An update on Venezuela's FX policy

The more things change, the more they stay the same

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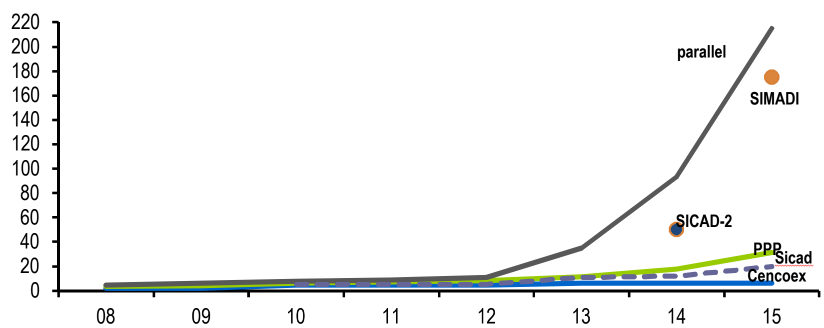
- **The existing template of 3 official rates and a higher parallel rate remains unchanged**
- **Cencoex (6.3) and Sicad (12) unchanged for now; SICAD-2 (50) is rebranded SIMADI (mid-170s)—but so far with little volume**
- **SIMADI initially approached the parallel rate, but failure to embrace full convergence has widened the parallel once again**
- **How volumes evolve on the platforms remains the key uncertainty**

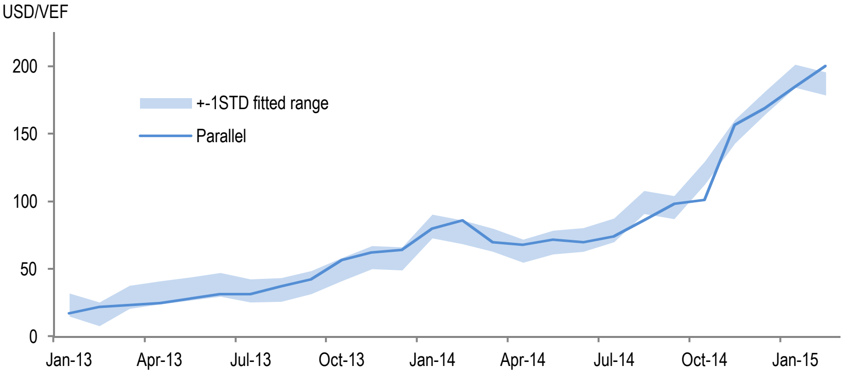
Earlier this month the Venezuelan government began rolling out adjustments in the FX regime—a much awaited policy change but one that so far still seems like a work in progress. In this note we briefly discuss the FX policy changes, the implementation developments, and scenarios for the evolution of the different FX platforms.

Exhibit 1: An increasingly distorted FX regime
USD/VEF



Source: BCV, Dolartoday.com and J.P. Morgan

Exhibit 2: Parallel FX and fitted levels
USD/VEF



Model includes: M2, oil price, US volumes transacted in different platforms and weighted average FX

Source: J.P. Morgan

See page 3 for analyst certification and important disclosures.

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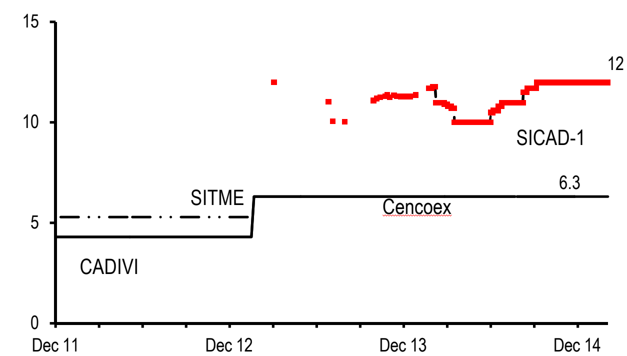
The FX policy measures: Essentially a rebranding of the previous template. On February 10, the Finance Ministry and the Central Bank began rolling out details on changes in Venezuela's increasingly complicated FX market. In line with President Maduro's broad announcements a month earlier (see our January 21 commentary), the authorities confirmed the multiple rate FX regime will remain intact:

