



Apocalypse Now Venezuela, Oil and Reconstruction

By Antoine Halff,¹ Francisco Monaldi,² Luisa Palacios³ and Miguel Angel Santos⁴

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Venezuela is at a breaking point. The political, economic, financial, social and humanitarian crisis that has gripped the country is intensifying. This unsustainable situation raises several urgent questions: Which path will the embattled OPEC country take out of the current turmoil? What type of political transition lies ahead? What short-term and long-term impact will the crisis have on its ailing oil industry, economy and bond debt? What would be the best and most effective prescription for oil and economic recovery under a new governance regime? To discuss these matters, the Center on Global Energy Policy brought together on June 19, 2017 a group of about 45 experts, including oil industry executives, investment bankers, economists and political scientists from leading think tanks and universities, consultants, and multilateral organization representatives. This note provides some of the highlights from that roundtable discussion, which was held under the Chatham House rule.

Executive Summary

Venezuela's oil-reliant economy has been battered over the past three years, as ongoing production problems were magnified by the drop in oil prices that began in mid-2014. The country's acute financial crisis has spiraled into a full-blown humanitarian crisis marked by deteriorating public health, spreading malnutrition and contagious disease, skyrocketing crime. Hyperinflation has exacerbated the country's woes. Meanwhile, the government of Nicolas Maduro has refused to recognize the National Assembly elected in December 2015, in which opposition parties won a super-majority (two-thirds), and has called for the election of a new Constitutional Assembly on July 30, in a bid to revise the Constitution, undermine the legislative and judiciary powers and consolidate his grip on power.

The outlook for the Venezuelan oil industry and the broader economic and political challenges facing the country are intrinsically linked. The recovery of its oil sector is essential to getting the country on track, but the oil sector itself cannot recover without much delayed investments and a prior recovery in the underlying economic conditions, needed to restore investor confidence. To a great extent, Venezuela's economic and oil-related outlook depends on the outcome of Maduro's bid to rewrite the Constitution, yet no government, whether dictatorial or democratic, can hope to hold on to power without curing the country's economic woes.

The workshop sought to chart the possible political scenarios ahead of the July 30 constitutional election; assess the scope of the challenges facing the oil industry and identify possible remedies that could restore needed oil export revenues; and size up the various economic issues that plague the country and undermine investor confidence in its oil sector, and sketch elements of a prescription. This brief report summarizes some

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of the opinions expressed during the discussions, and does not necessarily reflect the views of its authors. Key takeaways include:

- There is no constitutional cure to the country's descent into economic chaos. Even if Maduro succeeded in convening a Constitutional Assembly and installed himself as absolute ruler, his inability to fix the economy would keep his hold onto power tenuous at best. A Maduro success on July 30 could set the stage for an internal coup later on.
- A transitional government would be best placed to bring the oil sector and the broader economy back on track but would need broad support to take on far-reaching reforms. On the plus side, so much belt-tightening (quite literally) has already occurred that an economic adjustment package cannot make things worse for the population: with the minimum wage down to \$1/day, the political costs of a package have already occurred, without the benefits. On the other hand, the wellspring of popularity that is likely to greet a transition government leader could weaken his or her resolve to pursue an agenda of economic reform, making it a false start.
- There is a long list of hurdles facing the country's oil industry, both sector-specific and more broadly connected to the country's structural woes. Those include, but are not limited to, endemic corruption, bloated payrolls, a dysfunctional foreign exchange regime, rampant crime and an overwhelming debt burden. Corruption-driven cost increases have done as much to undermine the oil sector as the oil price collapse. Most participants agreed that fixing these problems was a prerequisite to rekindling foreign oil investment and oil production growth.
- There was broad agreement among participants that the country's Hydrocarbon Law needed to be revised, but opinions diverged as to whether such a reform should be a top priority of a new government, or whether the current legislative framework was attractive enough to bring foreign investment and get the oil industry back on track.
- No matter how quickly Venezuela restarts its oil production, it cannot hope to rebuild its economy without debt restructuring. At current oil prices, the country cannot grow its oil export revenue fast enough to service its debt, resume needed imports and jump start the economy. Caracas will have to negotiate simultaneously with multiple types of lenders, including financial markets, bilateral lenders such as Russia and China, and International Financial Institutions (IFIs), one of the few sources left untapped by the Chavez-Maduro administrations. Beijing's willingness to take a haircut on its debt will be key to Venezuela's reconstruction, and will be a test of China's international leadership.
- Comprehensive structural reform is needed. This includes the full restoration of market mechanisms such as lifting price controls, re-establishing a unified and free-floating exchange rate, reprivatizing nationalized companies to raise cash and restore production capacity, and replacing indirect subsidies with direct assistance to vulnerable households. Only with a broad economic reform package, deep enough to rebuild international confidence, can foreign investment in the country's oil and gas sector be rekindled. The oil sector is essential to nurse the Venezuelan economy back to health, but will itself not recover without a broader restructuring.

