Venezuela

Crisis in Caracas

Venezuela's rich oil resources, once a source of its strength, have now the South America's leading nation on mat as it faces an economic crisis at an unprecedented scale and size amid rout in international crude oil prices.

Ivo Pezzuto
Global Markets Analyst, Professor and Policy Advisor of Economics and International Business, and Member of Advisory Boards

In Venezuela, these days it's not unusual to see huge gatherings of people jostling with each other in long queues to get inside supermarkets and department stores but only to be welcomed by empty shelves as supplies of even basic goods like food and water have got badly affected as the nation faces its worst economic crisis in several decades. The cash-strapped Venezuelan government has been finding it hard to buy even essential items like medicines that have hit the healthcare services hard in the country, thus raising fears that its current political and economic crisis may soon turn into a potential humanitarian crisis if immediate steps are not taken. Meanwhile, the long lines at the supermarkets and the massive protests against the socialist government of President Nicolás Maduro represent the most dramatic illustration of Venezuela's current political and economic turmoil. Energy experts predict a decline of oil production for Venezuela to 2.25 million barrels a day by the end of this year. Some polls estimate that more than 80% of basic consumer products are now in short supply in Venezuela.

Much of the country's recent troubles stem from the prolonged global collapse in oil prices over the last two-and-a-half years. Oil prices after hovering above $100 a barrel in January 2014 came crashing down to below $30 a barrel by January 2016. Although they have recovered some of lost ground to reach around $50 a barrel by June 2016, it's still well below the comfort levels of many oil producing nations including Venezuela. "The latest figures from Venezuela's state oil company PDVSA show the average production cost for all its crudes is $18 a barrel, while Toronto-listed Pacific Exploration & Production, Colombia's largest private operator, reported that—its production cost including diluents, transportation and taxes averaged $20 to $22 in the third quarter of 2015," Reuters said in January. Venezuela's Diluted Crude Oil (DCO) was selling at around $15 a barrel in the early this year. "A more acute crude price slump this month has put several South American countries in the difficult position of selling oil for less than what it costs to produce, according to traders and sources at three companies in Colombia and Venezuela," commented Reuters, adding, "So far, the most affected crudes are blends formulated with naphtha and other imported diluents. But if the price rout that shows few signs of ending soon persists, other grades could be hit too, the sources added, potentially putting more pressure on public finances in the oil-dependent countries." Venezuela's President Maduro has requested emergency international help from the United Nations for public works funding and construction to help the country recover from what he called an 'extreme situation'. It narrowly avoided default on a $1.5 bn sovereign bond in February by draining its foreign reserves and squeezing imports for even daily necessities, like food and medicine, says Reuters. Venezuela derives nearly all of

its dollar revenues from oil exports, but the recent 'oil shock' has exposed it to the risk of growing budget deficit and ballooning foreign debt. Its oil exports revenues have fallen from about $80 bn in 2012 to less than $20 bn by 2016, according to Barclays' data.