- Cencoex will continue to disburse FX for priority imports (mainly food and medicine) at USD/VEF 6.3. Bureaucratic hurdles remain unchanged.
- SICAD-1 remains intact, though without any auctions called since 4Q14. Although the government spoke of a "merger" of SICAD-1 (USD/VEF 12) and Sicad-2 (USD/VEF 50), it seems that SICAD-1 is so-far little changed, outside of the fact that it is now back to being plain SICAD (no more "1"). While SICAD has not held an auction since last October, the authorities have said that this allocation platform will start to operate with an initial FX level of the prevailing 12 VEF per dollar and have suggested this can crawl higher over time. The first auction may be called in March.
- Introducing the "new" SIMADI (Sistema Marginal de Divisas). SIMADI was billed as a market-based, broker led system, similar to the "permuta" system that prevailed until 2010. However, in its initial days, SIMADI seems to be more like a re-branded SICAD-2, but at a much higher rate. SIMADI started to operate albeit with tiny volumes on February 12, after the government published the FX agreement Number 33 with the market guidelines.

SIMADI: A foggy and tepid beginning. The most salient point about SIMADI is the dose of reality the authorities acknowledged with the level. The government allowed the SIMADI level to start trading at an average rate of 170.0, a 240% increase over SICAD-2. SIMADI quickly moved up to 174.47, but has since moved lower to around 171, and—like SICAD-2 before—was starting to look more like a peg. The parallel FX rate stood at 184 at the time of SIMADI's debut (8.2% gap), but has since moved higher to over 220 (29% gap) according to widely tracked website dolartoday.com. SIMADI printed at 176.6 on Feb 27, the highest rate to date on the platform.

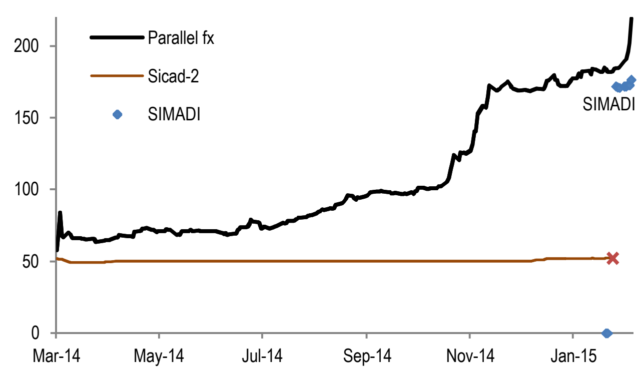
Supply and demand? The regulatory framework around which SIMADI was introduced suggested that the market would be allowed to clear based on supply and demand, with no quantitative restrictions for companies, and that local market participants could cross bids and offers of their own private clients without having to face the BCV in the transaction (as was required by the old SICAD-2) after complying with a reporting requirement. However, anecdotal evidence suggests the authorities have so far been reluctant to authorize "off-market" transactions that would validate a SIMADI rate closer to the parallel market. This, combined with our understanding that official supply of US dollars channeled through the SIMADI has so far been very small, would explain the failure of the parallel FX to converge lower, in fact quite the opposite.

Exhibit 3: Venezuela preferential FX rates
USD/VEF



Source: BCV, Dolartoday.com and J.P. Morgan

Exhibit 4: Wither Sicad-2, enter SIMADI
USD/VEF



Source: BCV, Dolartoday.com and J.P. Morgan

So far SIMADI flows have been quite small. In terms of volumes, the BCV has been reporting daily the percent of dollars liquidated at the SIMADI vs the "administered" platforms of Cencox/SICAD, but without defining in absolute USD terms either the total volumes or a breakdown of flows at the two preferential rates. So far the BCV has reported less than 2% of flows are going over SIMADI, below even the 3-5% that Maduro had originally signaled. The president has publicly said that Cencoex would see 70% of preferential dollar disbursements and Sicad would get 30%, but there is not enough information available to corroborate. Anecdotal evidence to date also points to BCV on the sidelines in terms of of supplying liquidity in SIMADI, with the exception of an "extraordinary auction" that took place February 18, to help banks and exchange houses build inventory ahead of the opening that day of SIMADI to the retail market. The total value auctioned was $4.2mn, allocated to 23 firms. However, local press reports have thus far suggested retail buyers of US dollars are unable to satisfy their $300/day limit due to lack of supply.

