*June 6, 2016*

## The Tragedy of Venezuela

The decline in oil prices has been a major problem for oil-exporting nations. In general, the degree of disruption is mostly based on how well the country was run before oil prices plunged.

Venezuela has arguably been the worst run of the major oil producing countries. The late President Hugo Chavez built an economy that was distorted by subsidies, price freezes and an arcane tiered exchange rate system. His economic program only worked because of revenue generated by high oil prices. Once oil prices declined, the Chavez economic system began to unravel.

Conditions have deteriorated to a critical point where it seems unlikely that the country can continue on its current path. Barring an unexpected rally in oil prices, the economy appears to be on the brink of collapse.

In this report, we will explain how the distortions in the economy have led to the current crisis, discuss the future of President Madero and explore the possibility that Venezuela will become the first major oil producer to collapse and lead to an unexpected supply shock. As always, we will conclude with market ramifications.

**How Did We Get Here?**

Modern economics is partly based on the concept that price is a rationing mechanism. Alfred Marshall is generally credited with developing the ideas of marginal utility and marginal revenue and suggested that prices are set when consumers try to maximize utility and businesses try to maximize profit. In other words, the intersection of these two groups, working in a self-interested manner, leads to markets that clear, and at that point both sides have maximized their goals under the constraints provided by each party. Although these ideas didn't necessarily originate with Marshall, his clear expression of them has led economic historians to credit Marshall with the marginal revolution in economics. Simply put, price doesn't represent absolute value; it reflects the relative value derived from competing interests.

However, there was an earlier theory that was focused on value. Classical economists, such as Adam Smith, argued that the underlying value of something was based on the labor put into it. However, he acknowledged that the exchange value might be different than the labor value in the short run. An even earlier tradition comes from St. Thomas Aquinas, who developed the "just price" theory, which suggested that prices should be set in a manner that is "fair" to all participants.

For example, if there is a hurricane, demand for batteries rises sharply. According to Marshall, the rise in price reflects the change in demand and suppliers will have an incentive to boost production as the price rises. The rise in price is merely a signal. For Classical economists and Aquinas, the rise in battery prices is unfair, immoral and a form of "price gouging." In marginal analysis, prices have no moral impact; for value theorists, prices carry a moral import.

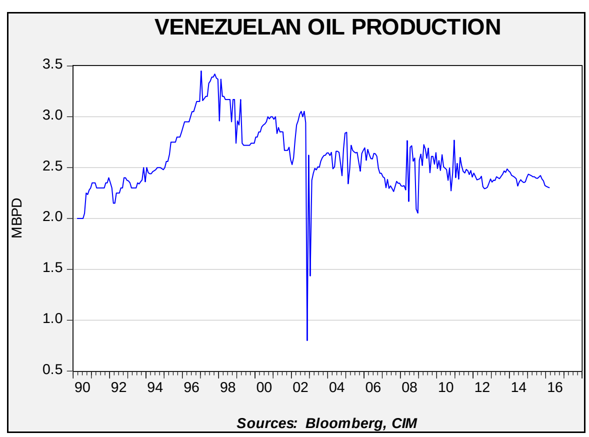
Although modern economics has mostly jettisoned the earlier theories and adopted Marshall's marginal concept, the earlier philosophies still have adherents. Marxist economics still rests on the labor theory of value and some religious thinkers harken back to Aquinas.

Perhaps the problem can be summed up in this way…what if governments, or powerful groups, conclude that they don't like the market-clearing price? One can still believe in Marshall's economics and not like market outcomes. The usual way to address "unfair" prices while still believing in modern microeconomics is to subsidize consumers of the unfairly priced product to give them the purchasing power required to buy the goods they desire. This method generally accepts that the market-clearing price is probably right and thus does not directly intervene in the price. Instead, it uses income support to improve the lot of disadvantaged or favored groups.

However, if one decides that prices should be "just" then the calculations are different. For example, if the price of a staple is "too high" then the producer should be forced to price the product at the just level. It appears that this method explains much of what has happened in the Venezuelan economy. The Venezuelan government set prices at a level too low to meet the marginal cost of business. Modern microeconomics predicts that setting a price below the market-clearing level will result in shortages and that is exactly what has occurred. As losses rose, firms started cutting production; these companies were accused of "hoarding" and, in many cases, were nationalized. According to the *Wall Street Journal*, over 1,200 companies have been taken over by the government.[1]

