An Economic Framework for Venezuela's Debt Restructuring

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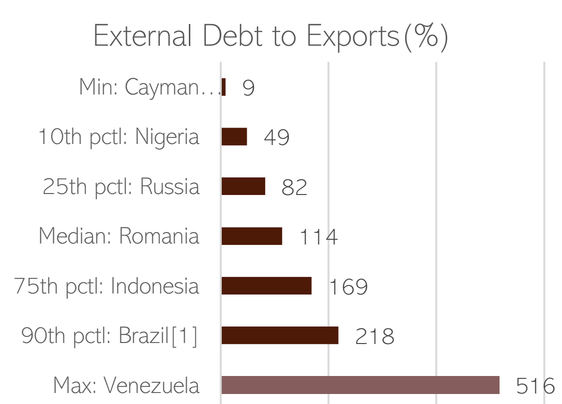
Under a new reform government, Venezuela will require exceptional access and financing from the IMF and other bilateral partners to cover upfront external funding needs during the first 4-5 years of reconstruction and adjustment. Funding needs before debt service are on the order of US$ 55bn over the next four years under current oil prices, and may grow as economic conditions and the oil industry deteriorate in 2019.

The restructuring will need to target large face value haircuts exceeding 70% and market value haircuts in excess of 85% for a broad universe of creditors. This is required for Venezuela's external debt and balance of payments framework to be credible, sustainable and resilient to shocks. Flow relief and maturity extensions without face value reductions are starkly insufficient for external sustainability.

Venezuela's humanitarian crisis and economic collapse likens episodes of state collapse or war, calling for extraordinary international financial assistance

1. Real GDP has fallen over 50%
2. Imports have fallen over 85%
3. Inflation is over 1,000,000% a year
4. Oil production has fallen 66%
5. Over 90% of the population is poor and over 2/3 report involuntary weight loss
6. Minimum wages have fallen below US$ 10/month
7. 3-5 million Venezuelans have left the country

Recovery prospects are hampered by an extremely large external debt that was contracted despite a trillion dollar oil bonanza thanks to the heterodox economic policies of the Chavez-Maduro era.

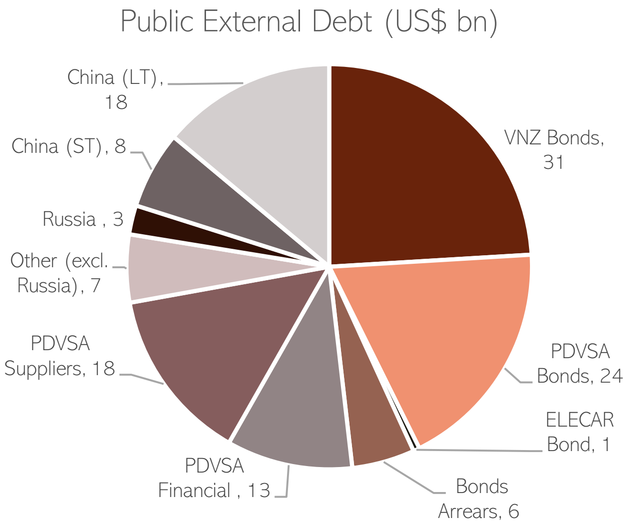


Source: Authors calculations, Moody's Statistical Handbook

Seven Myths About Venezuela's Debt Restructuring

1.) It's all about Venezuela and PDVSA's bonds

Venezuelan bonds are widely covered in the financial press, but the debt and associated arrears from PDVSA, ELECAR and Venezuela bonds is just $70bn out of $134bn of the public external debt (or 52%) not counting large ICSID liabilities and the backlog of claims on Venezuela's FX system. A restructuring that achieves debt relief from bonded debt but does not reduce PDVSA's financial debt, its debt to suppliers, and (if possible) bilateral debt to Russian and China is totally insufficient to make Venezuela solvent.



Source: Authors calculations, Bloomberg, BCV

2.) Odious debt is not on the table

Venezuela's next government will likely conduct a thorough audit of the outstanding external debt stock before beginning the restructuring process. If the issuance or terms of bilateral debts to Russia and China (or any other debts) are found to be illegal, odious debt arguments could be selectively invoked. For instance, congress or the courts could find that the sale of $3bn in PDVSA 2022 by the Central Bank in 2017 at a yield of 47% was illegal and that the bonds are therefore illegitimate.

3.) Venezuela is a standard EM market access country

Venezuela's collapse is profound. The economy and oil sector have crumbled, state capability and rule of law have been eroded and democratic institutions have been politically captured. Moving forward, Venezuela will need special treatment, including the use of precautionary debt thresholds as is the case for Low Income countries. Even under our "aggressive" restructuring scenario (where market and quasi-market debts are reduced by 70% with maturity extensions and reduced interest and non-market debts are also significantly reduced), debt to GDP remains above 40% and debt to exports remains above 100% by 2032.