Introduction

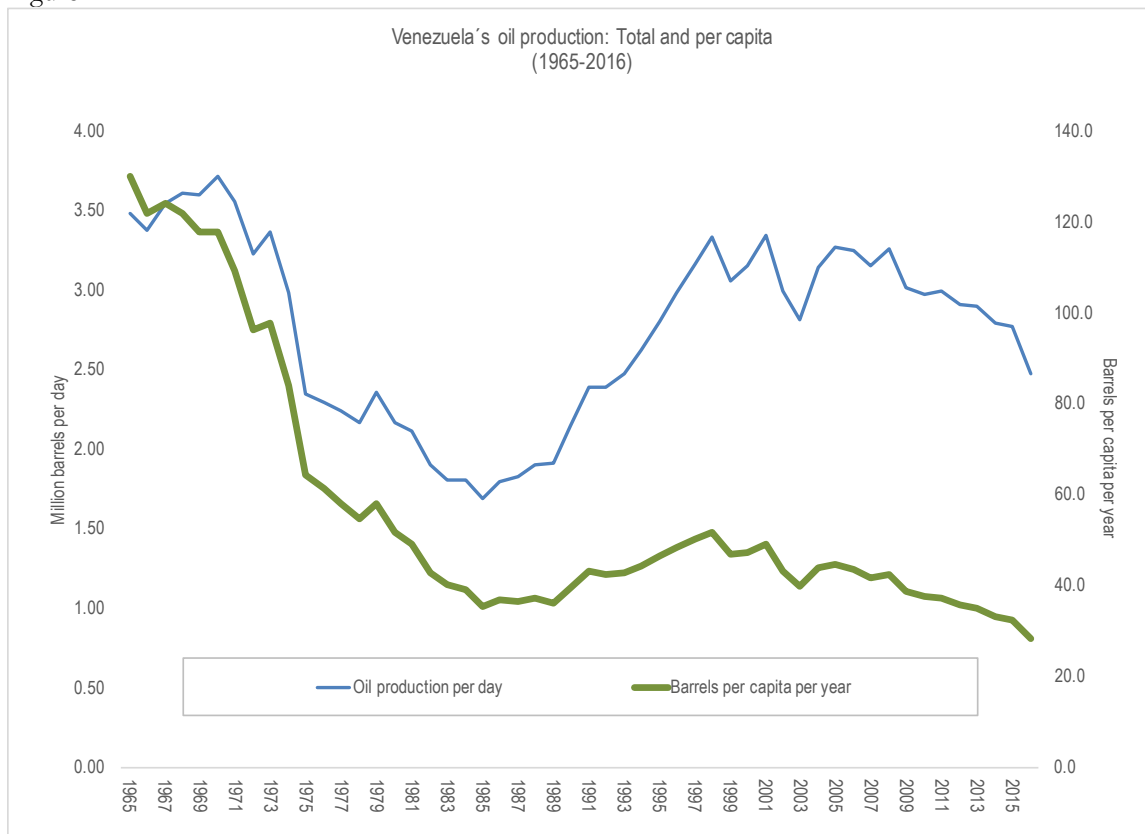
Venezuela's oil-reliant economy has been battered over the past three years, as ongoing production problems were magnified by the drop in oil prices that began in mid-2014. The economic pain became more severe in 2016, when export revenue fell to US \$27 billion, down 73% from US \$94 billion in 2012. Additionally, a



substantial amount of production is mortgaged and held up in the domestic market and debt payments, leaving only a fraction of its oil exports to generate revenue, which in turn is used to pay back the country's foreign debt. Imports of foods and manufactured goods have plummeted even as domestic production has been crippled by price controls. As a large chunk of the most important industries were expropriated throughout these years, there is no chance of having domestic production kick-in to substitute for those imports Venezuela can no longer afford.

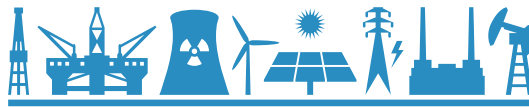
The country's acute financial crisis has spiraled into a full-blown humanitarian crisis marked by deteriorating public health, spreading malnutrition and contagious disease, skyrocketing crime. Hyperinflation has magnified the country's woes. Meanwhile, the government of Nicolas Maduro has refused to recognize the National Assembly elected in December 2015, in which opposition parties won a super-majority (two-thirds), and has called for the election of a new Constitutional Assembly on July 30, in a bid to revise the Constitution, undermine the legislative and judiciary powers and consolidate his grip on power.

Figure 1.



Source: PODE, PDVSA.

The outlook for the Venezuelan oil industry and the broader economic and political challenges facing the country are intrinsically linked together. Venezuela is trapped in a “catch-22:” the recovery of its oil sector is essential to getting the country on track, but the oil sector itself cannot recover without much delayed investments and a prior recovery in the underlying economic conditions, needed to restore investor confidence. The checklist of prerequisites to leverage the country's large oil and gas resources includes improving governance, strengthening the country's institutions, getting the fundamentals of the economy



right (such as a unified exchange rate and an end to the monetary financing of the fiscal deficit), taming runaway inflation and tackling down crime.

The workshop was divided into three interconnected parts: 1) a discussion of the political outlook ahead of the July 30 constitutional election; 2) an examination of the crisis in the oil sector and the prospect for recovery; and 3) a discussion of the broader economic outlook. Keynote remarks from an IOC industry practitioner with decades of experience in Venezuela, summarized below, kick started the debate.

The view from the trenches: perspective from an oil industry insider

In this insider's view, domestic politics and the oil industry are closely enmeshed in Venezuela as they are in most oil producing countries. Oil companies are used to dealing with the political aspirations and objectives of their host countries. In Venezuela, under the late President Hugo Chavez, the management of the oil sector was driven both by the domestic agenda of establishing "Bolivarian socialism" at home and by the use of the country's oil resources for foreign-policy purposes. But these political issues were counterbalanced by the size and quality of the country's resource endowment, and the reform of the Hydrocarbon Law undertaken by Chavez did not preclude foreign investment.

For this seasoned oil executive, the Hydrocarbon Law is not the main impediment to IOC engagement in the country's oil sector; therefore amending or repealing it should not be a top priority. Rather, what is holding back investment and causing oil production to plummet is a combination of endemic, entrenched corruption, gross inefficiencies, insecurity, hyperinflation and the challenge of multiple exchange rates. Fixing these issues is a *sine qua non* to bringing international oil companies (IOCs) and investment back in the country and rebuild investor confidence. It is up to Venezuela to fix its oil sector on its own, rather than count of foreign investment to get it back on track. Doing so cannot be accomplished overnight, however, and may take up to five years.

Just as the Hydrocarbon Law is not in and of itself a deterrent for industry, the daily hunger protests that are rocking the country do not necessarily amount to an ideological rejection of Chavismo per se. Media coverage of the Venezuelan crisis often casts it in overly political terms. The opposition leadership and international perceptions are focused on the ideological dimensions of the crisis; in fact the ideological battle is secondary.

For this industry insider, the best way to understand a country and operate effectively in it is to understand its objectives. The oil industry is a long-term business; executives are in for the long run and aim to ride the ups and downs of domestic politics. Managing political risk, understanding the political aspirations of the host country, is part of the course. Political risk is not in general the biggest challenge for IOCs; geological risk looms larger. Political stability and low resources form a riskier combination for an IOC than high resources and political instability. In Venezuela the resource risk is nil. The country's reserve-to-production rate is among the highest in the world, with over 300 billion barrels of reserves.

