showCASE
No. 43 | 11.09.2017

CASE – Centrum Analiz Społeczno-Ekonomicznych
CASE – Center for Social and Economic Research

Overview: In this week's edition of showCASE, our guest writer, Christopher Dembik of the Saxo Bank, looks at the role of Venezuela's national oil and gas company, PDVSA, and its impact on the country's financial situation.

Up Next On Venezuela's Front: PDVSA's Inevitable Default

By: *Christopher Dembik, Head of Macro Analysis, Saxo Bank*

Venezuela's default is only a matter of time, as by 2020 the country must repay 30% of the external debt due to expire in the next 23 years (based on Macrobond data). While debt servicing has been a government priority, a deteriorating domestic situation (triple-digit hyperinflation, shortages of food and other basic goods, and a political crisis between the government and the National Assembly – see showCASE No 39) makes it a daunting task.

Gas station in Caracas, Venezuela. *Source:* Reuters

In general, Venezuela can access liquidity in one of three main ways. The first option is to borrow directly from financial markets, which implies paying an increasingly prohibitive risk premium due to investor fear of sovereign default. The second approach is to borrow from another state, a possibility that Venezuela made use of extensively over the last few years; since 2009, through the Venezuelan-China fund, the country has borrowed at least USD 60 billion in order to pay foreign manufacturers and repay external debt. In return, Venezuela sold Chinese oil at a discounted price. However, with oil price plummeting and Venezuela's deteriorating political situation, Beijing decided to prudently reduce its exposure to Venezuela by cutting financial aid and reducing oil imports. As such, it is quite unlikely that Caracas will be able to count on China's help paying off its loans, increasing the probability of sovereign default in the medium term.

The final option involves the national oil company, PDVSA (Petróleos de Venezuela SA), the country's main source of income and key point of access to foreign currency. Over the past five years, PDVSA has accounted for virtually all (93%) of the country's foreign exchange earnings. The financial mechanism is quite simple: the company subsidiary Citgo Petroleum Corporation, the sixth largest refinery in the US, borrows cash in the US financial market and transfers it to PDVSA. A significant part of this money is then allocated to the Venezuelan government budget. As bonds are issued under US law, which offers a good level of protection for investors, borrowing rates are much more affordable than for bonds issued under Venezuelan law.

Until very recently, this approach has been the least costly way for the country to borrow. However, easy access to liquidity and foreign currency has been called into question by PDVSA's increasing financial difficulties. The problem dates back to 2003-2004, when then-president Hugo Chavez decided to transfer the majority of PDVSA's revenues to the government budget in order to finance Bolivarian missions (a series of social programs) rather than investing it to increase the company's productivity. This lack of investment did not have an immediate impact on PDVSA's financial situation as long as oil prices were above USD 100 per barrel. However, ever since oil prices started falling in mid-2014, the situation has changed drastically.

Thus far, in order not to cut off the Venezuelan's government financing flow, PDVSA has tried to maintain the appearance of sound finances, continuing to pay its bondholders cash on the barrelhead (which explains why 80% of these investors buy back bonds when they expire). However, PDVSA is running out of money. Already unable to pay the foreign oilfield service companies which it relies on, it has resorted to making extensive use of various financial instruments (credit notes and commercial papers) to settle outstanding bills. These instruments, while not very liquid and subject to a haircut, have two main immediate advantages: they buy PDVSA time (up to six years) and, should the worst case scenario come to pass, they give creditors a possibility of being reimbursed by confiscating PDVSA assets under international law.

In the short term, as well, PDVSA faces a challenging debt repayment schedule, needing to repay USD 3.5 billion mostly due in October and November despite having only an estimated USD $2 billion in cash on hand to service its debt, a shortfall of over a billion dollars. Nevertheless, a default is unlikely this year. Fighting a political crisis and defaulting at the same time could be too much to handle, and PDVSA might use a grace period of a few weeks, as it did last year, in order figure out how to pay the outstanding bills. Here, again, Venezuela has three options. It could obtain a new loan from the Russian oil company Rosneft and propose as collateral oilfield stakes, or it could receive funding from the country's public banks (which has already been done recently in order to raise half a billion dollars). Alternatively, the government can decide to use the central bank's foreign reserves, officially estimated at USD 10 billion.

