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Venezuela Trip Notes: No easy choices in 2015

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- **The government seems to have missed a window to make policy adjustments in time to improve the economic outlook for 2015—especially with lower oil prices**
- **The political outlook seems as uncertain as it has been in many years and National Assembly elections in 2015 represent a key test for the country**
- **Balance of payments constraints will force tough choices in 2015, but adjustment measures will likely be partial, complemented by asset sales**
- **There is still a consensus among locals that default on external bonds would only be a last resort**
- **A better tone for oil and even modest policy measures on the FX could lead to a temporary rally from depressed market levels in the coming months**
- **However, we maintain our Neutral recommendation in the EMBIG model portfolio and recommend overweights use rallies to get closer to home**

We visited Caracas this week for a series of meetings with economic and political analysts, representatives of the private sector, and public sector officials. The main focus of the trip was the challenging outlook for 2015, as increasingly acute economic stress is now set to be exacerbated by a lower oil price environment. With National Assembly elections supposed to take place sometime during the next year, we perceived political uncertainty to be as high as it has been in years.

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The economy is under severe stress. Although the Central Bank has not published statistics for 2014, GDP growth is widely seen contracting by at least 3% this year according to private analysts. Inflation, which was last reported at 63% in August, is seen heading to triple digits according to some local forecasts. The Central Bank stopped reporting scarcity figures back in February, but anecdotally the availability of goods remains an acute problem, both at the retail level and in terms of inputs for the productive sector. Although demand for consumption is booming, fueled by ample bolivares trapped behind capital controls, local industry is unable to respond and disbursement of dollars for imports remains suppressed. While unemployment remains near the lows, this partly reflects the relatively recent implementation of radical labor laws that make it nearly impossible to fire workers (undermining productivity), and accelerating inflation is eroding real wages. There are signs of commercial and residential construction in Caracas, as real estate is a popular store of value. Price controls are being adjusted on an *ad hoc* basis, but tend to be insufficient and margins have been squeezed. Some analysts think unemployment will have to go up, despite the regulations, or more business could be shuttered.

Economic stress is undermining government popularity. Polls showed President Maduro's approval rating going to the low 30s at the end of September—a 20%pt decline over the year, and the lows of the entire Chavez era—and preliminary indicators suggest the decline continued into November. So far there is no sign that Maduro's approval has bottomed. A vast majority (over 80% according to Datanalisis at end-September) think the country is on the wrong track. The rhetoric that the government is being subjected to an "economic war" seems to have grown tired, since the inability to win the "war" makes the administration look ineffectual. While inflation has always been a concern alongside scarcity and security, the acceleration of prices this year now appears to be a key pressure point for public opinion. And these numbers are coming before there has been any impact yet felt from lower oil prices.

For now there is little sign that popular frustration is set to boil over into street protests akin to those of February-April, as tensions seem to be channeled toward 2015 National Assembly elections. There is thus far no date set for the vote, which must only take place in time for a new Assembly to be seated by January 2016, as mandated by the constitution. The first step is to conform a new National Electoral Council after the terms of three of its five members (including the lone opposition representative) expired. So far, the government appears to be allowing a process to unfold that will deliver a CNE that would be acceptable to both sides, though this is not a given.

There is an open debate among analysts as to whether the government might try to have elections as early as possible or delay them as long as possible. On the one hand, early elections might allow the government to catch a still-divided opposition off guard and unprepared. Moreover, if the government pushes early elections under conditions that would be unacceptable to the opposition (say, with an overly biased CNE) this might exacerbate opposition divisions over whether or not to participate. One line of thought is that if elections happen early enough, the government just might be able to put off unpopular adjustment measures until after a vote. However, the current polling suggests the governing PSUV would have a very difficult time winning elections any time soon, even considering advantages due to over-representation of under-populated (Chavista) states and gerrymandering. The opposition divisions are real, but most analysts believe they understand how important it is to participate in the process in order to avoid a repeat of the 2005 boycott that effectively handed the AN to Chavez and let him govern unchecked.

