Economic Views – Where does Venezuela Stand?

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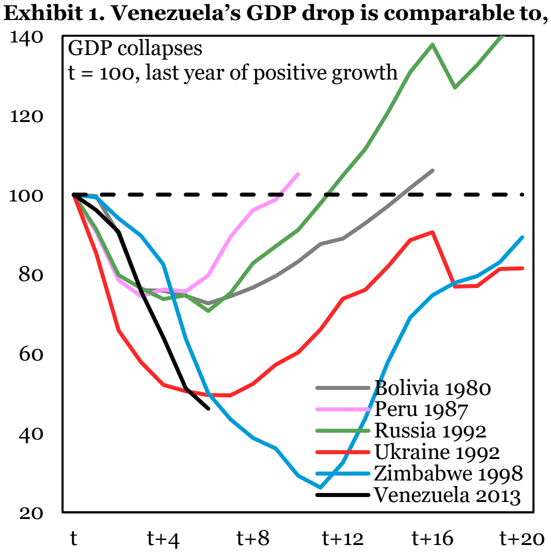
- We assess Venezuela's macroeconomic fundamentals, ...
- after years of policy mismanagement and social turmoil.
- The GDP drop is on par with the Soviet Union's collapse.
- Recent oil sanctions will likely exacerbate the downturn.
- Inflation is high even by the standards of hyperinflations, ...
- but history tells us it could end fast under policy change.

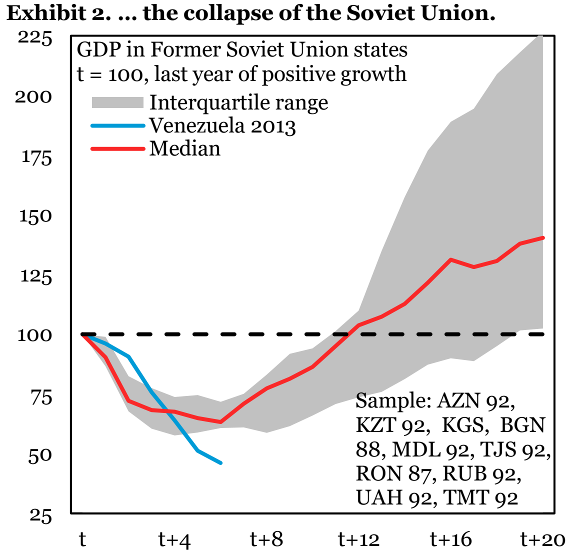
Venezuela is in focus as the international community is stepping up efforts to induce political change. This week, we start a series of ***Economic Views*** assessing the economic situation in Venezuela after years of political and social turmoil, and lack of official economic data. Venezuela's economic collapse is almost unprecedented in recent history. Zimbabwe in the last 20 years and the collapse of the Soviet Union are the only comparable episodes (Exhibit 1). The depth of the recession raises the risk of an incomplete recovery in the event of policy change. In the near term, new US sanctions on the oil sector will likely exacerbate the downturn. Inflation estimates are high even by the standards of past hyperinflations, but previous stabilization episodes show hyperinflation can be stopped quickly. If policy direction changes, engineering a strong activity recovery might be more complicated than ending hyperinflation.

Exhibit 1. Venezuela's GDP drop is comparable to, ...



Source: Haver, IIF

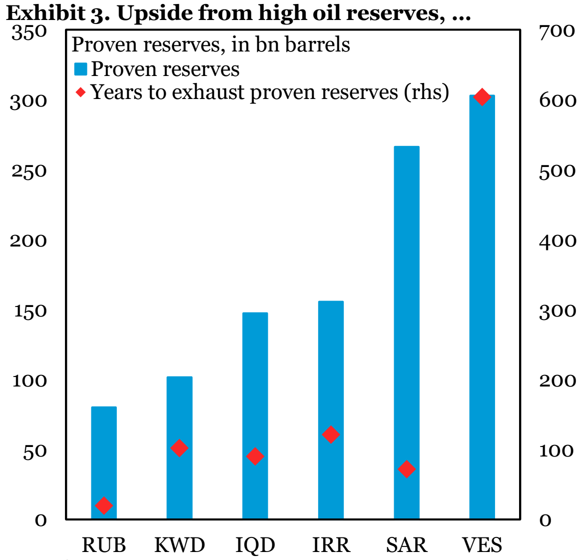
Exhibit 2. ... the collapse of the Soviet Union.



