# Venezuela: Hunger by Default

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**What happened?** On 14 November, credit ratings agencies declared Venezuela in partial default on its foreign debt, after the country failed to meet a $200 million payment to bondholders.

**Why did it happen?** Economic mismanagement and corruption have reduced Venezuela's foreign reserves to under $10 billion. Its dollar earnings have fallen dramatically due to a sharp decline in the oil price. Heavily dependent on imports, it must also pay billions every year to service huge liabilities, acquired at very high interest rates, during the oil boom.

**Why does it matter?** The Venezuelan economy is in free-fall amid a protracted political crisis, which saw dozens killed on the streets earlier this year. It faces a likely presidential election in 2018. A full-blown default could add an escalating humanitarian emergency to this economic and political crisis.

**What should be done?** The government should restore powers to the opposition-led parliament and seek its approval for a restructuring package. But this must form part of a full-scale political negotiation, with international supervision, including agreement on the appointment of an autonomous Supreme Court and Electoral Council and guarantees of a free and fair presidential election.

## I. Overview

The financial markets have long regarded Venezuela's default as probable, and have charged the country accordingly. Already by mid-2017, the implied risk of default within twelve months was over 50 per cent, while the risk over the subsequent five years was above 90 per cent. As of today, Venezuela is technically in default on part of its debt, raising the possibility that creditors at any moment could move to recover the full amount owed. That would total some $60 billion in bonds issued by the government and by the state oil corporation, Petróleos de Venezuela, S.A., or PDVSA, although the total foreign debt is generally thought to be around $150 billion, of which two thirds could be subject to immediate demand.

The last major default in Latin America was that of Argentina, which ceased payment on most of its $132 billion foreign debt in 2001 amid a severe economic and political crisis. It took Argentina fifteen years to reach a final settlement with "hold-out" creditors and restore its access to financial markets. A Venezuelan debt crisis is likely to be even more complex and cause more political and social damage. First, an orderly restructuring of the debt is all but impossible: the government not only lacks a credible economic and financial recovery plan, it also faces sanctions, which could expose those providing the country with fresh loans to criminal prosecution. Furthermore, the government is likely to maintain its rigid and economically harmful controls over currency exchange and access to U.S. dollars.

Moreover, while Argentina is one of a handful of countries that are self-sufficient in food, Venezuela has a declining food and agriculture sector and malnutrition is rampant. Some 96 per cent of its foreign earnings come from the oil industry, whose overseas assets may be vulnerable to seizure by creditors. The disruption of oil exports could trigger a humanitarian emergency in a country that is already suffering severe shortages of food, medicines and other vital goods. Politically, Venezuela is increasingly isolated: all major countries in the hemisphere, as well as the EU, have joined in demanding a restoration of democracy. Adding to the instability is a presidential election due to take place next year. The issue of who will be the official candidate has yet to be resolved.

## II. **Default**

On 2 November, President Maduro announced his decision to "decree a refinancing and restructuring" of Venezuela's foreign debt. Although the government insists it has no intention of defaulting, it subsequently failed to make several debt payments within contractual time-limits, leading ratings agencies to downgrade its debt to the "selective default" category. The International Swaps and Derivatives Association (ISDA) – a market association that decides whether to trigger insurance payments on bad debt – declared a technical default.

On 13 November, the government hosted a meeting in Caracas with bondholders, ostensibly to launch the restructuring/refinancing process. Maduro put Vice President Tareck el Aissami in charge, causing many bondholders to stay away because Aissami and another commission member (Finance Minister Simón Zerpa) face U.S. Treasury Department sanctions. Although the department ruled that merely attending the meeting was not a violation of U.S. law, negotiating with these individuals clearly would be. Moreover, U.S. sanctions prohibit issuing any new debt to Venezuela, unless it is approved by parliament,[1] rendering the process futile without a political agreement.

In the event, the meeting lasted a mere half-hour. Aissami read a communiqué devoted mainly to blaming U.S. sanctions for payment delays and offered few clues as to what the government would do. Some bondholders who attended said they were asked to pressure the Trump administration to lift sanctions. As long as the government continues to pay, albeit belatedly, creditors are likely to hold off taking

[1] The opposition-controlled National Assembly has for all practical purposes been replaced by the National Constituent Assembly, elected in July, which has no opposition members. See Crisis Group Commentary, "Venezuela's Last Flickers of Democracy", 3 August 2017. In August, the U.S. government imposed sanctions restricting loans to Venezuela. Ann Gearan & Anthony Faiola, "Trump tightens Venezuela's access to U.S. financial system", *Washington Post*, 23 August 2017.

action that would trigger a full-scale default. However, that may change, especially if it becomes clear the government is taking steps to safeguard assets that would be potential targets for seizure in the event of default.