Hard choices

It is against this complicated backdrop that the government is now forced to make hard policy choices due to balance of payments constraints that will only worsen in 2015 if oil remains at current levels. In terms of finding ways to generate more hard currency, the options seem limited.

Increasing oil production will be challenging in the short term. Oil production and exports may grow on the margin (perhaps 100kbd at most) if early production in the new Orinoco projects comes forward, and if joint ventures in existing fields continue to grow. However, many traditional fields are declining and it seems difficult to see a meaningful increase in production in 2015—especially as JV partners may ask for more concessions from the authorities now that lower oil prices are impacting the economics of the projects.

Petrocaribe remains a political priority. The other option to increase cash flow would be to cut still being sold under concessional agreements, namely Petrocaribe and similar arrangements with friendly governments. This would be the least sensitive measure for the domestic populace, and we heard anecdotal talk that these volumes may already be getting scaled back. However, Foreign Minister Ramirez this week publicly committed to maintain the relationship despite lower oil prices.

China is maintaining, but not increasing exposure. The authorities are also clearly engaged with China, who continue to roll-over part of their exposure to Venezuela, and apparently have granted some modest relief on the terms of the agreements by allowing Venezuela to send only the minimum volumes to cover debt service (we estimate close to 300kbd would be needed at current prices) rather than the 485kbd that were reported last year. However, the savings represented by selling the excess barrels to better and/or closer markets is minimal, notwithstanding that sales would accrue directly to PDVSA rather than get trapped in a government-owned collection account at the Chinese Development Bank.

All told, we see little impact from efforts to free up more barrels. Rather, the dramatic fall in dollar revenue implied by current oil prices will require either sales of assets or a much stronger domestic adjustment. On the side of asset sales, there is gold at the Central Bank, a relatively small portion of which remains offshore; there is a vaguely quantified amount of cash in off-balance funds; there is talk of securitizing claims on Petrocaribe; and there is Citgo and other off-shore refining assets.

Transparency of funds is positive, but not very significant. The authorities this week announced that $4bn of Chinese fund money would be deposited in a strategic reserve fund at the Central Bank in order to boost reserves. Indeed, headline reserve levels jumped to $23.5bn on November 19, an increase of $4bn over just two days.

However, cash reserves (ex-fund) likely stands at around $900 million by our calculation, near the recent lows. That leaves the Central Bank's gold holdings, which stand at an estimated $14.6bn on the BCV's balance sheet (valued at a 6mma) and $13.9bn at the current spot price. We understand about $2bn of the gold to be offshore, with the rest in the vaults of the BCV. The latter could be gradually transferred back offshore, though this would undo one of Chavez's more trumpeted "anti-imperialist" triumphs.

As for funds, we learned from government officials that there was roughly $16bn as of June, of which only $2.5bn was Fonden, while $8.1bn was in the Joint Chinese Fund (ie the revolving tranches A, B and C), while $3.7bn was in the originally $20bn Great Volume Chinese fund. According to President Maduro, the $4bn that is going to reserves comes from the disbursement of the second roll-over of the fully amortized tranche A. We still see China maintaining, but not increasing, exposure to Venezuela as long as a minimum level of Venezuelan barrels are going to service debt, and while the Chinese funds will be spent on imports, we understand these will be go towards projects approved by China. So basically this is status quo, with slightly improved transparency.

As for Citgo, the official line we heard was that if the price was right this would still be considered, but the idea was not to use cash to plug current expenditure gaps. This is despite Finance Minister Marco Torres's statement that the Citgo sale was off. Indeed, some industry experts still believe there are powerful voices inside the government and the company against selling Citgo. Still others thought the need for cash means some of Citgo's assets might be divested even if Venezuela might maintain some ownership of whatever is left over.

As for securitizing Petrocaribe claims, we think this would be difficult. Central Bank data as of 3Q13 suggested over $23bn of assets related to "commercial credits". However, much of this may be claims on Cuba (difficult to securitize) and some Petrocaribe partners may the have contractual ability to pay debt in kind (for example with agricultural products). While we are skeptical Venezuela could generate much cash from such a plan, we will continue to monitor developments on this front.