Whatever the decision, due to prolonged period of low oil prices and increased US sanctions, in the medium- to long-term, default seems inevitable. US President Donald Trump's Executive Order of August 24, 2017 strengthened sanctions against PDVSA by prohibiting all transactions related to new debt of the company with a maturity greater than 90 days and by forbidding Citgo from repatriating dividends in Venezuela. By cutting access to an essential source of funding, the Trump administration is effectively precipitating the default of PDVSA and, given the key economic role of the company, that of Venezuela.

Getting out of the crisis for the company will therefore necessarily involve an increase in oil production. Since 2005, the country has been aiming to produce 5 million barrels per day but this target has never been reached. In the first seven months of 2017, for instance, the average oil production was 1.9 million barrels per day. The 5 million threshold is achievable provided that the government allows the local private sector to step in and signs agreements with foreign companies. In this respect, it can draw inspiration from the United States which, over the past ten years, has increased oil production from ca. 5.3 million to 9.5 million barrels per day by relying on numerous small-scale private shale oil companies. Such a move would however bring expected results only under circumstances of full respect for private property, protection of minority investors, and political stability. Unfortunately, judging from recent events and the attitude of the current government, such a solution is unlikely to materialize any time soon.

This week: The Monetary Policy Council held a meeting on Sept 5th and 6th, deciding to keep the policy interest rate unchanged. The reference rate will remain at 1.5% on an annual basis. The National Bank of Poland's President Adam Głapiński explained the decision as due to a lack of imbalances in the economy, with an annual growth of 4% attainable, so there was not seen a need to change the rate strategy.

GDP (Q2 2017)

4.4% y/y (est.)

Up from 4.2% in Q1

Inflation (July 2017)

1.7% y/y

Up from 1.5% in June

Unemployment (July 2017)

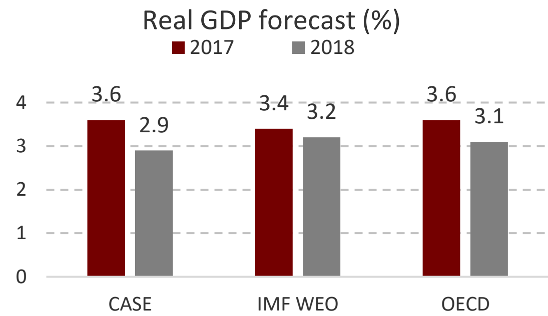
7.1%

Unchanged from June

NBP Base rate

1.5%

From 2% Mar 2015



This week: On September 4th, the Central Bank of Russia announced that a supplementary mechanism for liquidity provision will be implemented. The mechanism, similar to the EU's Emergency Liquidity Assistance (ELA) program, will support banks facing temporary cash-flow problems. The CBR claims the innovation is not connected with the present condition of the money market in Russia but has been forthcoming for some time.

GDP (Q2 2017)

2.5% y/y

Up from 0.5% in Q1

Inflation (Aug 2017)

3.3% y/y

Down from 3.9% in July

Unemployment (July 2017)

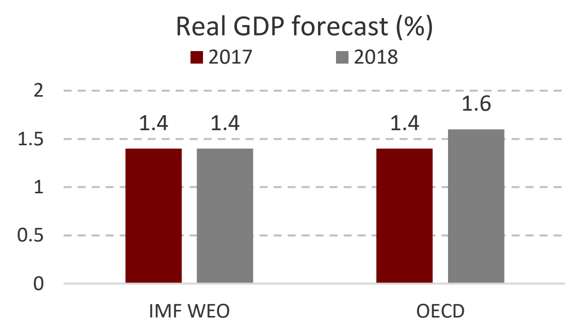
5.1%

Unchanged from June 2017

CBR Base rate

9 %

From 9.25%



This week: The second quarter of 2017 saw a 0.6% real (3.5% nominal) increase in wholesale trade turnover compared to the same period last year, according to data released by the German Federal Statistical Office. Advances were also observed in the manufacturing and service sector (accounting for two-thirds of the country's economy), which enjoyed an increase from 54.7 in July, to 55.8 in August in the Purchasing Managers' Index (PMI), indicating a moderate improvement in their performance.