Many causes

Multiple factors have contributed to the global oil glut and to the collapse in global commodity prices. Among these, the noticeable ones include geopolitical tensions and retaliations among countries in the Middle East; global competitive pressures among oil producers driven by their struggle to retain market shares and to outperform new aggressive entrants (Iran and USA shale crude producers); oil exporters' overcapacity and oversupply (global glut); imbalances between oil supply and demand due to the global economic slowdown; massive financial speculation in oil and commodities markets and volatile currency markets; markets' expectations on the Federal Reserve's monetary policy normalization process, the trajectory of the US dollar appreciation, and its impact on commodity prices; and higher production costs of oil per barrel vis-à-vis the market prices. Of all, it's the last one that has had a more profound impact on oil exporters like Venezuela. Its falling oil export revenues have hit this crisis-ravaged nation hard. In fact, Venezuela's income from oil in the last year has fallen by more than two-thirds. With less dollar inflows in the country the value of Venezuela's foreign-exchange reserves has declined alarmingly and it is now teetering on the brink of a default in spite of the fact that the country has the largest reserves of oil in the world. In fact, the risk of a potential default by Venezuela persists if oil prices remain lower, or if they should fall again for a prolonged period of time to close at or below $30 per barrel. However, Venezuela and other oil exporting countries such as Nigeria, Brazil, Ecuador, Canada, Colombia, and others with higher break-even points in their profitability model will probably benefit in the coming months from the stabilization and/or slight increase in the price per barrel of crude-oil as it is forecasted to stay in the $40 to $60 band. Yet, this potential benefit might be seriously undermined by a decline in oil production in Venezuela in the coming months as it owes almost $2 bn to oil service companies or by potential geopolitical risks and shocks in the oil market. In order to pay its debt, Venezuela will probably continue tapping into its gold and foreign currency reserves. Some international experts suggest that the recent gold swap is another indication that the country is desperate for cash, while some predict that the country might face the risk of a default in the next 12 to 18 months. Some even suggest that what Venezuela is currently experiencing is not an economic crisis rather a depression. The International Monetary Fund (IMF) forecasts that Venezuela will have an unemployment rate of 17% in 2016 and nearly 21% in 2017. The country however, could still prevent a potential default, in addition to the benefits of increasing oil prices, through financial assistance from one of its allies, such as China (China has recently accepted to lend Venezuela $5 bn to boost oil output), Russia or Iran, or through massive financial support from the international community (i.e., IMF and other multilateral lenders), or through an orderly foreign-debt restructuring. Venezuela's government, however, has not allowed the IMF to visit the country since 2004. Creditors are worried about the potential systemic risks of the dollar-denominated debt of corporate borrowers in Venezuela. They are also concerned about the potential spillover effects that an out of control political and economic crisis might have on other Latin American economies and emerging markets. There is a growing fear that a default by Venezuela might indeed trigger a blow-up across emerging markets (as distressed debt rises) fueled by high volatility in the commodity markets, macroeconomic imbalances, unwise economic policies, low interest rates and credit-led bubbles.

Venezuela currently owes about $123 bn to foreign creditors, according to estimates from Bank of America Merrill Lynch. The President, however, is fully aware of the fact that a default could be too costly for the country, since access to credit would be diminished and many of Venezuela's assets located outside the country (including refineries and oil tankers) could be seized by creditors. Furthermore, some Venezuela's sovereign-debt contracts have Collective-Action Clauses (CACs), which in case of debt restructuring can be imposed on all holders. On the contrary, Venezuela's main source of foreign exchange, the state-owned oil company PDVSA, has no CACs, thus it would have a harder time restructuring its debt in case of default.

In addition to high levels of uncertainty, volatility, and macroeconomic imbalances, Venezuela has suffered a deep recession due to a number of controversial policies. Some of these include the excessive reliance for economic growth on oil exports and state ownership (oil accounts for approximately 95% of Venezuela's export earnings and more than half of public sector revenues); unfettered government spending and massive budget deficits financed by printing money, which have allowed the country to finance expensive social programs; inefficient management of public enterprises, unproductive labor, and of direct and indirect subsidy schemes; crumbling infrastructure; the inability of the government to fend off rampant corruption; the decision of President Nicolás Maduro to raise fuel prices; the decision to sharply restricting imports (60% slump in imports over a four-year period) to conserve central bank reserves; the decision to enforce currency and price controls, and to introduce a complex exchange rate system; the decision to shorten the working days of civil servants to two days per week in a desperate effort to reduce electricity costs and to avoid an energy and hydropower generation crisis. The government in April announced a 40-day blackout as water levels at the country's hydroelectric dams touched its record lows, and is hurting its industry besides causing great inconvenience to its citizens. The government had also announced a 60-