Liability management or new issuance? The authorities have publicly stated that they will engage market participants with a possible liability management plan. We acknowledge that any success in pushing off 2015 maturities could deliver some welcome respite to markets, particularly the inverted front end. However, market conditions suggest any exchange would be costly, likely requiring healthy coupons and a large exchange ratio, keeping sustainability concerns alive over the medium term.

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Domestic adjustment would be key, but the window may have closed

As for domestic adjustment, imports had already fallen sharply in 2014 even before the oil price drop, and we question how much lower they can go without upsetting the already tenuous social balance. This means the government will need to do more with less, which could most efficiently be accomplished by eliminating the multiple FX regime and devaluing to a competitive rate, while also relaxing price controls. Such a policy could allow the same or even fewer import dollars to deliver more goods and services to the domestic economy considering that it could choke off contraband and capital flight via over-invoicing.

The government has said unification of FX rates remains a policy option "on the president's desk". However, there must be a reason that Maduro has been wed to maintaining the USD/VEF 6.3 Cencoex rate this year, and if it wasn't perceived to be politically costly, it probably would have been adjusted already. The key to understanding this conundrum is that a substantial segment of the population continues to get by on subsidized goods, particularly food and medicine, much of which are delivered through government markets and distribution networks. Even if scarcity is high among certain goods, and lines are maddeningly long, these subsidized goods are a critical part of the consumption basket of lower income Venezuelans. Moreover, we heard views that this segment of the population does in fact perceive a direct link between the 6.3 FX rate and their own pocketbook.

The other perceived obstacle to FX unification is the impact it would have in cutting out rent-seeking, which is politically risky in its own right. Of course cutting out rent seeking is the flip-side of the coin to more efficiently delivering more goods and services with the same (or diminished) flow of dollars. However, the conventional wisdom in Caracas is that the beneficiaries of access to cheap dollars for public sector imports are tied to military sectors. In the current context, the president is seen relying on the military to guarantee governability among low popularity.

Again, we think Maduro knows devaluation is inevitable, but he perceives strong political incentives to mask it, to keep the 6.3 at least for some minimal flow of goods, while quietly pushing volumes of FX up to higher platforms (Sicad-1 at 12 and probably crawling higher; and Sicad-2 at 50 for now). This outcome also keeps rent seeking opportunities intact, though with slightly diminished margins. However, the consequence of taking only partial adjustments would be more of the same for 2015: lower imports inefficiently delivering goods and services to the domestic economy and exacerbating current economic dynamics.

The other much discussed measure that has now been on and off the table for almost a year is gasoline price hikes. President Maduro this week announced he had "accepted" a proposal from Venezuelan workers to "rationalize" gasoline prices, channeling the funds into social spending, but that he was "not in a hurry". The timing of this latest reintroduction of the fuel hike debate seems both a

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recognition of the need to reduce this costly subsidy but also perhaps a nod to OPEC that Venezuela was on some level prepared to make sacrifices (Foreign Minister Ramirez subsequently said output cuts were on the table too, though we think Venezuela can ill afford any reduction at present, and rather maintains aggressive goals to raise output over the medium term). Aside from collecting more bolivares for domestic barrels, an aggressive fuel price hike could have the added benefit of reducing domestic consumption (700kbd, of which some 100kbd could be contraband). This would free up more barrels to export. That said, fuel price hikes have long been seen as a political third rail, even by Chavez, which is why they have been untouched for almost two decades. The risk is not only from a possible general domestic backlash (which may or may not be overstated), but once again such a move would presumably cut into rent seeking—with an unknowable impact on the political equilibrium *vis-a-vis* military sectors.