GDP (Q2 2017)

2.1% y/y

Up from 2.0% in Q1

Inflation (Aug 2017)

1.8% y/y (est.)

Up from 1.5% in July

Unemployment (July 2017)

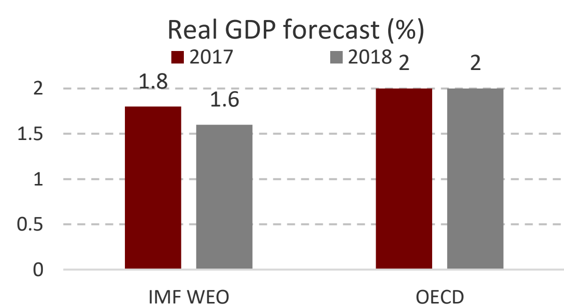
3.6%

Unchanged from June

ECB Deposit rate

-0.4%

From -0.3% Dec 2015



This week: The international reserves of Ukraine increased in August by 16% year-to-date, the highest since 2014, according to preliminary data released by the National Bank of Ukraine (NBU). At the equivalent of USD 18 million, the reserves are enough to cover 3.6 months of imports and allow for settling the NBU's and the government's current operations and foreign debt.

GDP (Q2 2017)

2.4% y/y

From 2.5% in Q1

Inflation (July 2017)

15.9% y/y

Up from 15.6% in June

Unemployment (Q1 2017)

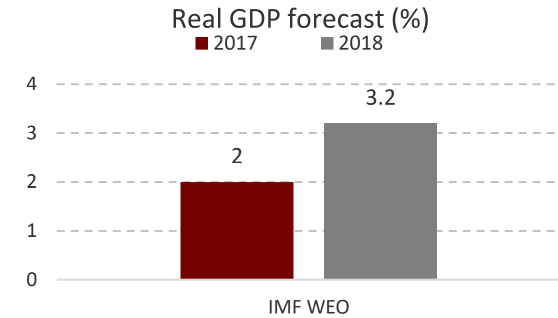
10.5%

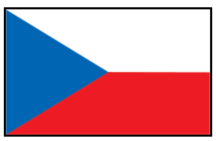
Up from 10.0% in Q4

NBU Base rate

12.5%

From 13.0% in May





This week: On September 4, the Czech Republic and Norway signed a Memorandum of Understanding, according to which EUR 184.5 million (approximately CZK 5 billion) will be allocated to the former under the European Economic Area (EEA) and Norwegian Funds. The money is to support projects involving human rights, Roma inclusion, and civil society development.

GDP (Q2 2017)

4.5% y/y (est.)

Up from 3.0% in Q1 2017

Inflation (July 2017)

2.5% y/y

Up from 2.3% in June

Unemployment (Q2 2017)

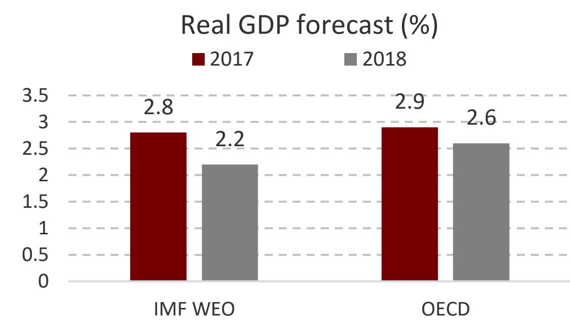
3.0% (est.)

Down from 3.4% in Q1

CNB Base rate

0.25%

From 0.05% (4 August 2017)



This week: The Monetary Council voted in favour of maintaining the base rate at 0.9%, as per minutes released on September 6, 2017. The council believes the external environment poses a risk to inflation and is prepared to ease monetary conditions using unconventional, targeted instruments to meet the inflation target.