day emergency plan to avoid a shutdown of its key hydropower facilities that could have plunged Caracas, the capital of Venezuela, into darkness. However, it has asked businesses like hotels and malls to generate their own power for 9 hours a day, while instructing heavy industries to reduce power consumption by a fifth. Even the availability of water in the country has been severely rationed. The country has used the oil boom of the past decade to quintuple its external public debt. Furthermore, creditors are increasingly demanding high yields on Venezuela's dollar-denominated bonds due to the plunge in oil prices; the large amount of foreign-currency denominated bonds; the growing concerns about the country's ability to service debt payments; and the fear of a potential default. A huge potential domestic default might lead also to high risk for external creditors. Yet, the current rebound in oil prices is making investors increasingly confident that the embattled Latin American nation might be able to make bond payments at least in the near future, unless systemic shocks or a much more profound economic crisis will hit it.

History of Venezuela's Inflation Compared to Oil Revenue

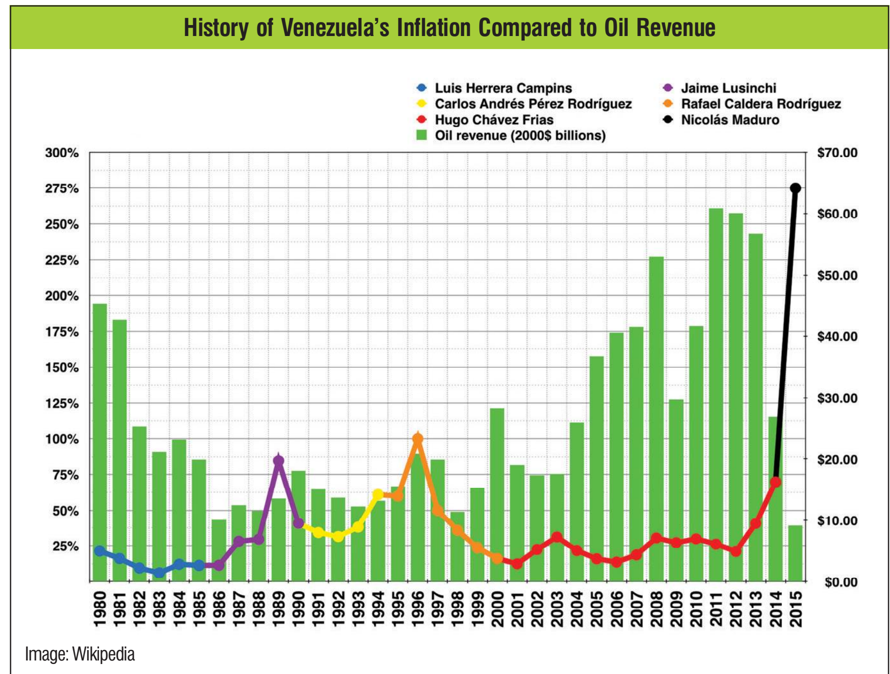


Image: Wikipedia

Managing multi-exchange rates

One of the major concerns regarding a potential default of Venezuela or its economic meltdown is the extent of impact that this crisis might have on the domestic market, international markets and its trading partners. The IMF identifies Venezuela, as one of four key countries along with Brazil, Ecuador and Argentina that will cause GDP growth contraction Latin America and the Caribbean in 2016.

Currently, its outlook remains bleak due to hyperinflation (inflation surged to 181% last year) and deep recession (IMF forecasts an 8% contraction of Venezuela's real GDP in 2016 and a 4.5% contraction in 2017, after a contraction of 5.7% in 2015). Furthermore, there is some skepticism among analysts about the government's commitment to the floating exchange rate which should eventually allow the exchange rate to be set by market forces. Out of the recently introduced four official exchange rates, at least two deeply overvalue the bolivar. Currency arbitrage has propelled in the country, while a rampant foreign exchange black-market has flourished (while official exchange rate is about 10 bolívars to the dollar, the black-market rate is about 1,100 bolívars to the dollar). Venezuela seems to rely significantly for its economic survival on the recovery and stabilization of the oil prices. The government has artificially overvalued the currency (the bolívar). Yet, a further devaluation would sharply increase prices of many basic products that many poor Venezuelans rely on to survive and would make debts denominated in dollars far more expensive to repay. According to Bloomberg, "Venezuela's government sells dollars for 6.3, 12 and 172 bolivars per dollar. The first two rates are used for imports of government-authorized priority goods including food, medicine and car parts. The third rate, introduced on February 12, can be used by anyone who doesn't receive authorization to buy dollars at the first two preferential rates. On the black market, one dollar currently fetches about 190 bolivars."