From Chavez to Maduro

Whereas political scientists and economists tend to see Chavismo as the root cause of the country's problems, from an industry perspective there is a big difference between Chavez and Maduro. Compared to the former, who was elected with a large majority, enjoyed genuine popularity and was a skilled communicator, the latter is ineffective and lacks real support.

Chavez's goal was to cater to his support base by controlling and redistributing oil revenues. This entailed undoing the oil reforms of the mid-1990s, the *apertura*, which saw Venezuela open up its oil industry to foreign investment and raise vast amounts of capital in the process. Chavez's main oil-policy target was to



seize control of the oil rent and divert it to para-fiscal entities that escaped public scrutiny. These vehicles were used to fund a vast revenue redistribution scheme, create a “Bolivarian socialist” system, reassert his political stance and even influence the politics from other countries (mostly Latin Americans, but also included financing to minded-like parties in Spain, Greece, and Belarus, to name a few).

Under Chavez’s leadership, Chavismo achieved quasi-full control of the oil sector. The problem is that owning the industry does not bestow on the owner the capacity to run it effectively.

Chavez’s self-appointed successor, President Nicolas Maduro, does not have his credibility nor as much support from the lower classes, and lacks his communications skills. Corruption and inefficiencies plague the oil industry. PdVSA is terribly managed. Its revenue is down but endemic corruption across the supply chain is increasing costs, which have risen to \$25 billion in 2015 from \$6 billion in 2006. The current regime lacks the financial capacity to move country forward, or to operationally and structurally fix PdVSA.

The Path to Recovery

Understanding how to work with Chavez was very important to IOCs in Venezuela and to their ability to operate. New contract terms promulgated under Chavez are not what holds investment back, and are in fact more advantageous to IOCs than those offered by some other countries. The margin on barrels in Venezuela is competitive for investment at current prices. Changing the hydrocarbon law should not be the first priority to kick-start much needed investment in the Venezuelan oil sector and allow oil revenues to recover from their current collapse.

The real difficulties are different in nature and have to do with logistics, human resources, the challenge of dealing with a multiple exchange rate that ranges from 600 to 8000 bolivars to the dollar, and hyperinflation. There is limited HR capacity in place under the current circumstances: infrastructure, local labor is critical; workers need to be fed and transported safely. Security continues to be a major issue.

Major oil-service companies like Halliburton and Schlumberger don’t actually sign contracts with PdVSA, but rather with its foreign partners: they do it for transparency purposes. Chavez essentially created a system where there are no avenues to create a competitive price environment. We all know where the oil is; it’s just a question of when there will be a better level of credibility. This cannot be fixed quickly.

PdVSA needs a plan if there is a political change. The country is highly leveraged: Production is about 2.2 million bpd, debt repayment exports to China and Russia about 0.5-0.6 million bpd, the domestic market about 0.5 million bpd, subsidized exports about 0.1 million bpd, other loans 0.1-0.2 million bpd, and the imports about 0.2 million bpd. As a result, the net cash flow generating exports are only 0.6- 0.8 million bpd. Inefficiencies built into system will continue to hold the country back; investors will not step in until they see changes taking place. Yet Venezuela is still a country where you can make it work: the cost of finding oil is zero, the costs of developing and operating are actually low; these are metrics that investors must understand too.

The first thing that needs to be done to fix economy is to restructure PdVSA debt, including that with China. The country’s total interest-bearing debt is about \$120 billion. China’s openness to debt restructuring is a wild card but Beijing must understand that it is in its own interest to agree to take a haircut, as there is no other way to get Venezuela back on its feet and nurse its oil industry back to health. The worse thing would be to infuse fresh capital in the country without first fixing its problems. More than new capital, Venezuela needs to fix its source of revenue – the oil sector – and restructure its debt. Only these steps can help rebuild confidence with investors, a process that could represent a five-year cycle.



THE DEBATE

Politics: a fork in the road?

Following these keynote remarks, the discussion focused on the political outlook in the run-up to the July 30 Constitutional Assembly vote. Venezuela appears to be at a political crossroads. Pressure is building both domestically, from the street, and internationally, from the diplomatic community. Daily protests have been occurring not just in the capital Caracas but across the country, including former pro-government strongholds. Repression by security forces and paramilitary groups known as *collectivos* has caused dozens of fatalities. The government cannot take the loyalty of the armed forces and police for granted, however, as those groups are not exempt from the hardships, salary delays and deprivation that plague the country as a whole. Against the background of an economic and social crisis of unprecedented proportions, even Chavismo is showing signs of fracturing.

At the moment, four scenarios seem possible: Maduro holds on to power; the current situation lingers on and the country gradually descends into low-intensity civil conflict; Maduro is removed and replaced internally; a coalition of opposition parties takes over and installs a transition government.

Participants debated the extent to which the outcome of the Constitutional Assembly may or may not seal the country's fate. At first glance, Maduro's bid for absolute, unlimited power would seem to be a game changer for the country if it succeeded, to open a new chapter in its history. Yet the country's economic woes are so severe that rewriting the Constitution alone would do little to secure the current regime. As contrasted as the scenarios may appear, under all of them political instability remains considerable.

Even if he holds on to political power, Maduro will still have to show some ability to govern and stabilize the economy. A Maduro victory on July 30 would only buy him time and would not solve the underlying economic crisis. The probability of a change of leadership within Chavismo might actually increase.

The opposition stands a better chance of leading a political transition if it manages to derail the Constitutional Assembly election. Once Maduro steps down or is forcibly removed, however, a broad political base and a wide coalition will be needed to push for economic reforms. These include, but are clearly not limited to, restructuring the country's debt and renegotiating terms with China, and a cleanup of the foreign exchange mess. These "big three" issues already are generating considerable internal conflict within Chavismo.

While economic adjustment packages frequently promote austerity measures that lead to economic benefits, but that can initially meet with resistance from the population, Venezuela offers a unique case. Most of the political costs of an economic adjustment package have in fact already occurred – as has, indeed, most of the adjustment itself – but without any of its benefits. Imports have dropped to a trickle. The minimum wage was brought down to the equivalent of \$1/day in real terms including the food bonus (\$12/month without it). Private consumption has plummeted. Such a draconian adjustment inflicted on people without anything in return has made Maduro widely unpopular, but could ease the task of his successors as they seek to get the country back on track.