GDP (Q2 2017)

3.2% y/y

Down from 4.2% in Q1

Inflation (July 2017)

2.1% y/y

Up from 1.9% in June

Unemployment (Q2 2017)

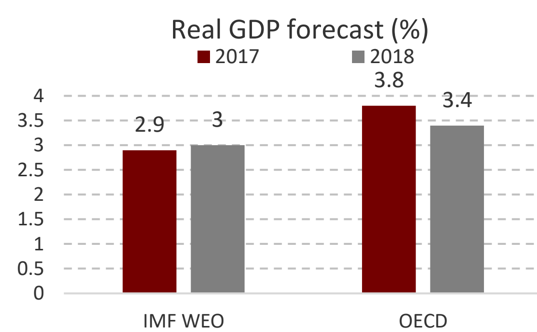
4.2%

Down from 4.3% in Q1

MNB Base rate

0.9%

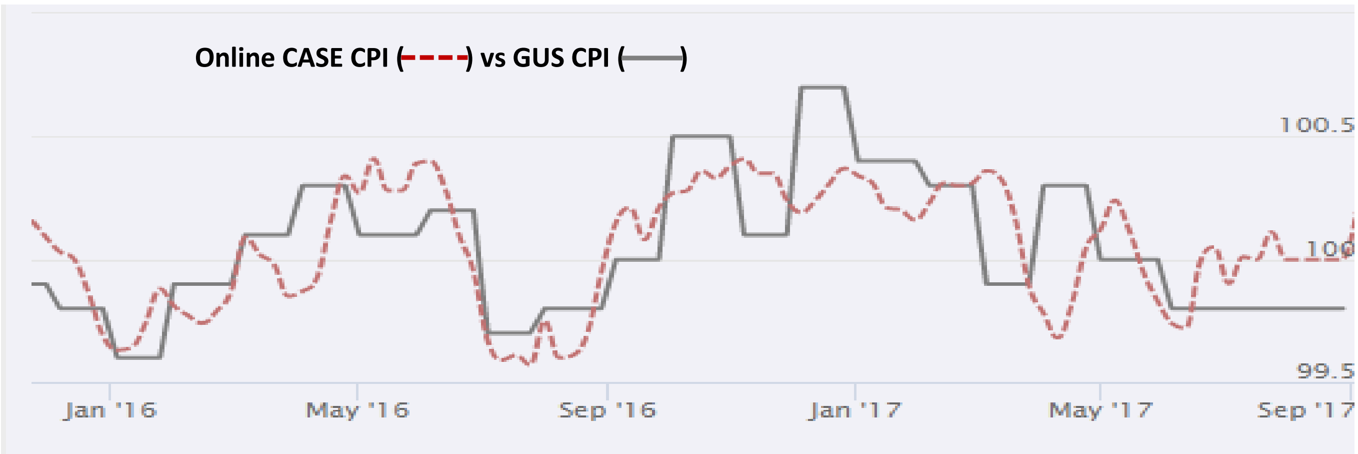
From 1.05% May 2016



The weekly online CASE CPI

The online CASE CPI is an innovative measurement of price dynamics in the Polish economy, which is entirely based on online data. The index is constructed by averaging prices of commodities from the last four weeks and comparing them to average prices of the same commodities from four weeks prior. The index is updated weekly.

Our weekly online CASE CPI



Monthly CASE forecasts for the Polish economy

Every month, CASE experts estimate a range of variables for the Polish economy, including future growth, private consumption, and foreign trade, current account balance, and the CPI.

CASE economic forecasts for the Polish economy
(average % change on previous calendar year, unless otherwise indicated)

	GDP	Private consumption	Gross fixed investment	Industrial production	Consumer prices
2017	3.6	3.9	2.9	3.8	1.9
2018	2.9	3.0	2.7	3.7	2.0
	Nominal monthly wages	**Merchandise exports (USD, bn)**	**Merchandise imports (USD, bn)**	**Merchandise trade balance (USD, bn)**	**CA balance (USD, bn)**
2017	4.7	201.6	201.8	-0.2	-4.7
2018	3.5	211.3	213.1	-1.8	-5.9

For more information on our weekly online CASE CPI, please visit: http://case-research.eu/en/online-case-cpi
To **subscribe** to our weekly showCASE newsletter, please visit: http://case-research.eu/en/showcase

Contributions: Krzysztof Głowacki, Katarzyna Mirecka, Aleksandra Polak, Katarzyna Sidło, Ellam Kulati **Editor:** Katarzyna Sidło **Editor-in-chief:** Christopher Hartwell