The country is currently experiencing runaway inflation exceeding 200% a year (The IMF predicts that inflation will be approximately 480% this year and 1,642% in 2017). The government has contributed to the spike of runaway inflation by raising wages, printing more bolivars, and restricting imports (price controls and shortage of foreign exchange are leading to acute shortages of basic goods such as flour, sugar, eggs, medicines, etc.), thus creating too much money chasing too few goods.

Venezuela, which has one of the world's biggest gold reserves, has sold $1.7 bn gold reserves in the first quarter of 2016 in order to repay debts, thus adding up to an overall reduction of gold reserves of almost a third over the past year. Analysts also report that in 2016 so far the country has shipped almost 60 metric tons of gold to Switzerland. The country's central bank is printing money to cover much of a fiscal deficit of around 20% of GDP. Real wages fell by 35% in 2015 and more than 70% of population is now poor.

President Nicolás Maduro recently declared a60-day state of emergency for Venezuela and ordered military exercises, citing foreign threats. The opposition wants President Maduro's resignation and a fresh election or his replacement with a moderate leader, but uncertainty remains on the future political scenario of the country where economic conditions have worsened over

the past few years. The former President, Hugo Chávez, died in 2013. After he passed away, the new President Nicolás Maduro introduced a number of controversial policies which are at least partly responsible for the current crisis while some reports suggest that billions of petrodollars have disappeared abroad during his time in office. Spiraling rates of violent crime in the country is causing large numbers of skilled workers to emigrate, which will eventually affect the economy's long-term performance.

The impact on industry

As shortages of basic goods and commodities increased and the country's economic outlook became highly risky and uncertain, a number of foreign companies are increasingly moving their businesses out of Venezuela. For example, Coca-Cola has decided to halt its production of sugary soft drinks in Venezuela as it ran out of sugar. Kraft Heinz Co. and Clorox Co. have also had to halt operations in the country. Two of the leading oil service companies in the world, Schlumberger Ltd. and Halliburton Co., also announced recently of their intention to curtail work in Venezuela as they were not getting paid (Schlumberger in fact announced the inability to collect payments from the national oil company Petroleos de Venezuela SA). Even German airline Deutsche Lufthansa AG has told of its intention to temporarily suspend flights to Venezuela due to the ongoing economic turmoil in the country and difficulties in repatriating billions of dollars in revenue held in the local bolivar currency due to exchange controls. LATAM Airlines, the biggest Latin American carrier, also decided to cut service to Venezuela. Recently, Avon Products Inc. shares fell to the lowest price in seven weeks after the cosmetics company reported among other causes, the impact of the restructuring costs and a write-down of its Venezuela business (inability to exchange the local currency forced the company to split off that business and write down its assets). Some Indian pharmaceutical companies like Dr. Reddy's Lab and Glenmark, with exposure to Venezuela, are yet to receive millions of dollars in payments that are pending with the Venezuelan government. In fact, a number of firms which include AT&T, General Motors, Colgate-Palmolive, American Airlines, PepsiCo, AT&T and Ford Motor have all experienced write-offs in recent years due to their businesses in Venezuela. The Italian energy explorer, Eni S.p.A., recently warned it expects payment delays from Venezuela. Goodyear Tire & Rubber's first quarter sales missed analysts' estimates as foreign currency rates and the loss of revenue from its Venezuela operations overshadowed US demand for its tires. Telefonica SA, Spain's largest phone company, posted its lowest quarterly revenue in more than a decade as high inflation and depreciating currencies in Latin America like in the case of Venezuela and Argentina added pressures. The country's largest privately-held company and biggest brewer, Empresas Polar SA, reported that it will be forced to stop producing beer because it cannot get the foreign currency it needs to purchase malted barley. Procter & Gamble's sales fell 12% in its fiscal first quarter of 2016 due also to the deconsolidation of its Venezuela business. Finally, a number of firms that include General Mills and Clorox have also left the country.