## III. Economic Freefall

The Maduro government boasts that it has disbursed more than $71 billion in debt repayments over the past four years. During the same period, imports have fallen from over $45 billion in 2012 to under $20 billion this year. The country's health service is close to collapse and most vital medicines have vanished from pharmacies. In October, for the first time, the monthly consumer price rise exceeded 50 per cent, often regarded as the threshold for hyperinflation. Food prices are rising even faster, yet wages are not indexed to prices. Millions of households rely at least partially on a government program to distribute cheap food to the poor, but the food has to be imported with oil dollars. The Catholic charity Caritas declared an emergency earlier this year when moderate to severe malnutrition among under-five year olds surpassed 10 per cent.

In 2018, debt servicing is likely to consume around a third of oil revenues, even if the present price recovery continues. Some economists have argued that it is immoral to pay bondholders while Venezuelans die from malnutrition and preventable diseases. Default – especially a simple cessation of payment, with no restructuring or refinancing deal in place – could leave the country even less able to pay its bills, however. This is not merely because it would further reduce Venezuela's access to credit, but also because bondholders could attempt to seize its significant oil industry-related overseas assets, potentially paralysing an industry on which the entire economy depends. These include not only physical assets, such as refineries, but also pending oil payments. Any attempt to confiscate these holdings is likely to result in drawn-out legal battles over the distinction between sovereign debt (which enjoys immunity from asset seizure) and that of PDVSA, whose sole shareholder is the Venezuelan state.

The surrounding region is already suffering the consequences of Venezuela's crisis, from declining trade to spreading epidemics and an expansion of organised crime. Middle-class professionals are no longer the only ones leaving. Colombia alone has received at least 470,000 Venezuelans,[2] many of them poor, placing welfare services under severe strain, especially in border areas.

## IV. Democratic Meltdown

Venezuela has been sliding toward dictatorship for years. The trend accelerated after the opposition Democratic Unity (MUD) alliance won control of the National Assembly (parliament) two years ago. The government used its control of the Supreme Court to block all parliamentary initiatives and strip the assembly of its

[2] Over half of these immigrants are clandestine, according to official Colombian migration figures. "¿Cuántos venezolanos hay en Colombia?", *El Colombiano*, 27 October 2017.

powers, including control of the budget and the issuance of foreign debt. It has used the National Electoral Council (CNE) to block a recall referendum against President Maduro, schedule elections at the ruling party's convenience and tilt the electoral playing field against the opposition. From April to July this year, the opposition demanded a return to democracy in almost daily mass demonstrations that were met with violence by security forces. More than 120 people died.

On 30 July, the government held an election to a National Constituent Assembly (ANC), ostensibly tasked with reforming the 1999 constitution. The opposition alliance boycotted the poll, arguing that the election was unconstitutional and violated the principle of one-person-one-vote. There is evidence the government falsified turnout figures. The 545-member assembly, composed exclusively of government supporters, was installed on 4 August. Two weeks later, after parliament refused to recognise the Constituent Assembly, the latter assumed legislative powers by decree. However, this new legislature is regarded as spurious by many foreign governments, including the twelve-member Lima Group of countries, mainly from Latin America, the U.S. and the European Union (EU), which continue to recognise the National Assembly's authority.

With the Constituent Assembly in place, the government called elections for state governors, which should have been held in December 2016. Polls showed the Democratic Unity alliance was likely to win more than half the 23 states, but the electoral council resorted to measures clearly aimed at depressing the opposition vote, such as relocating voting centres at the last minute. In the event, the government claimed eighteen governorships. Evidence of fraudulent vote counting emerged in one state – Bolívar – but overall the government appears to have out-manoeuvred the opposition.[3] It continues to enjoy the support of up to a quarter of the electorate and has also refined a system which makes access to food and other services conditional on political loyalty.

This political setback left the opposition severely weakened and more divided than ever over strategy. Pro-government factions are also vulnerable to divisions, which could be further exacerbated in the event of default and likely pressures to dismantle the system of currency controls. A significant portion of the sovereign and PDVSA bonds are reportedly held by government leaders and supporters.[4]

## V. International Sanctions

On 26 August, President Trump issued a ban to prevent any individual or corporation in the U.S. or subject to U.S. jurisdiction (which includes most of Venezuela's major creditors) from financing the state oil company for more than 90 days or the Bolivarian Republic of Venezuela for more than 30. This allows trading to take place but rules out long-term finance. Moreover, since the debt is in U.S. dollars, any renegotiation would inevitably involve the U.S. financial system. Thus, there is little prospect of a viable refinancing plan unless sanctions are lifted. In addition,

[3] Anatoly Kurmanaev, "How hundreds of mysterious votes flipped a Venezuelan election", *Wall Street Journal*, 2 November 2017.
[4] Crisis Group interview, Venezuelan economist, 22 November 2017.

