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Weekly Credit Brief Jun 28 - Jul 04

Venezuela faces a socio-economic mess

by Benjamin Lye

Venezuela is suffering from a socio-economic mess as a result of falling oil prices. Venezuela is overly dependent on its oil export, which makes up 95% of its total export revenue. Due to a mismanagement of the nationalized industries, the country has been forced to import its basic necessities. Suffering from cash flow problems, the Latin American country faces a scarcity of foods, household items, and medicines. Venezuelans have to queue up for hours and sometimes, overnight just to buy necessities, paying with bags full of cash. Medicine shortages and riots have also caused many deaths in Venezuela. The IMF has estimated skyrocketing inflation rates of 481.5% in 2016 and 1,642.76% in 2017. GDP growth was -7.06% at the end of September 2015, marking its seventh consecutive quarter of negative growth rate for the country.

The RMI-CRI aggregate 1-year Probability of Default (PD), a simple median for 10 Venezuelan companies, increased at a sharp rate in just two months from 8.65bps in April to 25.26bps in June 2016 (see Figure 1). This coincided with a mounting current account deficit and increasing debt obligation as a result of the oil price slump.

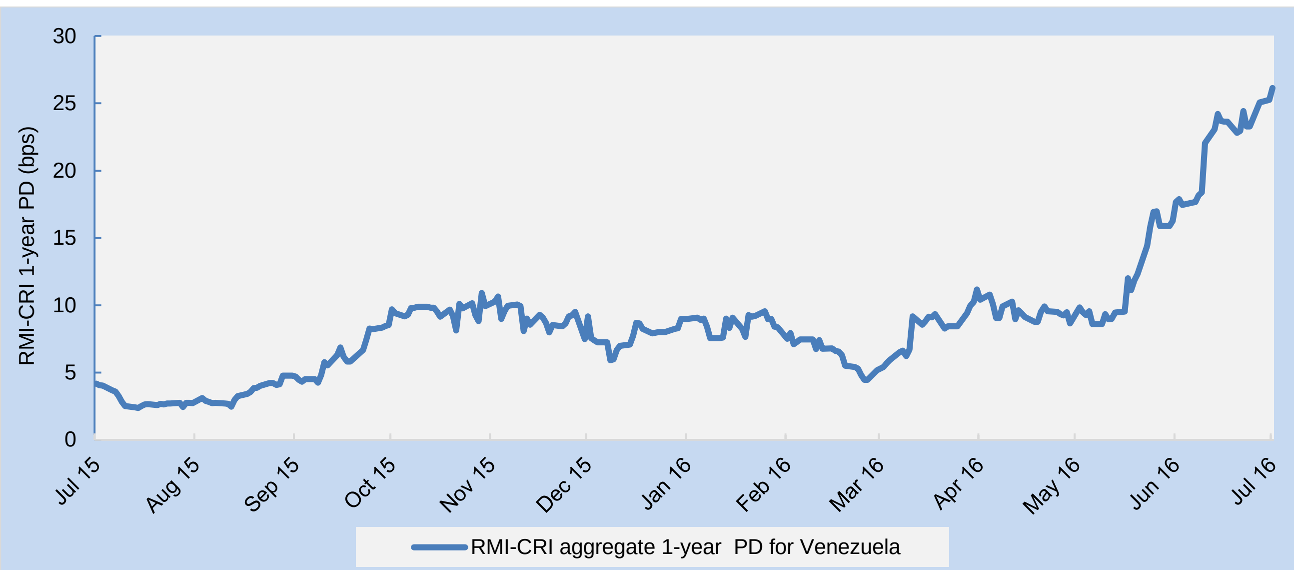

Figure 1: The RMI-CRI aggregate 1-year PD for Venezuelan firms. Source: RMI-CRI

The sharp decline in oil prices has wreaked havoc on Venezuela's underlying economy. Lower revenue from oil production, which makes up 40% of government revenue and 11% of GDP, triggered a slowdown in economic growth as well as a cash crunch for the country. A lack of investor's confidence made the country's currency, Bolivar depreciate 115.4% YoY against the US dollar in June 2016, based on trades in the black market in Venezuela (see Figure 2). The depreciated currency did not result in a boost for exports, but instead led to a current account deficit due to the country's dependency on imports for most of its basic necessities. The depreciation of the Bolivar worsened the hyperinflation problems and exacerbated existing social issues.

