LATIN AMERICA FOCUS

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CAPITAL ECONOMICS

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How can Venezuela cope with the fall in oil revenues?

- **The decision of Venezuela's President Hugo Chavez to nationalise more than 60 firms last month, including a Spanish bank, is a clear response to the effect that the collapse of oil prices has had on fiscal revenues. The government believes this strategy will solve its cash problems. But as the region slides into recession, these policies are only exacerbating the crisis in Venezuela.**
- During President Chavez's ten-year watch the economy's dependency on oil revenues has increased. Accordingly, **the collapse of oil prices has caused government income to plummet**.
- **The Venezuelan authorities have five mechanisms to cope with the collapse in fiscal revenues**. **Two of these are conventional** and have been already implemented to some degree. **The other three can be deemed as unorthodox**.
- **The conventional measures include tightening fiscal policy - cutting expenditure and raising VAT - plus issuing new debt - the government plans to raise funds equivalent to around 7.5% of GDP in the domestic market.**
- **The unorthodox measures** are more worrying. The **first is the nationalisation of private firms** (something President Chavez has done in more than 100 cases since 2007). This enables the government to have access to new sources of revenue and to cut costs. But it also contributes to the deterioration of the investment environment.
- **Second, the bolivar fuerte could be devalued against the dollar to boost the local currency value of oil revenues**. We believe that a devaluation of at least 35% is likely within the next 12 months. However, this would hurt those holding foreign denominated debt would. In addition, any devaluation would worsen inflation in Venezuela, which is already the highest in the Latin America.
- **Finally, the government could print money** in order to finance fiscal programs. This could cause a hyper inflation similar to that witnessed in Zimbabwe in recent years and Argentina in the 1980s. Of all the unorthodox methods this is the least likely to take place this year, but it is a serious threat.
- **Given this context, we are forecasting a 7% contraction of GDP this year, followed by another 3% fall in 2010.**

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How can Venezuela cope with the fall in oil revenues?

Venezuela's President, Hugo Chavez, continues his aggressive nationalisation plan as a mechanism to raise additional funds to compensate for the collapse of oil prices, which threatens his ambitious political agenda. In May, more than 60 firms were nationalised or forced to sell to the state. The latest include a Spanish bank and a US food company.

However, the ongoing wave of nationalisations is unlikely to enable the authorities to mend the government's cash problems. Instead, as the region's economy slides into a recession, this strategy is actually exacerbating the crisis in Venezuela. In this *Focus* we explain why.

Renewed nationalisation wave

On Friday 22nd May the Venezuelan government became the owner of the Banco de Venezuela (BDV), which has 10% of domestic credit and deposits. While the authorities have refused to disclose any figures regarding the the takeover, a source at the Group Santander, the BDV's main stakeholder, leaked to the media that the government had agreed to pay $1bn in compensation (though in practice it is unlikely that any payment will be made for some time). The deal means that state-owned banks will double their share of Venezuelan deposits.

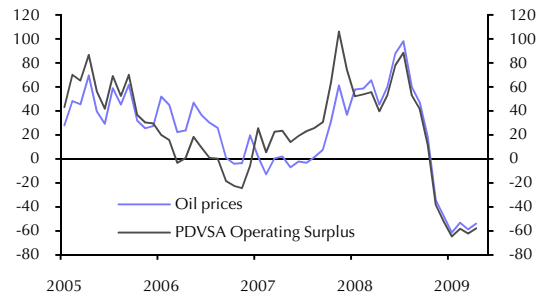
The move against BDV came shortly after the Venezuelan government had nationalised some 60 firms that provided different services to Petroleos de Venezuela (PDVSA), the government's oil company. President Chavez also nationalised a US food processing company in mid May.

Politics or economics?

The government claims that these nationalisations are part of President Chavez's "XXI century socialism", which the president has been trying to implement in Venezuela since he came to power 10 years ago. During this decade, the authorities have adopted drastic reforms that include removing the independence of the central bank, imposing domestic price controls, tightening restrictions on capital flows and nationalising companies in several industries.

