# Investment Note

13 February 2018

## Venezuela: Economic Chaos Continues

Venezuela's descent from its status as one of the richest countries in Latin America to being the poster child of an economy gone wrong continues to fascinate. According to the IMF, the country's economy could shrink by 15% this year as inflation pressure accelerates.[1] In this note, our Emerging Markets Debt team explains why it could be some time before the situation in the country improves.

With the largest proven oil reserves in the world, Venezuela was once one of Latin America's richest countries. Only five years ago, it represented about 10% of the Emerging Markets Bond index's market capitalization (JPMorgan EMBI Global).[2] Today Venezuela's debt is in default and represents less than 2% of this index, which includes bonds issued by both the government and PDVSA, its state-owned oil company.[3] The country is in deep economic crisis and plagued by shortages of basic goods including food, medicine and even toothpaste.

Though there is some debate about the extent to which external factors have forced the downturn, in our view, the government is ultimately responsible for the chain of events that led to the current crisis.

Since 1999, the government adopted an aggressive socialist agenda supported by the "nationalization" of private sector assets in both oil and non-oil sectors, and the implementation of broad-based social benefits via handouts, price controls and subsidies. Nearly 20 years of policy mismanagement has resulted in an incredibly fragile economic foundation and an economy totally dependent on oil sector revenues.

Despite higher oil prices today, the combination of a chronic lack of investment in the oil sector, misallocation of resources and widespread corruption has resulted in rapidly declining oil production, and in turn, lower fiscal revenues. The situation has been exacerbated by protracted hyper-inflation and a large discrepancy between the official exchange rate of the Venezuelan Bolivar and what it goes for in the black market. Structurally, the country is also hampered by its high dependency on imported goods. As a result, the foreign community (US, EU and others) has reacted to increasingly authoritarian actions by the government by imposing sanctions on numerous government officials and restricting commercial and financial activities in the country. Undoubtedly, this has led to much suffering in the country, as is often reported in the news. The biggest challenge confronting the Venezuelan government at this point is whether they have identified the right solutions to resolve the crisis, and how long it will take to get things back to normal.

Though Venezuelan President Nicolas Maduro lacks the widespread popularity of his mentor and predecessor Hugo Chavez, the political opposition appears largely fragmented and in our view, does not appear to have the necessary momentum to unseat his political base. It is likely that Mr. Maduro will stay

[1] IMF: Latin America and the Caribbean in 2018, 25 January, 2018.
[2] JPMorgan, as of 20 January, 2018.
[3] Bloomberg, as of 20 January, 2018.

in power in the near future because the military remains deeply loyal to him.[4] In addition, Mr. Maduro still enjoys a core base within the Venezuelan poor, who continue to hold on to the Chavismo ideology.[5] In the unlikely – although definitely positive – scenario that an opposition government were to come to power in the upcoming election, there will certainly be a long and difficult road ahead for the country's economy.

From a credit perspective we think, as a minimum, a detailed audit of the country's total liabilities (bilateral, market debt and oil sector suppliers) is required as it will serve to confirm the actual level of resources (FX reserves and other government accounts) that is available to the government. In addition, bilateral institutions (as well as the population) will demand a thorough assessment of the true state of the economy – GDP and key fiscal and monetary metrics. External pressure from global sanctions and the lack of access to capital markets could hasten the timeline but for now, we believe Mr. Maduro will be able to tolerate that pressure.

Based on our fundamental research and rigorous sovereign risk assessment, we had held a very negative view on Venezuela in recent years, finally exiting the market in early October 2017. The situation worsened shortly after (during November) to the degree that rating agencies downgraded the country's sovereign credit rating[6] and CDS (credit default swaps) were triggered.[7]

Though investing in distressed debt situations can at times be rewarding, the restructuring process is most often time consuming and labor intensive. With US creditors unable to engage with top officials in Venezuela due to sanctions that are currently in place, the process of reaching any kind of 'workout agreement' becomes even more complex and challenging. Finally, it remains possible for Venezuela to transfer PDVSA's assets to another legal entity, leaving the company as an empty shell with nothing but liabilities (i.e. a 'bad-bank' structure). This makes the country even less appealing to investors.

In our view, Venezuela will eventually offer a compelling opportunity, but it is difficult to say when that could happen, and at what price. From a risk/reward perspective, we think it makes more sense for investors to turn their attention elsewhere for now, where their efforts are more likely to lead to a more positive outcome.

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[4] Guardian: Venezuela Opposition Looks to Military to Oust Maduro. Dream On, 8 January, 2018.
[5] Foreign Policy: Why More Sanctions Won't Help Venezuela, 26 January, 2018.
[6] Barron's: Better Late Than Never – Ratings Agencies Downgrade Venezuela, 4 November, 2017.
[7] Reuters: ISDA Panel to Reconvene on Venezuela CDS Auction, 27 November, 2017.

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