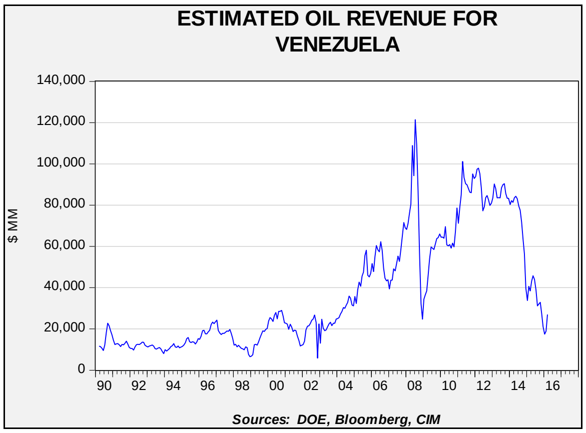
Exacerbating the problems of the Venezuelan economy is an old problem called the "Dutch disease." In the late 1950s, the Groningen natural gas field was discovered in the Netherlands. This discovery led to a massive increase in natural gas exports which led to a stronger currency. The stronger currency meant that domestic industry became less competitive, which resulted in rising imports. In addition, previously competitive export industries become less so due to the stronger currency, causing those sectors to contract. In the end, the country becomes dependent on foreign imports that it must pay for by selling a single commodity. All commodity exporters face this danger and Venezuela, in conjunction with its other policies, became increasingly dependent on oil revenues.

In the winter of 2002, workers at PDVSA, the state oil company, went on strike due to dissatisfaction with changes being made by President Chavez. Although production fell, Chavez prevailed and replaced most of the workers with loyalists.



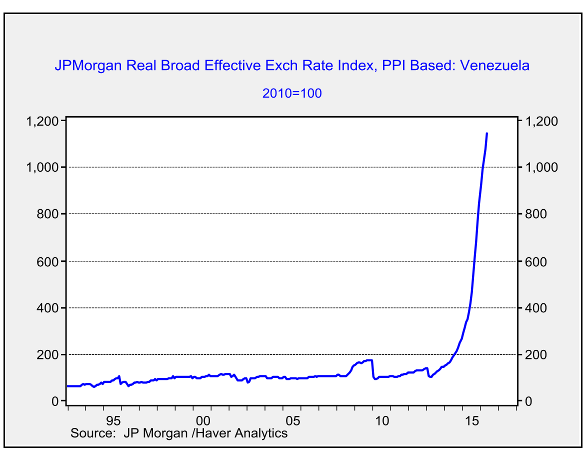

[1] http://www.wsj.com/articles/beer-becomes-the-latest-scarcity-in-a-venezuela-wracked-by-shortages-1461963129

Venezuelan oil production peaked at nearly 3.5 mbpd in the late 1990s. Since the strike, production has failed to recover to the pre-strike level of 3.0 mbpd. However, because oil prices rose, revenue from oil sales increased and funded the misallocation of resources caused by the government's price and redistribution policies.




This chart estimates Venezuela's oil revenue by taking production and multiplying it by the DOE's landed cost of Venezuelan crude oil. Although not a perfect estimate, it does show the catastrophic drop in revenue to levels not seen since early in the century.

Finally, the official exchange rate, at 10 bolivars to the dollar (VEF/USD), coupled with inflation estimated at 180% has led to a very strong currency.




The black market rate is quoted at 1,100 per USD, meaning that the opportunities for arbitrage are immense if one can import at the official rate.

**The Current Crisis**

Probably the best way to encapsulate the current crisis is with a list of current news items.

- The interference in the economy is stunning. Due to subsidies and price caps, the daily earnings from minimum wage can buy eight ounces of beef, one dozen eggs, 264 gallons of gasoline or 5,100 kilowatt hours of electricity (enough to power a small town). [2]

- Subsidies for gasoline and electricity are larger than the budget for education and health care combined.[3]

- Government offices are only open two days per week due to the lack of electricity, mostly because the drought has curtailed hydroelectric power. Schools are closed on Friday for the same reason.[4]

- Coca-Cola bottlers have stopped production of soft drinks due to the lack of sugar. Empresas Polar, a major brewer, has halted beer production because it's unable to import malt. LATAM, the largest Latin American airline, has suspended flights to

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[2] https://www.project-syndicate.org/commentary/heterodox-economics-venezuela-collapse-by-ricardo-hausmann-2016-05

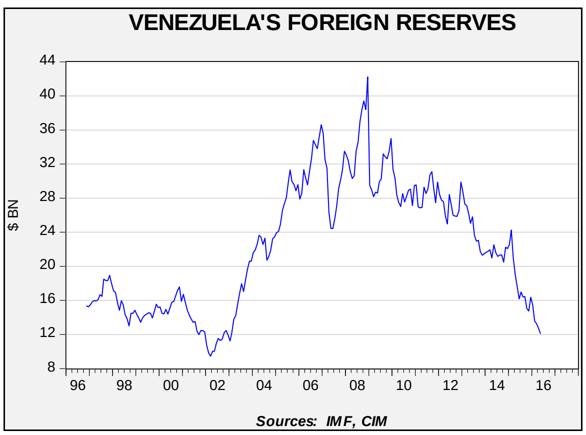
[3] ibid

[4] http://www.nytimes.com/2016/05/28/world/americas/venezuela-crisis-what-next.html?ref=topics

Venezuela, joining the German national airline, Lufthansa. [5]

- The country is facing about $7.0 bn of debt service this year, mostly in Q4. Although default is a possibility, the Maduro government will try to avoid this outcome because the country has assets in other parts of the world that might be seized. For example, PDVSA has ownership of refineries in Houston under the Citgo name. Although China has reportedly restructured some of its credit to Venezuela, we doubt this would be enough to give the Maduro government the necessary relief to avoid a debt problem later this year.