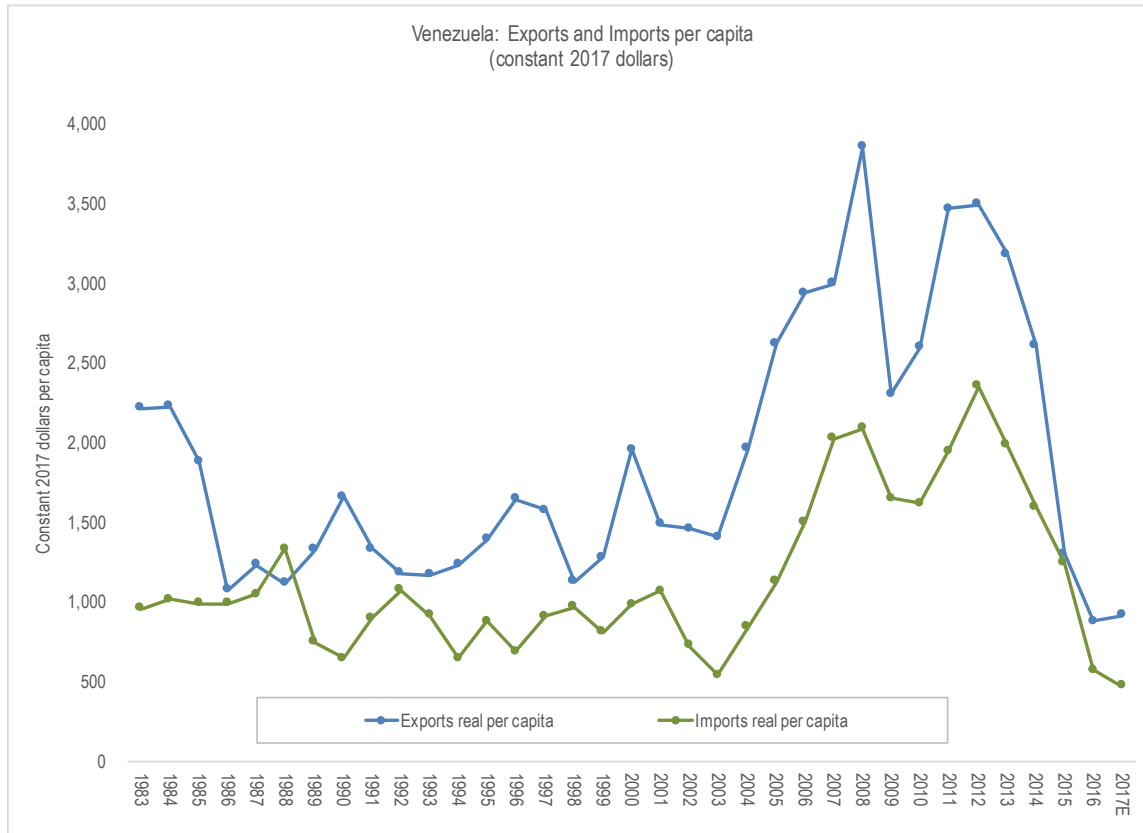
On the other hand, the wellspring of popularity that is likely to greet a transition government leader could weaken his or her resolve to pursue an agenda of economic reform making it a false start.

A transition government would, in any event, be in a much better position to set the oil sector and the rest of the economy on the path to recovery. So far, the opposition has understandably focused on political demands, including the recognition of the National Assembly elected in December 2015; the liberation of all political prisoners; the creation of a "humanitarian channel;" the organization of a presidential election and the cancellation of the Constitutional Assembly. A detailed economic platform has yet to be agreed. There



seems to be a fair degree of consensus among opposition forces about the need to deal with inflation and to fix the foreign exchange regime, less so on the question of debt restructuring and the potential role of the IMF.

Figure 2.



Source: Central Bank 1983-2015; estimates for 2016 and 2017 constructed by Miguel Angel Santos using data from Venezuela’s main trading partners.

Getting the oil sector back on track

The second part of the discussion focused on the oil sector. Despite being blessed with the world’s largest petroleum reserves, Venezuela’s oil industry has been hard hit by a combination of internal and external factors: the drop in oil prices since 2014 has compounded the effect of years of mismanagement, lack of maintenance and under-investment, and the vast underlying problems in the broader economy. Since January 2000, Venezuelan oil production has plummeted by more than 25%, going from 3 million barrels per day (bpd) in to an estimated 2.2 million bpd by May 2017, according to OPEC direct government communications. A large import cut and piling arrears with PdVSA contractors have accelerated the decline, with output collapsing by 18% in 2015-2016 alone.⁵ Oil exports, which comprise more than 90% of total exports and about 50% of fiscal revenues, held surprisingly well in volume until 2016 despite falling

⁵ OPEC *Monthly Oil Market Report*, OPEC crude oil production based on secondary sources, June 2017.



production, due to a collapse in domestic demand induced by a massive recession. Since then, the drop in both production and prices accelerated. A substantial amount of production is mortgaged and held up in the domestic market and debt payments, leaving only a fraction of its oil exports to generate revenue, which in turn is used to pay back the country's foreign debt.

The poor quality of official data obscures the scope of the damage inflicted on the oil industry. Statistics on production, internal consumption and exports are routinely delayed and vary considerably from secondary estimates. State oil company Petroleos de Venezuela's (PdVSA) only releases financial statements on a consolidated basis that do not allow for a proper assessment of its finances.

Given Venezuela's dependence on the oil sector, rekindling oil production growth is key to rebuilding its economy, but may not happen overnight. Participants differed as to whether "first aid" to the ailing oil sector should come from within or from without. Should Venezuela's first priority be attracting foreign investment and bringing back international oil companies (IOCs), and under what conditions? Or should the focus be fixing national oil company Petroleos de Venezuela (PDVSA), reducing inefficiencies and addressing the underlying economic problems that are undermining investor confidence.

Should reforming the Hydrocarbon Law be priority?

Two key areas of disagreement emerged in the discussion: the issue of the Hydrocarbon Law and that of PdVSA's debt. Most experts agreed that the Hydrocarbon Law passed by Chavez in 2001 needed to be amended to draw investment, but differed as to whether a broad-based reform – which could be a potentially divisive issue – was a top priority. Some industry insiders and academics at the roundtable felt that investment terms under the current legislative framework were attractive enough to bring substantial foreign investment and allow for rapid supply gains, but cautioned that investment inflows would not occur unless key underlying economic concerns were properly addressed. Others thought that the current law was a fundamental impediment to IOC participation and that the sector's reform ought to be fast-tracked to attract sufficient foreign investment.