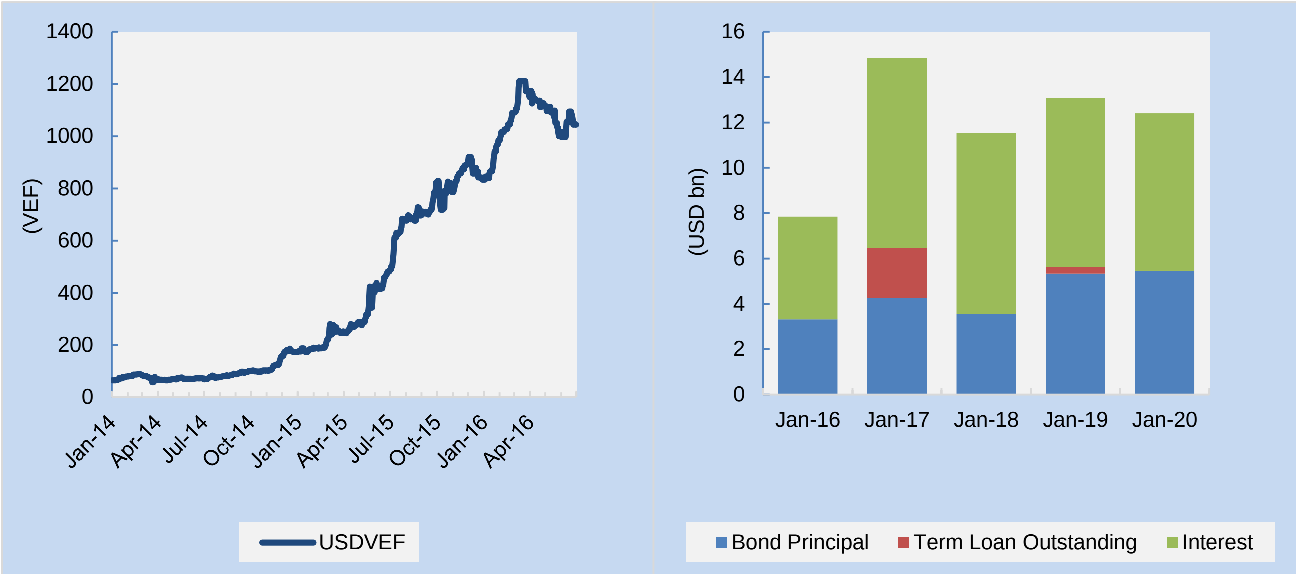

Figure 2: Venezuela's exchange rate traded in the black market (left panel); and debt distribution, including both principal and interest payment for Venezuela (right panel). Sources: Bloomberg

Venezuela may not have sufficient capital to repay its debt obligation. According to data from Bloomberg, Venezuela is obligated to pay a combined principal and interest payment of USD 4.49bn in Q3, USD 3.1bn in Q4 2016 and USD 14.8bn in 2017 (see Figure 2). Although the oil minister of Venezuela, Eulogio Del Pino claimed that the country will not default on its debt obligation, Bloomberg estimates that there is a 69% chance of non-payment through June 2017. The average annual combined principal and interest payment for the next 10 years is expected to be USD 4.8bn per annum, according to Bloomberg. The government plans to further reduce imports to boost the country's ability of repayment and this could make Venezuelans' life harder. The country simply does not have enough money to pay bondholders, importers, oil-production suppliers such as Schlumberger Ltd. to sustain production and even to currency maker, De la Rue to produce its own currency notes.

On a brighter note, Venezuela successfully restructured its loan terms with its main financier, China, who has lent Venezuela USD 50bn over the last decade. The country has also been trying to pay off current obligations using foreign and gold reserves. Venezuela's international reserves sunk from USD 28bn in 2013 to USD 12.07bn in June 2016, reflecting a weakening liquidity position of Venezuela, according to Bloomberg data (see Figure 3). This could add further pressure on the value of Bolivar and escalate hyperinflation.