But **the real motivation behind recent nationalisations - and those that might occur over coming months - is the devastating effect that the collapse of commodity prices has had on government revenues**. Chart 1 shows how PDVSA operating surpluses have been hit by the drastic fall in oil prices.

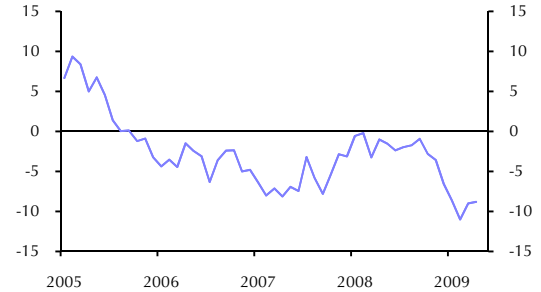
CHART 1: PDVSA SURPLUSES AND OIL PRICES (% Y/Y)



Sources – Thomson Datastream, OPEC and Capital Economics

In addition, but to a lesser degree, government revenues have been affected by falling oil production. Indeed, since October 2005 Venezuela's oil output has been shrinking on annual basis, according to OPEC's monthly report. (See Chart 2.)

CHART 2: VENEZUELAN OIL PRODUCTION (% Y/Y)



Source – OPEC

In Q1 oil output shrank by more than 10% y/y, its sharpest decline in five years. This contrasts with the 4.8% y/y drop that the government claims took place in the first quarter of the year. The fall in oil output is due to the fact that PDVSA has failed to invest in upgrading its equipment and properly maintain its facilities.

That said, **the core of the problem is - without a doubt - the collapse of oil prices and the deterioration of terms of trade, which has had a dramatic impact on the rest of the economy**. In Q1 GDP managed to expand by 0.3% y/y. This prompted the authorities to claim that the economy was experiencing a soft landing. However, a detailed look at the data shows a grim picture. (See our *Latin America Update* 'Venezuela's economy on the brink of recession', 20th May.) The year-on-year growth rates were flattered by weakening but still strong growth in the final three quarters of last year. Since the authorities do not provide seasonally adjusted data, we did it ourselves. Our estimates show that the economy shrank by 3.9% q/q in Q1.

Black gold

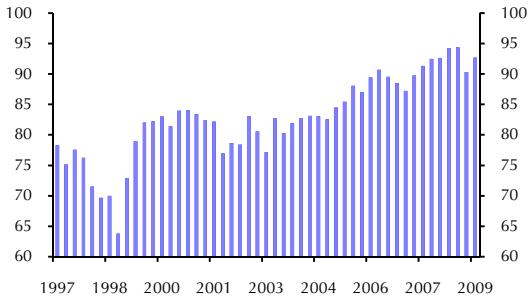
While most countries in the region have sought to reduce their dependency on commodities by diversifying their export portfolio, in Venezuela the opposite has taken place. Indeed, **during President Chavez's watch the value of oil exports has risen from 78% of total export revenues, ten years ago, to 93% last year**. (See Chart 3.) Of course, much of this was driven by the commodity price boom that occurred between 2004 and 2008. It is fair to say that the government did not deliberately try to come to this situation. That said, it is also valid to argue that this situation is the indirect effect of the policies implemented by President Chavez.

In any case, the result is that oil exports are the most important source of foreign exchange earnings and fiscal revenues.

Venezuela's fiscal problems

It's difficult to say how bad the fiscal situation in Venezuela is, given the lack of transparency and timeliness of the authorities when publishing data. **The latest official data on the public finances are for 2007, when the budget deficit was reported at 2.6% of GDP.** We estimate that it was closer to 2.0% of GDP in 2008. This suggests that President Chavez spent close to all of the extra income from the oil price boom. (See our *Latin America Focus* "Heading for the worst recession since the 1930's", 11th March.)

CHART 3: OIL EXPORTS AS SHARE OF TOTAL EXPORTS (%)



Source - Central Bank of Venezuela

For 2009 we assume that oil prices average around $45 per barrel (this is similar to the $40 per barrel assumption made by Venezuelan authorities). In addition, we estimate that oil output continues to fall sharply this year. (Based on performance of recent years, we believe oil production is likely to shrink by around 9% this year.)