The 2001 Hydrocarbon Law introduced two significant sets of changes to previous legislation: it reinforced state control over the oil sector by mandating that national oil company PdVSA own a 51% minimum majority stake of all exploration and production projects, and made oil resources the ownership of the State (Articles 3 and 9). At the same time, it also created the institution of so-called 'Mixed Companies,' i.e. joint ventures between PdVSA and private operators (Article 22).

One industry participant felt that Chavez's law was actually more advantageous to IOCs than the previous one because it recognizes their role as partners. He argued that the Law does not need modification, and that what is keeping FDI away is not the Law, but rather the uncertainty of Venezuela's outlook and its macro-economic woes.

Others disagreed, and pointed to reforms in Mexico and Brazil as evidence that legal reform is a prerequisite for new investment. Reform advocates argued that the +51% ownership clause was detrimental to production because PdVSA often lacks the financial capability to fund project development. Others countered that it is common practice for private partners to function as de facto operators and extend financial loans to PdVSA to help cover its share of financing and get projects off the ground while complying with the Law.

Most of the discussion about changing the law had to do with the time needed to make and implement legislative changes rather than with the desirability of making the Venezuelan hydrocarbon law more



attractive. Some felt that the current law provides an acceptable starting point and that working within this framework might save a new government precious time to start attracting foreign investment from day one.

PdVSA's debt burden

The question of PdVSA's debt emerged as another focus of disagreement. Debt relief was seen as critical not only to let PdVSA keep more of its earnings for reinvestment, but simply because the company is collapsing under the weight of its debt. As noted, of the country's estimated 2.2 million bpd production, only 600,000-800,000 bpd is revenue generating and is being monetized by PdVSA. About 500,000 bpd still goes to massively subsidized local consumption, down from 800,000 bpd a few years ago. Most participants agreed that PdVSA was headed for bankruptcy, perhaps as soon as October or November 2017, but differed as to whether filing for Chapter 11 protection in the US was an option. One of the speakers emphasized the high hurdles and challenges of Chapter 11: a US judge would have to be allowed to take over a case that would normally fall under Venezuelan jurisdiction; some bondholders may take a litigious approach to bankruptcy talks; last but not least, it would be politically difficult for a Venezuelan leader to justify putting PdVSA in the hands of a US judge. Hence a wide gap between theoretical economic options for PdVSA and the political reality of the country.

A PdVSA default would carry high contagion risks and send ripple effects in the Caribbean and along the company's supply chain. It could cost PdVSA its US refining arm, Citgo, which was put up as collateral for a bond-exchange in October last year (50% + one share) and a Rosneft loan. Citgo imports about 200,000 bpd of heavy Venezuelan crude. The loss of that outlet would leave PdVSA scrambling to find alternate markets and would likely force it to concede punishingly deep discounts. PdVSA's heavy oil is unfit for its own domestic refineries. Other Venezuelan creditors, notably Crystallex and Gold Reserve, are also trying to get a hold of Citgo assets. Citgo is a prime example of the situation facing Venezuela and its multiple creditors: too few assets for far too many claims.

Venezuela would suffer deeply if its ability to import light crude were impeded. The country needs imported light crude or light products as diluent to market its heavy oil output.

Changing PdVSA's flawed management

Industry insiders argued that the real problems facing PdVSA was the country's unstable economic situation and the company's poor management, depleted labor force despite bloated payrolls and corruption problem. Corruption came up like a leitmotiv in the discussion and was described as a "cancer" eating PdVSA. Corruption is disproportionately inflating costs as multiple intermediaries take their cuts of projects and cause massive inefficiencies.

PdVSA's payroll is also loaded with 140,000 employees to produce less than 2.5 million bpd, a number that should be closer to 40,000. At the same time, its skilled personnel are grossly underpaid: the average salary of a PdVSA engineer is \$100 per/month. PdVSA's management, rather than the Law, needs to change. Eradicating corruption and trimming PdVSA's inflated payroll was seen as essential to kick-start the sector's recovery.

As Venezuela production declined in recent years, so has the quality of its oil.

PdVSA's own operated output is about a third of what it was at its peak. Close to two thirds of Venezuela's production today is of heavy and extra-heavy grades, which trade at a deep discount to lighter grades and require diluents to be brought to market. Conventional production has collapsed. Year-to-date, total oil production declines average around 90,000 bpd. The plunge in conventional output has turned Venezuela into an importer of diluent such as light crude oil, condensate or naphtha, which PdVSA uses to blend with



heavy oil at a great cost in foreign currency. Rekindling conventional production is thus imperative, if only to substitute for imports and get heavy oil to market more economically.

Reinventing the oil sector

Beyond short-term needs, a restructuring of the oil sector must mitigate longer-term resource-curse risks. Reconstructing the oil sector must also aim at more than a return to the status quo ante. Discussions about the future of Venezuela and the role of its oil sector are often tinted with nostalgia: it is all about bringing oil production back up to previous levels, restoring the sector and PdVSA to their past glory. Venezuela also ought to tap new opportunities in the natural gas sector. The country sits on vast – and largely undeveloped – natural gas resources. Natural gas is poised to play a larger role in the global fuel mix as world LNG capacity rises and helps gas trade globalize. Venezuela’s endowment in this area is an asset that ought to be developed.

Setting aside aboveground challenges, Venezuela’s geology remains a formidable asset. Although much of its crude however is heavy and sour, even at current prices most of its production is commercially viable. One positive legacy of Chavez – and also one that potential members of Maduro’s fraudulent Constitutional Assembly have offered to reverse – is that he allowed for equity stakes by private-sector companies in most major oil projects. Even within the current regulatory framework, there is room for IOCs to play a role in the recovery. In the medium term, though, most participants agreed that major institutional reforms would be needed to bolster the country’s credibility.