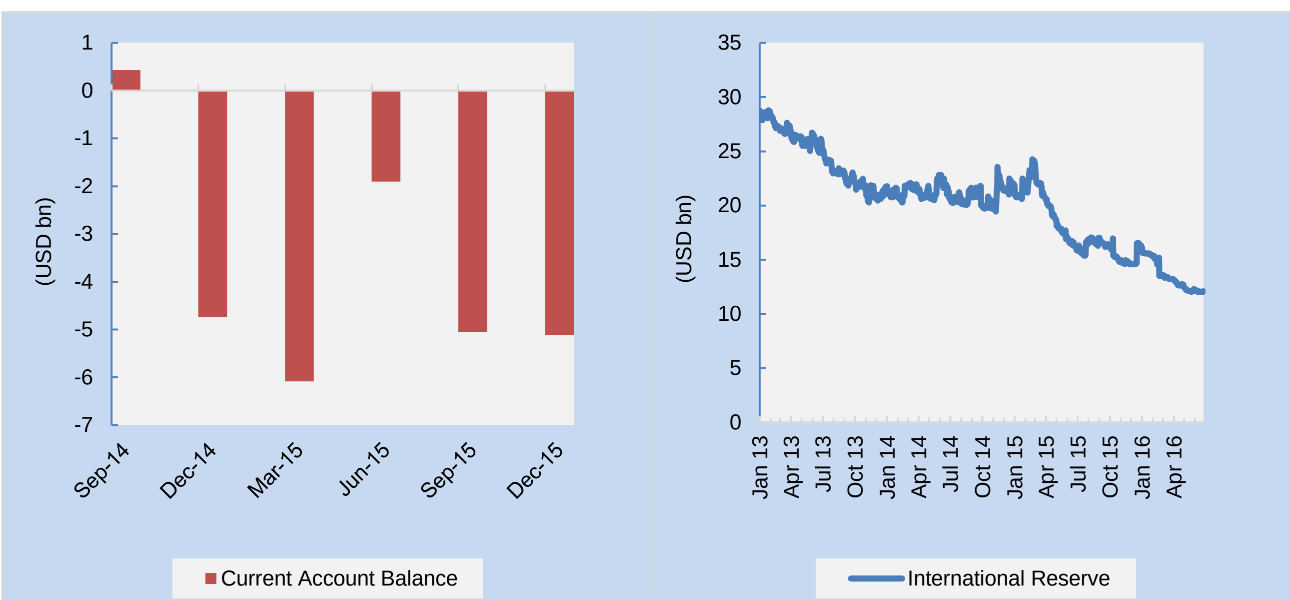

Figure 3: Current account balance of Venezuela (left panel); and international reserve (right panel).
Sources: Bloomberg, DolarToday.com

The dire situation faced by Venezuela is a result of the recent oil price slump. Venezuelans praised President Chavez's effort to bring prosperity for the poor but blamed Chavez's successor, President Maduro for economic mismanagement and trying to keep his power intact at the expense of the social well-being of Venezuelans. The opposition successfully gathered 200,000 signatures to trigger a recall referendum against Maduro. Critics argue that the referendum could force Maduro to tighten subsidies and currency controls to reduce present economic distortions. However, 4 million people have to sign a second petition to trigger another referendum for a new election within Maduro's four-year presidency. The government tried to delay the vote till 2017 (the remaining two years of Maduro presidency) to allow the vice president to take over if Maduro is recalled, instead of triggering a new election. In essence, the current socialist government will be able to continue to run the country. Even if the opposition successfully recalls President Maduro, the dozens of opposition parties have no single plan or leader to unwind President Chavez's legacy. With the political and economic uncertain outlook, the credit profiles of Venezuelan firms are likely to remain under pressure.

Credit News

Puerto Rico defaults on constitutionally guaranteed debt

Jul 1. The Puerto Rican government failed to pay almost half of USD 2bn in bond payments due July 1. It is the commonwealth's first default on its constitutionally guaranteed debt. Major insurers backing Puerto Rico's debt are likely to lose as they could be forced to pay out as much as hundreds of millions of dollars to bondholders. President Barack Obama already signed a legislation that addressed the debt crisis but it did not provide any mechanism to avert the default. Instead, the law provided protection against creditor litigation. The island has been in a recession for most of the past decade and has seen its population rapidly dwindling. (WSJ)

China's domestic credit rating agencies see no debt problem

Jun 30. China's domestic credit rating agencies harbor a general positive outlook of the publicly-issued debt - a stark contrast with the views from the IMF and external credit rating agencies. The domestic credit rating entities suggested that only a tiny number of the RMB 13.2tn in rated enterprise bonds, corporate bonds and medium-term notes are at risk. Critics pointed out that China's rating agencies would be swayed by the state to provide optimistic assessments. However, deputy finance minister Zhang Shiyao mentioned that foreign agencies such as Moody's and Standard & Poor's magnified China's debt problems and undermined China's ability to implement reforms when faced with downgrades by Moody's and Standard & Poor's earlier this year. (FT)