Given the current dramatic situation in Venezuela of hyperinflation, deep recession, currency and price controls, political power struggle, social unrest, and financial strain, the international community is highly concerned about possible policies and emergency measures that the country could potentially undertake in the attempt to rein in runaway inflation and to avoid a default. However, there is no easy solution to avoid Venezuela's looming collapse due to its complex political environment. Further, a disorderly default in Venezuela, like in the case of Argentina, at this point is quite likely. Yet, in a worse-case scenario, the potential rise of systemic political and financial risks in the country, and in the Latin American area, and their potential spillover effects on a global scale might lead the international community and the G7 or G20 leading nations to orchestrate rescue plans to help mitigate the Venezuelan crisis.

Options before Venezuela

In early June 2016, the crude oil price has almost doubled since January due to the wave of unplanned outages that have eroded production in Canada, Venezuela, Libya and Nigeria (i.e. attacks on oilfields and pipelines), and by a steady decline in higher-cost US shale output, yet if oil prices do not continue to increase and do not stabilize in the medium-term in order to allow the Venezuelan economy to overcome the current emergency situation and to recover; and if the Country does not introduces sound growth-oriented economic policies that aim to limit the current excessive dependency on the oil industry, the Country might probably face a catastrophic scenario.Credit default swap markets estimate high risks for Venezuela as the country's future of oil output remain highly uncertain. Venezuela's current reduced capacity will temporarily contribute to a higher crude oil price until conditions will change and unconventional production might rise again. Yet, against the odds, the country so far has been incredibly resilient in meeting all its debt payments. In the worst-case scenario, however, the options left to the Venezuelan leader might be few and very painful to implement if crude oil prices do not continue to rise.

Zimbabwe adopted the dollar following its bout with hyperinflation in 2008-09. This solution is quite unlikely in Venezuela since the political leaders have warned for years of the dangerous reach of American imperialism. An alternative option could be adopting the Chinese yuan or some sort of currency's peg to the yuan, especially now that the Chinese currency has entered the SRD basket of currencies of the IMF, and it is gradually becoming an internationally traded currency. Still, Venezuela could seek support of the IMF's SDR basket or some other strong currency. Like in the case of Zimbabwe's Hyperinflation

About Venezuela

Venezuela, officially the Bolivarian Republic of Venezuela (Spanish: República Bolivariana de Venezuela), is a federal republic located on the northern coast of South America. The name Venezuela comes from the Italian word 'Veneziola' which means 'piccola Venezia' or little Venice. It was named so as its native stilt houses built in Lake Maracaibo reminded the explorer Amerigo Vespucci of Venice. Venezuela is known widely for its petroleum industry, the environmental diversity of its territory, and for its stunning tourist attractions including the famous Angel Falls, which is also the world's tallest water fall. The territory currently known as Venezuela was colonized by Spain in 1522 amid resistance from indigenous peoples. In 1811, it became one of the first Spanish-American colonies to declare independence, which was not securely established until 1821, when Venezuela was a department of the federal republic of Gran Colombia. It gained full independence as a separate country in 1830.