So, what to expect regarding adjustment? Assets will likely be drawn down. We think a partial sale of the BCV's gold (perhaps $2-3bn) is plausible. The sale of US refining assets still seems like it is on the table, despite mixed messages from the authorities and news reports. Chinese funds will be drawn down at whatever pace suits China. While we have been skeptical about gasoline hikes, we may see some timid, gradual move in that direction—probably insufficient to have much impact on 2015 external accounts. On the FX front, we still think a partial devaluation that maintains multiple rates (at least two) is still the most likely scenario. This would likely be accompanied by a relaxation of the restriction on sales of oil exports at the higher rate, thereby delivering more VEF to PDVSA and its partners, and helping diminish monetary financing from the BCV. These would be helpful and necessary adjustments but likely insufficient to fully address imbalances. Imports will continue to be forced lower in line with the realities of dollar revenues, keeping the supply side under pressure and preventing any meaningful release of pent up demand into consumption. Overall this seems like an equation that will maintain upward pressure on prices without relieving scarcity much, if it all. We see little reason in this scenario why the president's approval rating should see any significant rebound.

…bringing the conversation back to politics and elections. While we acknowledge that many analysts think early elections are probable, we don't see much advantage to the government in the current polling context. We also tend to think the opposition—while still suffering divisions—will probably be adept enough to field (mostly) unified candidates with a strong chance to win. Perhaps the government will instead choose to wait until November or early December, hoping for a rebound in oil and that the sting from adjustment measures (even if partial) may have passed. This risk here is that Venezuelans run out of patience, and unresolved economic stress boils over in the interim into social tension.

The initial question of what is the ideal timing for elections (perhaps none), leads us down the path of even further uncertainty with more questions than answers. Would the government accept electoral defeat? Could the PSUV continue to effectively exercise power without a majority in the National Assembly? Could Maduro continue to effectively hold together the distinct factions of Chavismo if he is no longer seen as politically viable? Could the authorities postpone elections altogether? What would be the opposition reaction to electoral tension or perceived constitutional break? Would the opposition respond in a unified way? Would a critical mass of the population come to the streets? How would the army react? What about the pro-government armed parallel groups? What would be the reaction of the international community? At this stage, we think these among the relevant set of questions, but it remains too early to arrive at any conclusive answers.

Default is a topic of debate in New York and London, not Caracas

The most consistent theme was default would only be a last option. On nearly every topic of discussion, we heard a wide range of often contrasting opinions in Caracas, in line with the overall high level of uncertainty. However, it is notable that the most consistent view across our meetings was that default on bonds is not being seriously considered or advocated by nearly anyone across the political spectrum, and would only be a last option. We met several private analysts and a representative from the opposition that all called the Hausmann concept of bond payments versus imports a "false dilemma". Locals—both opposition and government—seem to have internalized the notion that a bond default would preclude Venezuela from selling oil and importing most of the goods and services that the economy needs. Locals also point out that Venezuela takes pride in having historically been a strong creditor, with only a few temporary blips on its track record of servicing external debt. There is also thought to be a large level of local holdings. Nor do odious debt arguments hold much water since President Chavez issued nearly all the bonded debt, and the opposition—if they every come to power—would want to leverage their credibility with markets, not squander it. We acknowledge that external market participants are much less convinced, and many think Venezuela could find ways to export and import even if in default. When pressed, locals can't rule out a default given the difficult state of external accounts and political uncertainty. However, they are nearly unanimous that this would be a last option, and this is the color that we are trying to convey: external market participants are talking about default, but most locals are not. At least not yet.

Stay Neutral on Venezuela in the EMBIG model portfolio

We come away from our trip still perceiving a high level of uncertainty about how the government will deal with balance of payments constraints without upsetting a tenuous political and social equilibrium in 2015. The government seems to be facing few good options within the realm of its own perceptions of political constraints. Political outcomes seem highly uncertain, and social tension cannot be ruled out. In this context, we reiterate the views we conveyed in our October 20 note "Oil prices may be a game changer". From the currently depressed levels, we think Venezuelan asset prices would react positively over a short horizon to a better tone for oil prices and any measures that rationalize the FX regime. However, barring a return of oil back to 1H14 levels, we think the risk of balance of payments constraints interacting with unpredictable social and political outcomes remain high in 2015. For investors that remain overweight, we would continue to recommend using rallies to get closer to home.

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