Brexit vote leads S&P to cut EU credit rating

Jun 30. S&P cut its rating for the European Union (EU) from AA+ to AA after the Brexit vote as the UK's decision to leave the EU had triggered "great uncertainty" over long-term economic and financial planning. Meanwhile, S&P also cut the UK's top AAA rating to AA, warning that Brexit would lead to "a less predictable, stable and effective policy framework in the UK". A number of economists have warned about the consequences of leaving the EU, with IHS Global Insight cutting its growth forecasts to 1.5% from 2% for 2016 and to 0.2% from 2.4% for 2017. (BBC)

Negative-yield government debt surges USD 1.3tn to USD 11.7tn

Jun 30. The amount of negative yielding sovereign debt increased to nearly USD 12tn after results of the UK's EU referendum were released. The drop in bond yields produced strong gains for bondholders as the first half of the year came to an end. 1H returns of Gilts exceeded 11.5 percent, German Bunds have rallied close to 7 percent and US Treasuries were up 5.5 percent. Yields on the 10-year UK Gilt dropped to a record low after comments from the Bank of England that further monetary policy easing may be warranted. Many economists have cut their growth forecast for the UK, with some predicting a mild recession in 2017. (FT)

China Fishery Group files for bankruptcy protection in US (WSJ)

Accounting choices blur profit picture (WSJ)

Moody's outlook for Singapore banking industry cut to negative (TODAY)

Regulatory Updates

George Osborne to slash UK corporate tax to less than 15%

Jul 4. British Finance Minister George Osborne plans to reduce corporate tax below 15 percent in an attempt to cushion Brexit's economic shocks. Mr Osborne said that he will focus on Britain's relationship with China as he wanted to make Britain more competitive with low business taxes and a global focus. The 15 percent corporate tax is much higher than the average of 25 percent among other OECD countries and is likely to anger some EU countries which have expressed concerns regarding competitive tax policies. The finance minister also promised to support bank lending, increase direct investment to northern England, and maintain Britain's fiscal credibility. (Straits Times)

RBI says setting up a Bank Holding and Investment Company a 'sub-optimal solution'

Jul 3. The Indian government's plan to set up a Bank Holding and Investment Company (BHIC) was met with opposition from the Reserve Bank of India (RBI). Although a BHIC will improve the bank's ability to raise capital and reduce the government's load of providing capital for state-owned banks, the RBI mentioned that the BHIC would hold shares that are diverse. This creates complexity for investors who wish to transact in banks shares as financial performance parameters of the holding company would be difficult to trace. The Bank Board Bureau will search and appoint heads of Public Sector banks and aid them to develop "differentiated strategies and capital raising plans through innovative financial methods and instruments". (Indian Express)

Carney prepares for 'economic post-traumatic stress'

Jun 30. The Bank of England is preparing to unleash another round of monetary stimulus as it battles to contain the economic fallout of the UK's decision to leave the EU. Governor Mark Carney said the central bank would take "whatever action is needed to support the growth", which probably included "some monetary policy easing" in the next few months. Sterling fell more than 1% to USD 1.32 as traders began preparing either for rates to be cut to historic lows, more quantitative easing, or both. British government bond yields entered negative territory for the first time following Mr. Carney's speech, with the yield on one two-year bond hitting -0.003%. (FT)

Nearly all US banks pass Fed's stress test

Jun 29. Morgan Stanley, one of the US largest banks, did not receive an unconditional pass from the Federal Reserve during the 2016 annual comprehensive capital analysis and review. The tests assessed the bank's ability to manage capital and liquidity in varied scenarios, including a sudden increase in interest rates or unemployment. The Fed said that the bank's models did not adequately capture the risks specific to the bank and the bank needed to strengthen its internal processes specific to governance and controls in scenario designs and modeling. Morgan Stanley needs to make the improvements by the end of the year but will be allowed to return capital to shareholders. (NYT)

RBI flags corporate loan risks (Financial Express)

EBA clarifies use of 2016 EU-wide stress test results in the SREP process (EBA)

Abu Dhabi's NBAD, FGB approve plan to form USD 175bn bank (Bloomberg)