "to help Venezuela meet its obligations with other creditors" according to the Russian Ministry of Finance. Venezuela also appears to owe Rosneft, Russia's state-owed oil company, USD4.5 billion through PDVSA, including USD3.0 billion outstanding for a USD6.0 billion loan made in earlier years and a USD1.5 billion loan made in 2016 and guaranteed with a 49.9 per cent stake in Citgo, a U.S. oil company owned by the Venezuelan government. Despite grand declarations and glad smiles from Russian officials, we see no desire to lend Venezuela any more money.

Debt restructuring looms near

We estimate Venezuela's outstanding external debt at USD154 billion, consisting mainly of Republic and PDVSA bonds and money owed to China and Russia.

Most of Venezuela's bond debt owes to careless borrowing to sustain a controlled currency regime with multiple exchange rates. From 2003 to 2012, the government and PDVSA issued USD52 billion in dollar-denominated bonds payable in bolivars to keep the national currency strongly overvalued. Businesses and individuals seeking to send assets abroad but having few means of doing so bought these bonds with bolivars and sold them in the international market to obtain foreign exchange. Global markets gobbled up the high-yield bonds. With oil prices high and international liquidity abundant, investors were nonchalant, while the Venezuelan government made poor policy choices, weakened its institutions, hid fiscal and capital account data and neglected its oil industry.

When restructuring talks inevitably begin, bond holders will show up at the table with over USD70 billion[2] in overdue claims. PDVSA's contractors and suppliers are owed at least USD7 billion in overdue payments and hold USD3 billion worth of promissory notes. Rulings and pending cases at the International Center for Settlement of Investment Disputes add up to about USD22 billion. A wide array of multinational and Venezuelan companies claim they are owed USD13 billion in foreign exchange disbursements not honored by the government for imports brought to the country and sold at prices set by the government. Total debt at stake will add up to at least USD154 billion, or 1,275 per cent of GDP.

That is a large sum to negotiate with a diverse group of creditors. The silver lining is that tallying up the debt will be less difficult this time than it was in the 1980s, when many small and medium financial institutions operating in the United States, Europe and Asia had freely lent money to Venezuelan public sector entities. In this round, because external debt was issued only by the Republic and PDVSA, and Venezuela has been unable to issue any new bonds for several years, it will be easier to track.

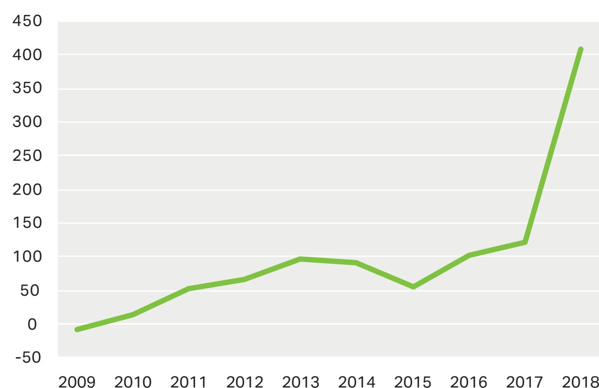
Bad policy, bad outcomes

Declining oil output and the exhaustion of external assets and foreign borrowing opportunities dragged down imports and created shortages. Other bad policies made matters worse. Stifling government controls and corruption have left the non-oil economy in a deep depression since 2014, exacerbating shortages. And fiscal disorder has led to reckless monetary expansion since at least 2009, when, overburdened by social spending and fiscal obligations, PDVSA began to rely on the Venezuelan central bank credit to cover its bolivar-denominated operating expenses and fiscal contributions.

Shortages and out-of-control monetary expansion have caused inflation to soar. Venezuela officially entered hyperinflation territory in the fourth quarter of 2017, when prices rose by 200 per cent year-on-year. We expect inflation to reach almost 2 million per cent this year.

With the economy shrinking and money becoming practically worthless, purchasing power has plunged.

Financing to public enterprises
(% of monetary base), Jan. 2009 – April 2018



Source: Central Bank of Venezuela, Síntesis Financiera.

Money Supply and Monetary Base
(year-on-year % change), Dec. 2009 – Jul. 2018

	Money supply	Monetary base
2009	14.3	16.7
2010	19.1	26.1
2011	50.6	40.4
2012	61.0	55.3
2013	69.7	64.2
2014	64.0	68.5
2015	100.7	107.7
2016	159.2	248.8
2017	1,123.7	1,485.0
2018*	9,455.6	9,027.5

* Through July 13, 2018.
Source: Central Bank of Venezuela, Síntesis Financiera.