- To meet debt service needs and to import critical goods, Venezuela has been spending down its foreign reserves.




About 70% of the country's reserves are in gold. This makes it more difficult for the country to liquefy its reserves to pay bills. In general, in my experience as a country risk analyst, selling gold reserves is usually a sign that a nation is in desperate straits. That's because gold is harder to sell and the last item to go. However, in this case, given the unusually large level of Venezuela's gold reserves compared to its total reserves, selling gold may be unavoidable. [6]

- Lines for basic foodstuffs are lengthening in a manner similar to what was seen in the Soviet Union before the economy collapsed. There are reports that Venezuelans are lining up to buy things in state stores solely to sell on the black market. Bloomberg estimates that 25% of the population is engaged in black market activities. [7] According to the *Financial Times*, 96% of those polled in Venezuela put food scarcity as their principal problem. [8]

**What Now?**

The opposition, led by Henrique Capriles, is trying to use the legal system to oust President Maduro. His first ploy was to pass a law in the National Assembly that would shorten a president's term to four years from six years. The courts ruled that this law could not be applied retroactively, meaning that Maduro would stay regardless.

The second attempt at removal is impeachment. Although the opposition has the two-thirds majority required in the legislature to remove Maduro, the courts have denied three seats to the opposition due

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[5] http://abcnews.go.com/International/wireStory/latam-airlines-suspend-flights-venezuela-39486176

[6] Venezuela's gold reserves to total reserves are 66%, the fifth largest in the world. The largest percentage is the U.S. at 75%, but since every U.S. dollar is, in theory, also a foreign reserve, the lack of liquid foreign reserves in the U.S. is understandable. Venezuela is the only non-OECD member in the top 10.

[7] http://www.bloomberg.com/news/features/2016-05-13/venezuela-s-only-booming-business-buy-and-flip-at-1-000-markup

[8] *Financial Times*, May 28, 2016, page 4.

to voting irregularities. Without these three seats, the supermajority is lost.

The third method is to call for a referendum. The part of the government that certifies petitions has been slow to give Capriles the requirements for gathering signatures. If the administration can prevent a referendum vote until Jan. 10, 2017, even the removal of Maduro won't result in a new election. Instead, the sitting vice president would finish out his term, which runs into 2019.

If democratic means of removing Maduro fail, the odds of a violent removal increase. The most obvious way to remove the Venezuelan president would be the time-honored method in Latin America, the military coup. However, the military appears loyal to the president, if for no other reason than the fact that many of them are engaged in illegal activities that might lead to their arrest with a new government in power. A secondary issue is that it isn't obvious why the military would want to take control of the government. The austerity required to reverse the years of economic mismanagement will be unpopular. It does not appear the military has the incentive to wrest control of the government only to face civil unrest from fixing the problems caused by the Bolivarian Revolution.

Another option would be a foreign incursion. Although Maduro is constantly warning that the U.S. is poised to invade, there is no chance that the current administration, nor subsequent candidates, would even consider such a move. Nor is it likely that any other outside power would consider it. About the only way an outside military force would become involved in Venezuela would be if Maduro declared war on one of his neighbors. That possibility is remote as well.

Therefore, the most likely force that would remove Maduro is a civil conflict. Given the growing desperation of Venezuelans, it would not be unrealistic to see a devolution of the country, where anarchy rules and the central government loses control of parts of the country. Perhaps the closest analog would be the current situation in Libya.

**Ramifications**

The most obvious worry is that a breakdown of civil order in Venezuela could lead to a sharp reduction in its oil output. Normally, OPEC has enough excess capacity to smooth out such events. However, current Saudi oil policy is designed to maximize market share and thus, global excess capacity may be only around 2.0 mbpd. A complete loss of Venezuelan oil would tighten markets considerably. Of course, current commercial inventories are large and there are Strategic Reserves set aside for these type of events. Nevertheless, psychologically, fears of supply security would almost certainly lead to higher oil prices.

There is a scene in the movie *Forrest Gump* where his shrimp boat was out during a hurricane. When he returned to port, he found that his vessel was the only one still operating and, at least for a while, he enjoyed monopoly profits. The Saudi decision to capture market share has put tremendous pressure on oil exporters and the potential for one of them to face a domestic crisis is increasing. Obviously, for the nation that runs into trouble, Saudi policy is terrible. But, for the other producers who avoid the crisis, the rise in prices becomes a very positive event. To some extent, Saudi Arabia is banking on the idea that it and the kingdom's allies are less likely to be the first to face a crisis. It is looking increasingly likely that Venezuela will face a production decline.

Consequently, oil prices, related equities and the assets of other oil producers would all benefit from a crisis in Venezuela.

Obviously, Venezuelan assets are vulnerable to further declines in value.

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