The industry's disappointing performance will only exacerbate the fall in oil revenues triggered by the collapse of oil prices, which are considerably below last year's levels (despite a recent rebound). Of course, **the overall impact on PDVSA operating surplus and, consequently, in public sector revenues, will depend on fluctuations in oil prices over coming months.** Table 1 shows three scenarios for this year assuming that the remaining components of income - and all of expenditure - increase at a rate of 20%, our inflation forecast for 2009. As mentioned above, our baseline scenario assumes the price of the barrel of oil averages $45.

Even in the most optimistic scenario, which assumes that oil prices reach the $100 per barrel

mark and remain there until the end of the year, thus averaging $80 per barrel this year, PDVSA's operational surplus shrinks by more than 40%. Accordingly, the public sector balance deficit rises to about 10% of GDP. **In the baseline scenario, the public sector deficit rises to around 18% of GDP.**

TABLE 1: FISCAL SCENARIOS

Scenario	Average oil price*	PDVSA operating surplus % y/y	Public Sector rev. %GDP	Public Sector Bal. %GDP
2007 **	66	13.0	32.9	-2.6
2008***	123	77.3	39.6	-2.0
2009 Baseline	45	-66.3	27.7	-18.4
2009 Middle	65	-52.0	31.6	-14.6
2009 Optimistic	80	-43.4	34.7	-11.5

Sources – Thomson Datastream, Venezuelan Ministry of Finance, Capital Economics
* Average oil prices are based on actual prices as of 1 June. For the rest of the year we assume that oil prices remain constant at $45 per barrel, for the baseline scenario, $80 for middle scenario and $100 for optimistic scenario.
** Official results
*** Estimated by CE

What can the authorities do to cover the fiscal gap?

The government's options

President Chavez can use five mechanisms to cope with the collapse of oil revenues. Two are conventional measures, while three can be deemed as unorthodox. (All conventional measures have already been implemented, but so far only one of the unorthodox options has been used).

In the first instance, a government would fund a fiscal deficit by issuing new debt. However, since Venezuela has limited credibility in international markets, issuing new external debt or obtaining loans from multilateral organizations is not a viable option. Thus, the authorities will have to go down a different route.

This means that the fiscal gap needs to be covered by issuing new debt in the domestic market. The Venezuelan authorities are planning to sell about 50bn bolivares fuertes (7.5% of GDP) in domestic currency denominated bonds. If successful, the government would double the stock of public domestic debt. The Venezuelan National Assembly is currently debating this alternative and it's likely that it will approve the changes to the budget.

Given the baseline scenario, issuing new domestic debt is not enough to cover the fiscal gap. The authorities have therefore announced a fiscal tightening to balance the budget. **In April President Chavez announced a 7% reduction in current public expenditure for this year, excluding wages and salaries plus capital expenditure, which will remain constant**. This generates savings equivalent to around 9% of GDP.

In addition, the government will increase VAT from 9% to 12%. This should increase revenues by a modest half percentage point of GDP. **Overall, the fiscal tightening is equivalent to about 10% of GDP relative to a scenario where all expenditure is assumed to rise in line with inflation.**

On the face of it, the combination of new debt and fiscal tightening solves most of the problem. However, we have reasons to believe the Venezuelan authorities are being overly optimistic.

For a start, **it seems unlikely that the Venezuelan authorities will be able to issue this amount of domestic debt this year**, the largest increase since 1996 (there is no domestic debt data available prior to this year). The ongoing wave of nationalisations has damaged investor confidence in Venezuela, which is essential if an auction of this magnitude is to succeed.

Second, we believe the fiscal plan is unlikely to yield the benefits expected by the authorities. At a time when most governments across the world are loosening the purse strings in an attempt to cushion the blow from the global slump, President Chavez is doing the opposite. **Raising VAT by three percentage points is a direct blow to households and businesses. Thus, with the economy sliding into recession, it seems unlikely that tax revenues will climb this year**. In addition, reducing public expenditure would exacerbate the

fall in economic activity, which would then have a knock-on effect on tax revenues.