Venezuela is a federal presidential republic consisting of 23 states, the Capital District (covering Caracas), and federal dependencies (covering Venezuela's offshore islands). Previously an underdeveloped exporter of agricultural commodities such as coffee and cocoa, oil quickly came to dominate exports and government revenues. The 1980s oil glut led to an external debt crisis and a long-running economic crisis, in which inflation peaked at 100% in 1996. Venezuela under Hugo Chávez suffered "one of the worst cases of Dutch Disease in the world" due to the Bolivarian government's large dependence on oil sales. Venezuela is considered a major renowned player in beauty pageants and cosmetics industry, a popular pastime of many Venezuelans, raking in with 22 victorious pageant titles to date. Today, Venezuela's one of the world's largest oil exporters, economy is in tatters faced with falling petro dollars owing to substantial fall in oil prices, which have fallen from over $100 per barrel in mid-July 2014 to below $50 per barrel now.

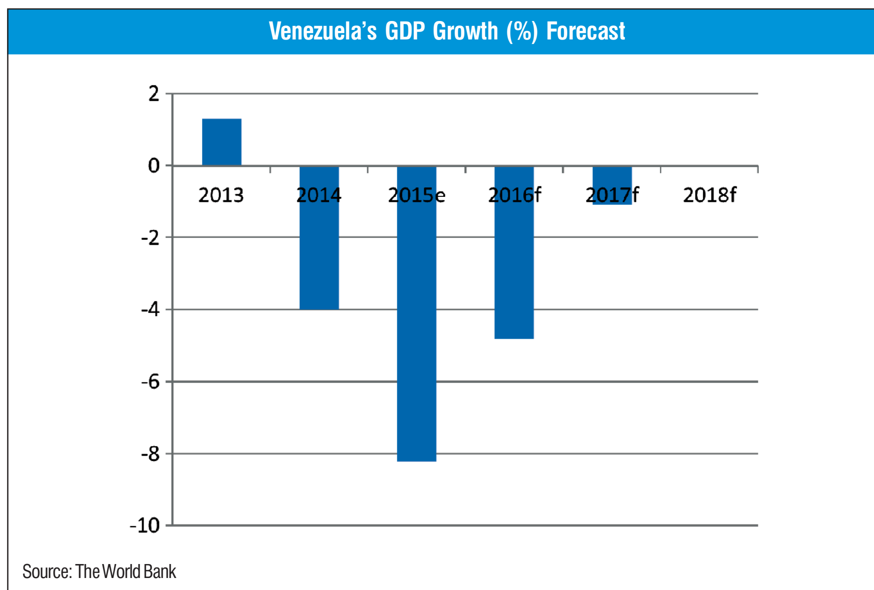
Source: Wikipedia, Global Analyst Research

crisis, Venezuela could probably adopt a 'cash budgeting' rule, thus allowing itself to spend only the money it brings in through taxes.

But, first and foremost, the country should be allowed to pursue political stability and an open market economy ideology. The country should introduce economic reforms in order to liberalize and privatize the economy. It should also fight corruption, crime, tax evasion, and reduce the inefficient management of public enterprises and unfit subsidy schemes. Venezuela should also encourage the development of a business-friendly environment and ecosystem (with a more efficient political, legal, tax collection, judiciary system, and full independence of the central bank) and should foster an environment that encourages true entrepreneurship, foreign direct investments (it could sell publicly owned oil and telecommunication companies or help develop international partnerships, joint ventures, alliances, clusters, and global value networks), savvy infrastructural investments, global competitiveness, and an improved Mercosur trade agreement. Venezuela should lift the restrictions and controls on the imports, prices, and exchange rates. The country should also strengthen its legal system with strong protection of property rights and human rights.

Overall, the situation in Venezuela appears to be worrisome and collapsing. Time is running out for an orderly solution of the crisis. Yet, the international community might still take immediate action and help prevent, or at least, mitigate the devastating impact of this tragic humanitarian and economic crisis. ■

Venezuela's GDP Growth (%) Forecast



Source: The World Bank

Reference # 20M-2016-06-04-01