Underlying challenges

While some of the challenges facing the oil industry are sector-specific or unique to PdVSA, in many ways the oil sector’s most daunting obstacles are just part of a broader set of challenges facing the economy as a whole. Structural economic reform is as important to boost short-term oil production as oil-sector reform, if not more so. One of the broader problems undermining the oil sector is that of the foreign exchange rate, as the current multiple exchange rates make it extraordinarily difficult for companies to manage their costs and operate. These issues are discussed in more detail in the next section.

In the absence of a transition, the oil sector looks set for a continued downward spiral, due both to the prospects of a default by PdVSA and to the risks of international sanctions. Either one of these developments, some participants felt, could be the straw that breaks PdVSA’s back and set oil production on an even more precipitous downward path.

Time horizons and expectations

In a transition scenario, how fast could Venezuela turn around? Participants were of two minds. On the one hand, there are obvious measures that could help kick start production quickly, proverbial low-hanging fruits with a quick payoff. On the other hand, the country’s problems are deep-seated and it is going to take long for things to turn around in Venezuela. Some felt that it would take at least five years in a best-case scenario to rebuild investor confidence in the country. Others felt that oil production declines could be arrested sooner and that under the right conditions supply could even rebound relatively fast.

A look at the history of Latin American oil liberalization provides some perspective. Both Brazil and Venezuela carried out liberalization programs in the past that successfully delivered substantial production gains in the first two years. Venezuela’s own experience with *apertura* in the mid-1990s was impressive, unlocking 700,000 bpd of production over five years (1994-1998), most of it PdVSA-operated. In contrast, Mexico is entering year 3 and its oil production decline has yet to stabilize. The difference between these cases is the financial and operational performance of the national oil companies prior to liberalization. Both



Brazil's Petroleiros Brasileiros (Petrobras) and PdVSA managed to raise their production before the oil-sector opening in the 1990s. Private investment only helped accelerate a process that was already underway. For these reasons, opening the oil sector in Venezuela today may not deliver production growth as quickly as during the *apertura*, one discussant thought.

Pathways to economic reconstruction

Discussions of the oil sector naturally led to the broader economic challenges. The prolonged economic and social crisis facing Venezuela is of unprecedented proportions for a peacetime economy. Despite the fact that Beijing granted the Maduro regime a two-year grace period (2016-2017) over the Chinese debt, the cut in imports needed to accommodate debt service has been draconian. By 2016, real imports per capita had fallen by 74% from 2012 levels. Data from commercial partners indicate that total imports have fallen by 29% over January-April 2017 compared to the same period last year.

As most of the industrial apparatus was expropriated, occupied, or crippled by a myriad of administrative controls in the years since Chavez first took office, Venezuela cannot substitute domestic production for the imports it can no longer afford.

At the same time, given that over the past decade the country has come to rely increasingly on non-tradable goods which are highly dependent on imports (banking, insurance, transportation, construction and retail), the fall in imports has brought down GDP like dominoes.

The large import cut was implemented administratively, rather than through market mechanisms. That implies that the few dollars Venezuela has left for imports have been inefficiently allocated by the Central Government. That, coupled with the fact that Venezuela lacks the means to substitute the imports it can no longer afford with domestic production, has drained food and medicine inventories, triggering a full-blown humanitarian crisis.

Maduro has placed bond repayment obligations above all else, a fact that besides the large import cut has resulted in massive arrears and effectively suspended trade credit.

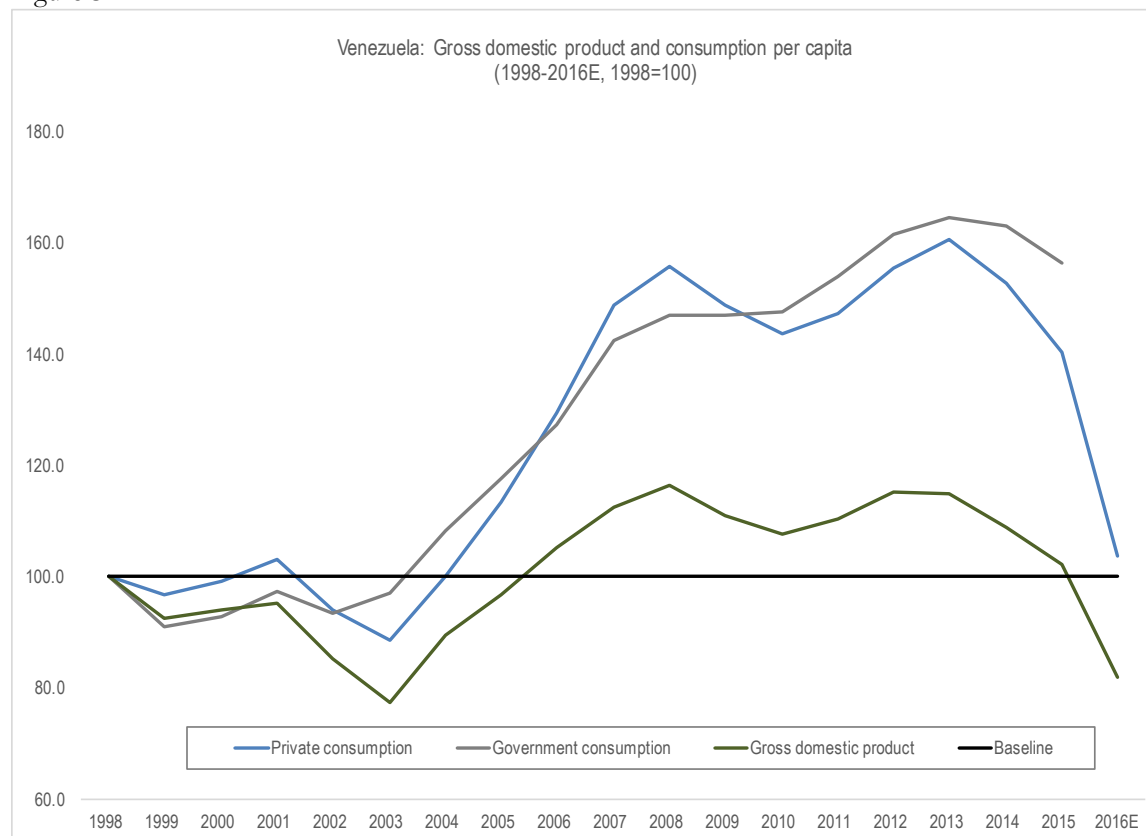
This situation is clearly unsustainable. The Venezuelan government had been running double-digit fiscal deficit for seven consecutive years. Before 2015, that fiscal deficit was not mirrored in the current account, but rather in the net accumulation of public and private assets abroad. That changed in 2015, when a \$20 billion current-account deficit was offset by a massive sell-off of foreign public assets. If Venezuela keeps importing \$16 billion per year, it will be poorer every year going forward – a “death spiral.”