More worryingly, we think President Chavez is unlikely to maintain fiscal discipline, especially when he has announced that all of the social programs of his administrations would remain untouched.

The bottom line is that we do not believe Venezuela's budget is credible and President Chavez is likely to adopt unorthodox measures to cover the fiscal gap.

Unorthodox fiscal management

As mentioned above, there are three unorthodox mechanisms that the authorities can use to compensate for the collapse in oil prices.

First, the government can continue to expropriate businesses in order to have access to new sources of revenues (the case of BDV), and lower costs by absorbing firms that provide goods and services to the state (the case of the 60 firms in the oil industry). The authorities have nationalised nearly 100 firms since 2007, including 66 during May in response to low oil prices. What's more, President Chavez is currently eyeing a telecommunications company. It seems plausible that the nationalisations will continue during the rest of the year.

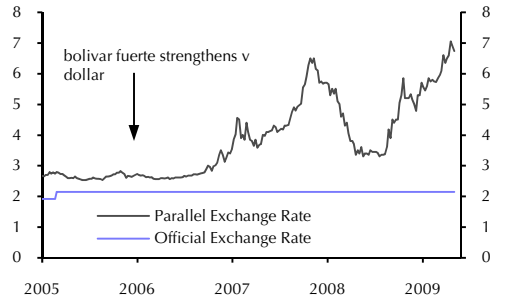
Second, the government could devalue the bolivar fuerte against the dollar. This could boost local currency earnings from oil exports, which take place in dollars. This would reduce the gap between public sector expenditure and income. **But the devaluation would, of course, have an effect on the foreign denominated obligations and inflation.**

In the case of the former, a devaluation of the bolivar could increase sharply the value in local currency of interest debt payments on foreign currency denominated debt. Admittedly, Venezuela's external debt, at 15% of GDP, is relatively low in comparison with other emerging economies.

Nevertheless, nearly 65% of the foreign denominated debt is held by the private sector. What's more, almost all of the short term external debt, equivalent to 5% of GDP, is held by businesses. Accordingly, a devaluation would increase substantially the risk of default in the private sector. (That said, the risk of default in the public sector could also increase substantially as the government inherits the external obligations of the companies that are nationalised.)

In the case of inflation, the consequences of a devaluation of the bolivar against the dollar are unclear. Theoretically, a devaluation of the currency would trigger a sharp rise in import prices, which, in turn, would cause headline inflation to increase drastically. Of course, this would depend on how import-dependent the economy is. In the case of Venezuela, imports are equivalent to about 20% of GDP, so it can be assumed that import inflation could have a significant effect on headline inflation.

CHART 4: OFFICIAL AND UNOFFICIAL EXCHANGE RATE



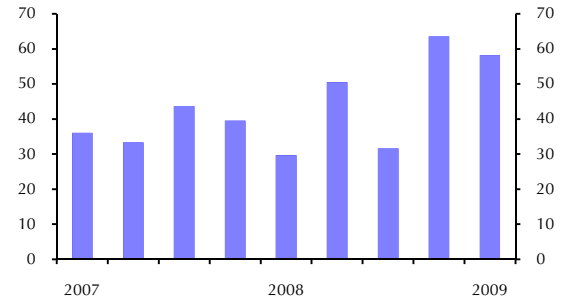
Source – Venezuela FX blog spot, Thomson Datastream

But the situation in Venezuela is more complicated. **There is an unofficial or 'black market' exchange rate, which is clearly overvalued.** (See Chart 4, above.) Indeed, in the unofficial market the bolivar fell by 35% against the dollar since September, which means that it is 67% below the official rate.

The fall of the bolivar in the parallel market should have an impact on domestic inflation, depending on the share of imports that are actually purchased using the unofficial rate. Chart

5 shows that this share has increased in recent months to about 60% in Q1 from 30% in early 2007. Thus, it can be argued that the fall of the bolivar in the black market had something to do with inflation reaching 30% last year.