What are the relevant operational features of SIMADI? While we reiterate SIMADI still seems like a work in progress, there seems to be some salient operational features that differ from SICAD-2. First, financial intermediaries can cross their own clients; before on Sicad-2 all transactions had to face the Central Bank. Brokers (*casas de bolsas*) are now involved in a more meaningful way (banks had been the main intermediaries on Sicad 2), and the Public Securities exchange has a formal role as the exchange for USD-denominated securities. That said, neither brokers nor banks can trade with each other, which so far has conspired against the SIMADI getting traction. Indeed, acceptable counterparties may only be a non-financial intermediary (clients) or the Central Bank. Worth noting, the SIMADI rate will be allowed to be used for accounting purposes. The necessary condition is for agents to have dollar-denominated bank accounts to transact remained in place (in line with the Exchange Agreement 20). SIMADI also applies to tourists, foreign credit cards and remittances.

Supply on the three platforms: a zero-sum game. If the authorities are not going to allow the market to clear at levels higher than their desired range (so far low 170s) then private supply, which was never expected to be huge, will be quite limited. Some exceptions can arise from private actors in the oil sector, including importantly PDVSA's JV partners, which will be able to access SIMADI to cover local currency operational needs.

The only significant source of potential supply to overvalued rationing platforms is PDVSA. Up to now, FX regulations have mandated that PDVSA sell most of its cash from oil export proceeds onto preferential platforms. PDVSA's incentives would be to sell on the highest platform, but this would de-fund Cenceox and SICAD. For now, the state oil company's ability to sell cash from oil export proceeds to SIMADI appears to remain constrained (with some limited exceptions including sales related to energy agreements like Petrocaribe and China, though these don't generate much cashflow). Thus, much like Sicad-2 before it, official supply for SIMADI may be skewed more towards USD-denominated PDVSA bonds, which do not face the same constraints as cash from exports. The problem here is the steep discount in the secondary market means PDVSA has to add roughly $3 to the liability side of its balance sheet to generate $1 for balance of payments purposes on SIMADI. If we consider $2bn could be forthcoming from bond sales, $1.5-2bn from energy agreements exports, and $1.5bn other sources, then we could estimate some $5bn of annual supply onto SIMADI, or about $20mn/day. However, so far USD supply on SIMADI has been very limited, as reflected in the rising parallel rate.

SIMADI could move lower, temporarily, if supply is forthcoming. Despite the inauspicious beginning, we believe SIMADI rate could decline a bit in the near term once the government begins to provide more supply, including via $3bn face value of new PDVSA '22 bonds (see our January 26 note for details). We would however expect a weakening trend to resume, as demand for USD should remain persistent (given ongoing deficit monetization and pent up demand from corporates) and USD supply can't keep up in the lower oil environment. We call for SIMADI at 190 year-end. The caveat here is if the government begins putting substantial volumes on SIMADI at the expense of the preferential platforms. In this case, the very high starting rate of SIMADI would be capable of draining substantial liquidity from the system (note US$5bn at USD/VEF 170 is equivalent to 43% of end-2014 M2). The more dollars that go to SIMADI, the less fuel there is for arbitrage and capital flight via the preferential platforms. Moreover, the more dollars that go to SIMADI, the better the fiscal results above the line for PDVSA and the government, helping to short-circuit the current vicious cycle of deficit monetization. However, so far the Maduro administration seems committed to keeping SIMADI "marginal" and prioritizing preferential USD flows.

SICAD level seems likely to crawl higher, with rates increasingly deviating from the 6.3 Cencoex level. We think the government would like for SICAD to eventually be consistent with a PPP rate, which should be exceeding USD/VEF 30 this year. Once the government starts calling new SICAD auctions, it seems logical that more volumes could be shifted up from Cencoex (though flows on the 6.3 platform are also reported to be much lower so far this year). That said, at this point the magnitude of overvaluation vis-à-vis either SIMADI or the parallel rate is so stark that the relative weight between Cencoex and SICAD disbursements is becoming increasingly irrelevant.

Exhibit 5: Sicad and SIMADI projections
USD/VEF

	Mar 15	Jun 15	Sep 15	Dec 15
Sicad	12	20	25	30
SIMADI	170	160	180	190

Source: J.P. Morgan

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