In the words of one of the participants, the crisis must be undone in reverse sequence. Ramping up imports is indispensable to address the humanitarian crisis and restart economic growth. Inventories need to be restocked. Raw-material imports must resume to make the most of what is left of the country's industrial structure. Import requirements must be assessed to size up the needed trade deficit, address issues of policy design and figure out what a recovery program might look like. Some participants estimated the level of imports needed to jumpstart the economy at \$34 billion, including around \$8 billion for oil imports and \$26 billion for non-oil imports.

To help pay for those, oil revenues, hard hit by production declines and the oil price drop, must increase. Given the oil industry's woes and continued low oil prices, however, oil exports will not immediately offset expenditures. Hence the need for debt restructuring. There is just no way Caracas can continue to service current debt levels.



Figure 3.



Source: Central Bank 1998-2015; Reuters and estimates by Miguel Angel Santos 2016.

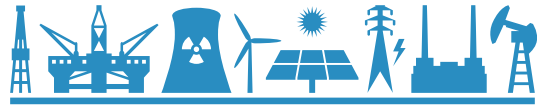
Revenue generation

Revenue generation must be restored by stimulating the oil sector and privatizing sectors of the economy that had been nationalized under Chavez.

A policy blueprint for the oil sector's recovery is key not just to bring in needed oil revenues, but also to successfully restructure the debt. In addition, Venezuela must undo Chavez-era nationalizations and reprivatize the many assets put into the public sector under him.

Reviving the oil sector is easier said than done. For some of the participants, the Chavez and Maduro administrations have wrought long-lasting damage on the oil sector. It takes much longer to rebuild managerial capacity than to wreck it. Part of the strategy must include a plan to free investment in the oil sector. The oil industry and PdVSA can no longer be seen as synonymous.

Absent a major price recovery, Venezuela cannot generate the trade surpluses needed to service its debt within a reasonable time frame. At best, oil production can be expected to increase by 100,000 bpd-200,000 bpd per year. At current prices, a 100,000 bpd increase in oil exports would only yield \$1 billion-\$2 billion of additional annualized revenue, whereas a \$10/barrel increase in the oil price would lift revenue by \$7 billion. At these level of oil prices, the country thus cannot hope to export its way out its current crisis without substantial international financing.



Debt restructuring

The country's total interest-bearing debt is about \$120 billion. Before debt payments, Venezuela's import requirements would leave it in the red by an estimated \$14 billion-\$15 billion. In the event of a transition, participants estimated that the country would need to refinance a total gap of \$50 billion over the first three years of a stabilization program. This financing could come from bilateral, multilateral or market sources. Venezuela should pursue all three channels and negotiate on multiple fronts, including multilateral organizations, bilateral lenders such as Russia and China and financial markets, with special emphasis in the latter case on reducing the impact of litigation risks. PdVSA debt must also be restructured, including with China.

1) Multilateral organizations

One of the few financing sources that the Chavez-Maduro regime has not depleted are IFIs such as the International Monetary Fund (IMF), World Bank, Inter-American Development Bank (IADB) and Development Bank of Latin America (CAF). Lack of fiscal transparency, unwillingness to comply with loan conditions, poor execution capacity as well as an ideological adversity to multilateral financing have left this financial source untapped. Under current circumstances, a stabilization program could be an effective way to recover consumption levels and help establish support for a new government.

IFIs, especially the IMF, would be unlikely to ship in money just to see it being turned over to bondholders. After the experience of Greece, where billions of euros were used to pay private debts, there will be no appetite to do something similar in Venezuela. Most likely, a debt restructuring will be required within the context of an IMF program, which some participants believed should contain a significant reduction in principal. The question then is to cope up with restructuring scheme that avoids chaos.

Caracas needs massive financial assistance, including not only loans from international financial institutions, but also a significant haircut on existing stock of debt. Either one of those steps will not by itself be enough to jump start the economy. Countries are allocated quotas at the International Monetary Fund (IMF) according to the size of their economy. Financial assistance is then usually presented as a multiple of this quota. The Venezuela IMF quota is \$5.2 billion. After the financial crisis of 2008-2009, Greece got a loan equivalent to 15 times its quota. The Greek economy was not in as bad a shape as Venezuela's, but then again Venezuela might not be as important to the world's economy as Greece was perceived to be (to Europe in particular) at the time. Most participants agreed that a more feasible program for Venezuela would be in the vicinity of 6-8 times quote (i.e. US\$30-40 billion). Given that size of package, Venezuela will need to restructure debt and introduce comprehensive reforms

A new government will also have to convince the IMF that it will steer the economy towards a "V" shaped recovery. Moving principal payments four years down the road would not ensure a V-shaped, but rather a "W-shaped" recovery that will keep the country's GDP and income levels stuck years into the program. Achieving a significant reduction in the net present value of claims, whether by outright haircuts or exchange for lower interest rate bonds, is an essential component of a policy package aimed at producing a sustainable recovery with a steady debt-to-GDP ratio.

2) Bilateral deals

Flexibility will be required from bilateral creditors, including the Chinese government. China will likely be a key partner in the Venezuelan recovery. At present, Venezuela's debt with China is around US\$26 billion, to be paid in oil over five years. That debt will need to be restructured over longer periods at lower interest rates.



The package of transactions today comprised under the Joint Fund China-Venezuela (JFCV) will have to be unbundled. Venezuela will continue exporting oil to, and importing goods from, China; Chinese investments in Venezuela will be fostered and protected; and Venezuela will be happy to receive loans from the Chinese Development Bank to fund projects at lower-than-market rates. All these transactions will be carried separately by the corresponding entities and – unlike previous JFCV transactions – will pass the scrutiny of the National Assembly and be subject to the process of accountability dictated by Venezuelan laws.

3) Financial markets

Some participants believed that the way Venezuela conducts debt restructuring will be key to ensure that bond markets remains a future source of financing.

