21 February 2003

An update on Venezuela

We had Michael Penfold in our offices this morning for a small investor breakfast. Michael is an expert in Venezuelan constitutional and electoral issues. Michael has served as a consultant to the Carter Center in Venezuela. He has his Ph.D. from Columbia University in Political Science and currently serves as Executive Director of the National Council for Investment Promotion (CONAPRI) in Venezuela.

I thought it worth summarizing some of the key themes from the discussion this morning; in particular in light of the arrest of Carlos Fernandez. Because events remain quite fluid, I have tried to focus on issues still ill-defined and of relevance.

To watch near-term:

- A further consolidation of domestic political power by Chavez; fracturing his opposition while holding at bay the international community; the response to the Fernandez arrest will be critical;
- Oil production is likely to be higher than expected on an average annual basis with greater upside from the increasing likelihood that the government manages to contractually harness international oil company resources to re-engage capacity and production;
- Washington consensus is likely to be far more tolerant of Chavez remaining in power with unfolding geopolitical events; in particular if violence is contained in Venezuela and a semblance of order and governability maintained;
- Chavez has at a minimum 6 months until he is reengaged around an August referendum by OAS and the friends of Venezuela (with a constitution and courts to hide behind in challenge and interpretation for far longer); there remains noise here, but with oil re-engagement and external debt service, it remains for Chavez, a bark without meaningful bite;
- The banking system will continue to bear the fiscal brunt as captive lender of last resort; degenerative until it is broken; though again debt rollovers will make this long and painful.

Chavez is repositioning himself, isolating opposition while managing to hold the international community at bay; focused on August elections that Michael does not believe will materialize; neither did those attending. We spoke a great deal about the degenerative economic and socio-political environment and why it gets worse, but remains sustainable for Chavez; with external debt continuing to be serviced.

The view from Washington per Michael seems to be that with such a fractured opposition in Venezuela, the devil you know (in particular given the current geopolitical environment) is better than the devil you don't. Chavez strong-arming of Fedecamaras and Fernandez is politically expedient and helps further fracture opposition and consolidate power. It is also an inflection of sorts. If it again reunites a national and vocal opposition, Chavez may again find himself facing violent protest. If it does not, he further consolidates his domestic power base, keeping opposition splintered, as he turns to oil production.

Chavez is likely to continue to wield the constitution in his favor, stalling to retain power; keeping the international community keenly focused on a revocatory referendum in August; it is expedient for the government as well as for the international community*, for the moment*. While it does not set a timeframe for elections, it does provide a date and the pretense of a framework to dialogue around.

Chavez near-term focus is on PdVSA and pumping oil. There is a great deal of speculation at the moment as to what current production and average production will look like this year. Market estimates today range around 1.3mm barrels per day in production. Conjecture remains as to how quickly further capacity can be brought on line.

The market is focused on an average production number for the year of 1.5mm bpd. Penfold believes the average number will be higher, around 2mm bpd. The gap is a relevant difference for the government and while shy of the 3.2mm bpd production levels of days past, does afford the administration additional fiscal flexibility (and room for some reinvestment in PdVSA that may prove decisive).

Michael mentioned that he believes aggressive negotiations are going on with the government to allow for the sub-contracting and management of oil fields and wells by foreign oil concerns; to get production up and running faster and more efficiently. Like external debt servicing, it is a means for the government to maintain its relevance and engagement with the international community at a pertinent geopolitical moment.

This is something to watch closely for as it again would mark a radical inflection of power and a further consolidation for Chavez. Against this political dynamic, Venezuela remains an economy that contracted an estimated 20% in the first quarter and is likely to see a full year contraction of between 15-20% (this figure predicated obviously on PdVSA production and investment). Reserves are likely to fall, as external debt is serviced; again politically expedient for an administration holding domestic opposition and international criticism at bay.

The local banking system will continue to bear the brunt of the government's fiscal short fall, as captive lender of last resort. As someone remarked at breakfast, it will remain a banking sector whose balance sheet increasingly reflects only local government debt as *investment*. The banks will continue to look sound as long as domestic debt is rolled and bankrupt when it is not.

The near-term view seems to be that while economically degenerative and politically divisive, Chavez is rearming himself politically and likely to retain power (a 6-12 month view). He understands all too well the relevance of oil (fiscally and geopolitically) and the importance of continued external debt service (at the increasing cost to local banks). Opening well and field management to foreign participation would radically swing both the fiscal and perception of geopolitical relevance further in his favor. With oil again pumping, we are back to Bill Cline's willingness versus ability to pay dilemma. As long as Chavez holds onto power, with his constitution, and oil is pumping, ability and willingness remain aligned.

Chavez is focused on keeping his political opposition fractured and making it increasingly difficult for the international community to engage with that opposition on a consistent and focused basis (why the Fernandez arrest is so important to watch). That said the international community is unlikely to either have the interest of desire to meddle in what is still a very confused domestic political environment. At the very least through an engagement with Iraq, with an eye towards this August at the earliest to revisit.

Capital controls along with oil retain the integrity of the government's ability to service external debt. They are also increasingly likely to make the domestic economic situation untenable. The longer Chavez holds onto power the worse Venezuela will be economically de-constructed. The key will be the voice, strength, organization and assertiveness of an increasingly frustrated and hostile opposition. A fractured and more radical opposition is easier for the government to address under the guise of national security. Organized opposition may force again more violent opposition and engagement.

For the moment, external debt holders will continue to weigh current yield against 12-mos default probabilities and hold. The longer this drags on, however, the more degenerative it becomes. Investors are likely to ride the near-term volatility with a keen eye to oil production and social dissonance. There remains a great deal of political headline risk yet ahead. In parallel to the depths of Evita's "New Argentina", Chavez's "New Venezuela" looms large and far more threatening (in particular to what is left of middle-class Venezuela).

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