President Maduro and many other senior government figures are subject to individual U.S. sanctions, which make it a crime for anyone subject to U.S. jurisdiction to have dealings with them. Vice President Tareck el Aissami is also accused by U.S. authorities of links to drug trafficking.[5] Canada has also imposed individual sanctions, while the EU has approved a legal framework for travel bans and asset seizure.

Venezuela's exclusion from the dollar-based financial system is driving it to seek closer ties with Russia and China, both of which have rejected what they consider Western interventionism and shown far greater flexibility in renegotiating their own bilateral debt. These two countries are believed to hold some $30 billion in Venezuelan debt.

## VI. Talks Offer Slim Hope

On 1 December, the government will once again sit down for talks with some leading opposition members in Santo Domingo, Dominican Republic. However, the two sides have very different agendas. The government wants the opposition to recognise the Constituent Assembly, call for an end to sanctions and promise to secure parliament's approval to issue more debt. The opposition's principal demand is free and fair elections, which it believes would remove the present government from power. Previous rounds of talks have led nowhere. The main difference on this occasion appears to be the presence of Latin American foreign ministers acting as "guarantors" for the negotiations.

Past talks foundered partly because the government used them to buy time and to divide and disparage the opposition. This task was made easier by opposition politicians who failed to agree on a unified strategy and by international facilitators who did not insist on a solid framework for negotiation and guarantees of compliance. The opposition remains fractured, with only seven of its two dozen parties agreeing to attend the talks, though this round will be preceded by a wider consultation process, including talks with civil society organisations.

Venezuela's dire economic, financial, social and political crisis cannot be resolved piecemeal. The government will only be able to manage the debt crisis by de-coupling sovereign debt from PDVSA debt to avoid asset seizure and by working out a refinancing agreement with bondholders. But it cannot do this without also making significant concessions in return for the National Assembly's approval of fresh debt and an agreement to call for the gradual lifting of sanctions.

Government concessions would have to include giving up monopoly control over the Supreme Court and Electoral Council and agreeing to hold free elections under international supervision. It would also have to produce an economic reform package, including dismantling distortionary exchange and price controls and agreeing to a

[5] For the details of what U.S. sanctions mean in practice, see "Frequently Asked Questions on Venezuela-related Sanctions", U.S. Treasury Department. For the Canadian sanctions, see "Canadian Sanctions Related to Venezuela", Global Affairs Canada. Regarding the EU, see Michael O'Kane, "EU imposes arms embargo and targeted sanctions on Venezuela", in europeansanctions.com blog, 13 November 2017.

unified exchange rate.[6] Such a package likely would be credible to investors only if announced by a completely fresh economic team incorporating independent experts. Any agreement should also include an emergency social program, financed in part by money freed up by debt relief, and incorporating aid from foreign governments and NGOs.

The prospects for agreement are slender, however. Therefore, the international community needs to prepare for a significant deterioration in the humanitarian crisis by increasing assistance to neighbouring countries to meet the needs of destitute migrants, and continuing to press the Venezuelan government to allow humanitarian aid deliveries inside the country. It should also address the reasons for the repeated failure of talks to produce a solution. This means devising a credible and workable procedure for negotiations, and applying sufficient pressure through allies of Venezuela's government and opposition to induce both parties to accept it.

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[6] Venezuela introduced exchange controls in 2003 and price controls have been steadily ratcheted up over the same period. The main official rate (for "essential imports") is currently set at 10 bolívars to the U.S. dollar, while the black-market rate recently passed 80,000 bolívars to the dollar. In theory, dollars can be obtained by citizens and the private sector at a third rate (currently 3,345 bolívars) but the system of so-called currency auctions has been suspended for the past two months. Independent economists attribute severe price distortions and other economic ills in Venezuela to the byzantine system of controls, which has also helped foment corruption.

## Appendix A: About Crisis Group

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Crisis Group's President & CEO, Jean-Marie Guéhenno, served as the UN Under-Secretary-General for Peacekeeping Operations from 2000-2008, and in 2012, as Deputy Joint Special Envoy of the United Nations and the League of Arab States on Syria. He left his post as Deputy Joint Special Envoy to chair the commission that prepared the white paper on French defence and national security in 2013.

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