Venezuela is unlikely to attract large amounts of foreign direct investment (FDI) over the first years of the reform program. At the same time, issuing debt at rates higher than the expected growth rate will only accelerate the deterioration of the debt-to-GDP ratio (which will start the program in the surroundings of 150%). That is why some participants believed that a significant reduction in principal is required. That reduction, in turn, will make Venezuela a more attractive country to FDI and will reduce the perceived risk of further debt issuances.

For a decade, the Venezuelan debt has been working as a sort of Ponzi scheme, where successive rounds of investors are promised increasingly higher interest rates to help make payment on the previous rounds. Most of the Venezuelan foreign debt was issued in domestic currency and placed at large discounts. The coupon rates range from 6% to 12%. In November last year, a debt-exchange was proposed at an implicit rate of 21% in dollars. Earlier this year, Venezuela sold PDVSA bonds that were at the Central Bank balance at an implicit rate of 48%. In a bubble-like dynamic, the more unsustainable the Venezuelan debt seems to be, the higher the return offered so that investors decide to participate in equilibrium. There is a limit to that, however, and the 48% implicit in the Goldman Sachs bond deal may have tested it.

The question of how to deal with disgruntled bondholders that would not participate in a future debt restructuring emerged as an area of debate among participants. Venezuela needs a program where the overwhelming majority of bondholders agree to restructure. Some participants argued that Venezuela could face litigation risk from “holdouts” on any debt restructuring. Concerns about the inevitability of litigation should not be grounds to compromise the end result, hence the need to contain those holdout creditors and insulate oil sales. To that end, any restructuring would have to proceed under the clear assumption that PdVSA is an “alter ego” of the Venezuelan government in the lingo of US courts.

Structural reforms

Comprehensive structural reform is needed, including the full restoration of market mechanisms, such as lifting price controls on goods and services, unifying and letting float the foreign exchange rate, lifting interest-rate controls, and replacing existing indirect subsidies (for goods and services) with direct ones (cash transfers to vulnerable families).

Changes will have to affect all parts of the budget. Minor changes will not solve the problem. PdVSA needs to restructure its own organization as a first step (in particular staff the company with capable managers, eradicate corruption, and find a way out of the large payroll excess).

A major source of price distortions in Venezuela lies in the massive indirect subsidies through imports, including electricity and gasoline. One option would be to replace these with direct subsidies, as these are actually quite regressive: the rich consume more gasoline than the poor. A substitution of indirect subsidies



for direct ones will allow vulnerable families to cope with the crisis from the very outset, while at the same time allowing the price mechanism to function.

Another key element of the policy package is the recapitalization of the banking sector. For many years, the banks got the capital they needed to grow their assets from retained earnings. The moment that banks stopped making enough earnings, they stopped the expansion of the credit portfolio, as they were reluctant to provide fresh capital. As a consequence, the credit portfolio of banks shrunk significantly amidst the large recession, and at the parallel market rate today it represents roughly \$1 billion. Within the context of a policy reform, banks will have to recover their role as intermediaries of money, terms and risks across the economy, and for that large injections of capital will be needed. If the banks are reluctant to supply capital, then the state can provide a lifeline and reserve the right to sell their participation to foreign investors. As such, the banking sector might well be one of the immediate receptors of FDI in Venezuela.

Unifying Exchange Rates

The difference between official exchange rates, and between those and black market rates, discourages FDI, and makes it hard for international companies to transact. The collapse in output has to do with a very ineffective allocation of imports, the need to unify the foreign exchange rate and restore market mechanisms in order to liberalize prices. In order to credibly unify the exchange rate and let it float, the more reserves you have the better.

Given the expansive nature of the program, and the fact that it will take time for fiscal revenues to recover and expenditure consolidation to occur, Venezuela needs to find means of financing its fiscal deficit that rely gradually less on money creation. Some money creation will be needed as the demand for domestic currency – today at minimum levels – is restored. That should set the ceiling for money creation and puts a clear limit to the monetary financing that can be carried over the first years of the program. Other than these, the new government shall seek for ways to finance the fiscal deficit that are consistent with the expected growth, inflation, and the recovery of money demand.

There was a consensus among participants that some form of control over capital transaction in foreign exchange will have to be in place. That should be done in a way that does not lead to dual exchange rates, distorted incentives, or increased supervision on imports. That can be achieved through a number of mechanisms.

Liberalizing Prices

Artificially set prices (food, gasoline, etc.) have collapsed the country's productive capacity and led to an inflammatory combination of scarcity and four-digit inflation. While the government has allowed for a de-facto liberalization of prices, the fact that the legal and administrative structure that was put up to penalize transgressors remain in place has made Venezuelans bear all the costs of price liberalization without any of its benefits. Importers and domestic producers fear using their own foreign assets to import goods, parts or raw materials, for fear of an arbitrary application of the legal instruments that remain in place. That, together with the decrease in domestic and foreign (imported) supply of goods, and the monetization of fiscal deficit, has led Venezuela to the brink of hyperinflation.

Yet despite the scope of Venezuela's challenges, many participants felt that with IMF support and debt restructuring, the country could bounce back and reverse its decline relatively quickly – albeit up to a point. Bringing income and consumption back to 2010-2012 levels would take longer.



Next Steps

The domestic political situation in Venezuela is extremely fluid. Even as Maduro seeks to consolidate his control and reach for absolute, unlimited power, the chances of “unscheduled change of governance” are dramatically on the rise. Keeping the pressure on the country, including international appeals to release political prisoners, recognize the democratically elected National Assembly and other steps, is of critical importance to help the country get back on track.

Amid looming prospects of leadership change, it is perhaps equally important to be ready for the “day after” with a set of actionable policies to rekindle economic growth and alleviate the current economic and humanitarian crisis. While the scope of the problems facing the country is clear, a consensus needs to be reached on what the top priorities and the proper sequencing of emergency measures by a transition government should look like.

In Venezuela itself, elected officials and politicians are actively debating these issues. Outside of the country, the Venezuelan academic and business diaspora is also intensifying its consultations. More generally, energy industry stakeholders have a keen interest in getting greater visibility on, and understanding of, the country’s travails, and in assisting with its recovery. Participants in the roundtable felt that it helped bring clarity on these complex issues. The discussion is not over, and will continue.