CHART 5: IMPORTS PAID WITH UNOFFICIAL RATE (%TOTAL IMPORTS)



Sources - CADIVI, Thomson Datastream, Capital Economics

The inflation in Venezuela has also been driven by other factors such as the commodity price boom that ended last year, and the shortage of goods (which began after government imposed price controls and businesses could not cover their costs).

The short point is that since 40% of imports continue to be purchased using the official rate, it is not unreasonable to believe that an official devaluation of the bolivar fuerte could worsen inflation and hit Venezuelan's real income.

What's more, we believe there is a significant risk that President Chavez will adopt this route, which would then raise three questions. How much are the authorities likely to devalue? What would be the impact on the value in local currency of foreign denominated obligations? And how much would inflation rise?

Assuming the baseline scenario, without issuing new debt or any fiscal tightening, the authorities would have to move the exchange rate from 2.14 bolivares fuertes per dollar to 7.5 (that is a 70% drop in the currency in terms of the number of dollars per bolivares fuertes) in order to balance the budget. Of course, this is the extreme case and it is unlikely. If we assume that the conventional measures are effective to some degree, the budget could be balanced by devaluing the currency by at least 35% (to 3.3 bolivares per dollar), which seems more plausible.

The obvious implication for those holding foreign debt is that the local currency value of the dollar denominated obligations would rise accordingly. In the context of recession, this is a direct blow that could easily exacerbate the crisis in some sectors.

The effect on inflation is much harder to assess. The Venezuelan institute of statistics does not publish the weighing factors of components of the consumer price index. We therefore assume that imports carry the same weight in the Venezuelan CPI as they do in overall GDP. Accordingly, **a 35% devaluation of the bolivar fuerte would cause headline inflation to climb by more than three percentage points** (this is based on the fact that total imports are equivalent to 20% of GDP and about 40% of imports are purchased via the official rate).

On the face of it, the rise in inflation does not seem so drastic. After all, inflation was 30% last year. But **we would have to add to it the impact of the VAT increase**. This means that inflation would increase by at least six percentage points. This could also trigger a price/wage spiral that could worsen Venezuela's inflation profile.

Finally, the authorities could print money to finance public expenditure. This is an extremely risky option since it could trigger hyper inflation, similar to that of Zimbabwe or the one that hit Argentina in the late 1980s. **We believe this is the less likely option**, which would only be triggered if everything else fails and the price of oil falls below the $40 threshold. Nonetheless, it is a serious threat given the deterioration of institutions in Venezuela.

Conclusions

In this *Focus* we have discussed the options that the Venezuelan authorities might adopt depending

on the price of oil in international markets. Table 2 summarises the measures that could be taken at various levels of oil price.

TABLE 2: SUMMARY

	Average Oil Prices			
Measures	**Below $45**	**$45**	**$65**	**$80**
Issuance of new debt *	>10	9.1	5.3	2.2
Fiscal tightening*	9.3	9.3	9.3	9.3
Devaluation (%)	>70	35	35	×
Nationalisations	√	√	√	√
Printing money	√	×	×	×

*** As a share of GDP**

We can see that if oil prices average $45 per barrel this year, the government would have to use a cocktail of new debt, fiscal tightening, nationalisation and devaluation. This combination of measures would assure that the public sector's budget is balanced. But it would hurt businesses and households (via higher taxes and higher inflation) and worsen the situation for those companies that have to make payments on foreign denominated debt.

In this context, recession is all but inevitable. We are sticking to our forecast that the country will enter a two-year recession. We believe GDP is on track to shrink by 7% this year, and 3% in 2010.

President Chavez has been telling the world that Venezuela will weather the current global economic crisis better than most countries in the Latin America thanks to the reforms he has pushed through in the last ten years. However, the reality is the complete opposite. The decisions made by the President Chavez administration have cornered Venezuela, and the country is now more vulnerable to external shocks than it was in the past. Also, the investment climate in the country has deteriorated sharply. The nationalisation of key firms has nothing to do with the implementation of a better system - as President Chavez claims - and everything with guaranteeing the financial sustainability of the regime regardless of the social and economic costs.