4.) The restructuring will be quick and easy

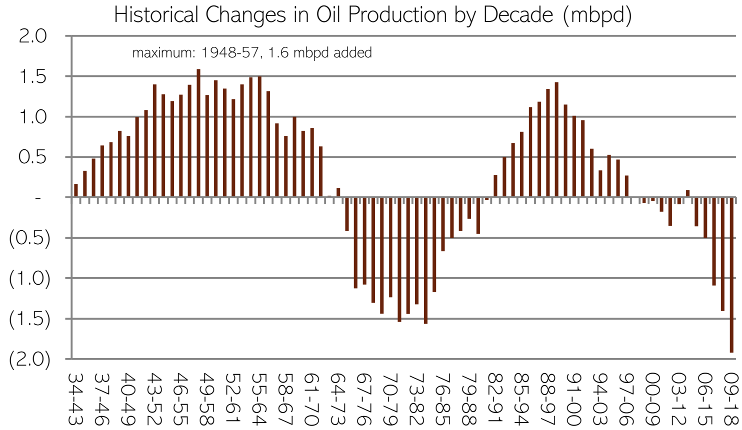
Venezuela's restructuring will be one of the most complex in history. Given the case's specifics and the fact that the average restructuring takes two and a half years to complete (with a high standard deviation of almost three years), the process could easily take five to ten years.

Complicating factors include:

1. Large debt stock and diversity of creditors and debt instruments
2. High risk of asset seizures and oil price uncertainty
3. Lack of legal restructuring provisions in PDVSA bond documentation
4. Debts owed to China (a large official creditor not in the Paris club)
5. The prospect that some debts will be considered odious

5.) The oil sector can be recovered rapidly with limited funds

In an ambitious investment scenario, it takes ten years and a cumulative capital investment of $115bn to raise production back to 3mbpd. About 30% of this total needs to be financed upfront, while the remaining 70% can funded by retained earnings. This 10-year recovery is faster than any other in Venezuela's history, including the 1948-1957 decade when production grew by 1.6mbpd (see right).



Source: Miguel Santos and Douglas Barrios (2017), PDVSA, Oil and Mining Ministry

6.) Venezuela's restructuring cannot overcome oil price volatility

Oil warrants are equity-like instruments that can help "immunize" Venezuela's restructuring from oil price volatility. Holders of these instruments are compensated in "good times" of high oil prices. These instruments have important downsides, but if well designed, they may be issued in exchange for larger face value haircuts such that both creditors and Venezuela are better off.

7.) Bondholders should expect high recovery values because Venezuela is rich

At current oil prices, face value haircuts exceeding 70% and market value haircuts in excess of 85% are required for Venezuela to recover oil production and economic output within a decade. Venezuela may have the largest oil reserves in the world, but it is insolvent. Available foreign exchange should go towards national reconstruction and servicing new multilateral loans, not paying off legacy creditors.

The Way Forward for a New Government: Sequenced Policy Recommendations

Preparatory phase (interim government in charge)

- Order a **national debt audit** and appoint a national debt committee in charge of defining the scope of the restructuring (incl. case of odious debts)
- **Engage negotiations with Chinese and Russian official creditors** to secure new financial commitments as well as credible intentions to restructure the terms of the loans
- Carry-on negotiations for the **rapid conclusion of an IMF financial assistance package**

Launch restructuring process

- Draft and pass **legal framework required to protect Venezuelan assets from seizures** from creditors
- **Resist pressures to enter discussions with bondholders** too early
- National debt committee to appoint and oversee **a task force with key representatives** (MoF, PDVSA, CB, BANDES, financial, legal, and PR advisors) **in charge of the debt restructuring negotiations**

Negotiation phase

- Encourage the **formation** of a **market creditors' committee** to engage negotiations
- **Sanctify the economic reconstruction path** to ensure that there is no trade-off between imports and debt service during the debt negotiations
- **Make Value Recovery Instruments (oil warrants) a central instrument to the debt restructuring strategy** to manage oil price uncertainty and avoid repeated balance of payment pressures in case of lower oil prices.

Closing

- **Potentially use coercive legal to achieve large debt relief** and limit holdouts risk (use of exit consent clauses as proposed by L. Buchheit)
- **Manage public opinion** regarding the restructuring. Assign a team to write talking points for politicians, speeches, Op-Eds, factsheets, organize mobilizations and protests, etc., to stay on top of the public narrative.
- Execute financial and legal closing of the restructuring