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	CPI	Real minimum wage index, eop	Minimum wage	
	Year-on-Year % Change	(100=2000)	Bs	USD @ PPP
2004	19.2	104.3	321	170
2005	14.4	113.5	405	191
2006	17.0	126.3	512	220
2007	22.5	127.7	615	245
2008	31.9	127.3	799	251
2009	26.9	120.2	959	238
2010	27.4	119.7	1,224	253
2011	29.0	120.1	1,548	576
2012	20.1	131.1	2,048	496
2013	56.1	135.4	2,973	281
2014	68.5	135.0	4,889	277
2015	269	104.0	9,648	177
2016	472	59.8	27,092	96
2017	2,803	27.9	177,507	25
2018	1,984,414	13.2	880,795,780	3

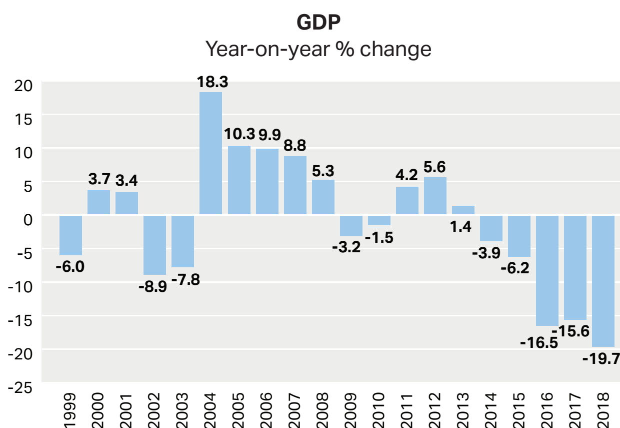
PPP: Purchasing Power Parity proxy
Source: Central Bank of Venezuela, Official Gazettes, Síntesis Financiera

The risk of new international sanctions

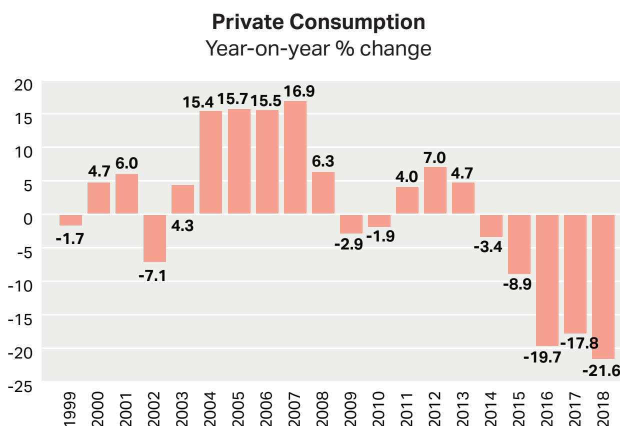
Despite widespread international rejection of Venezuela's electoral process, Maduro pushed forward with the May 20 snap presidential election. New rounds of sanctions may go as far as limiting oil trade between the United States and Venezuela even though the collapse in oil production make it less likely.

Venezuela's exports to the United States are profitable, thanks to low transportation costs and fast payment cycles. The government has nonetheless sought to reduce dependence by redirecting oil exports to China and India, though results so far have been trivial. If and when it achieves meaningful oil export diversification, those two countries appear as its main alternative destination.

Exports to the United States make up 39 per cent of total oil shipments. With no constraints on its oil trade from sanctions, we project that Venezuela's exports to that country will fall to USD8.0 billion in 2018 from USD11.5 billion in 2017, with volumes falling to 410 from 674 thousand barrels per day.



Source: Central Bank of Venezuela, Síntesis Financiera



Source: Central Bank of Venezuela, Síntesis Financiera

What is needed to escape the crisis

Even though Maduro won reelection on May 20, his victory failed to convince anyone either at home or abroad. Turnout was low, rules were blatantly unfair, and the international community is rejecting the entire process. More importantly, he has overseen one of the worst economic and political crises in Venezuela's history. Even hitherto cohesive ruling coalitions come under strain in such circumstances. We do not know how or exactly when it will happen, but we do expect a change of government in the medium term.

To succeed in leading Venezuela out of its crisis, a new government must be committed to change and have the political capital to carry out tough measures to stabilize the economy and reignite growth and to address the humanitarian crisis. It must be capable of managing a diverse coalition for the common good and promoting a national dialogue to construct a shared, long-term vision for Venezuela.

This will require legal reforms to restore property rights and foster investor confidence. Three Venezuelan institutions, especially, need bolstering: the judicial system, PDVSA and the central bank—the first to restore rule of law, the second to feed the country, the third to restore confidence in Venezuela's currency.

Finally, Venezuela will need cash. A stabilization program will require at least USD50–60 billion to import food and material to alleviate our country's humanitarian crisis, revive domestic production, jumpstart oil production and recapitalize the financial system. Foreign debt restructuring will be part of this process.

All of this will require strong international support. ■

1. More precisely, Venezuela has access to the money in this account as long as it maintains a minimum balance equivalent to three months of debt service plus 30 per cent.
2. Approximate amount at the time of publication.

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Ms. Krivoy provides independent, in-depth insights into Venezuela's political, macroeconomic, financial, monetary and fiscal dynamics for a candid assessment of short- and long-term risks and opportunities, including around Venezuela's foreign debt obligations. Her intimate knowledge of politics and policy in Venezuela — informed by her career at the Central Bank of Venezuela, where she served as President in the early 1990s, the first woman appointed to this position — ensures a nuanced perspective that is unconstrained by corporate or political considerations. Clients include financial services firms, global commercial banks, multinational corporations, and multilateral institutions.

Ms. Krivoy holds a degree in economics from Universidad Central de Venezuela, where she graduated summa cum laude. She has authored papers on monetary, financial and regulatory topics, as well as the book Collapse: The Venezuelan Banking Crisis of 1994.