Source: Haver, IIF

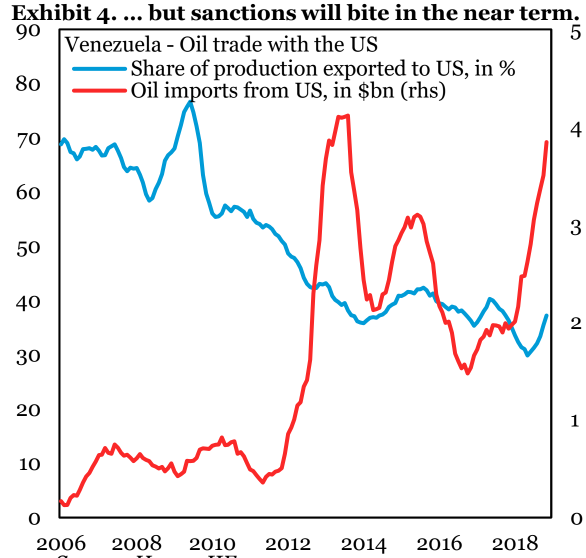
No official growth data exist past 2016, but a 37% cumulative decline in oil production since then suggests the economy is tanking. Former Soviet Union (FSU) states in the early 1990s are the only group that suffered a roughly comparable collapse (Exhibit 2). It took the median FSU state 12 years to achieve pre-crisis real GDP levels and significantly more in some cases. The FSU experience suggests that Venezuela's recovery in a scenario where policies change is not assured to be fast. On the upside, the largest proven oil reserves in the world could help Venezuela turn around if deep reform in the oil sector lifted production from historically low levels and attracted FDI (Exhibit 3). In the near term, the oil sector is likely to drive the economy deeper into depression as new US sanctions could have serious implications. The ramifications of sanctions on the oil sector are twofold. First, oil exports are likely to suffer as the US is one of Venezuela's main trading partners (Exhibit 4). Second, Venezuela relies to a large extent on imports of refined oil products from the US to dilute extra heavy Venezuelan oil and make up for crumbling domestic refining capacity. In this context, we expect the decline in oil production to be well north of 10% in 2019.

Exhibit 3. Upside from high oil reserves, ...



Source: Haver, IIF

Exhibit 4. ... but sanctions will bite in the near term.

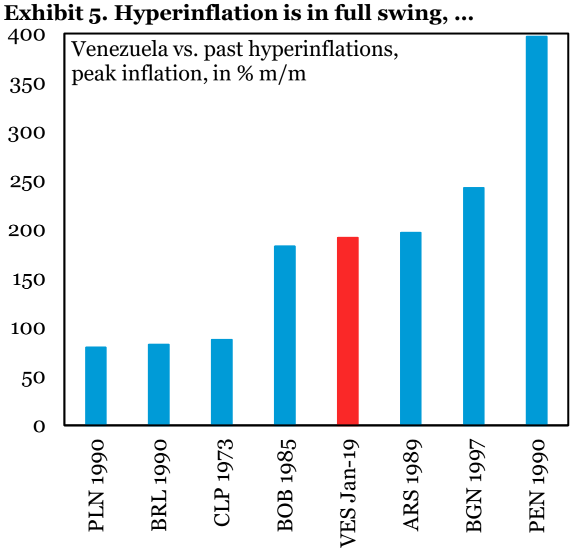


Source: Haver, IIF

The situation on the inflation front is also critical due to continued monetization of large fiscal deficits. Unofficial inflation estimates are very high even by the standards of hyperinflations in the FSU and Latin America in the 1980s and 1990s (Exhibit 5). While GDP was slow to recover in the aftermath of most hyperinflations, inflation itself fell fast upon the adoption of stabilization policies (Exhibit 6), which were based on either money base targets or fixed exchange rates. In the median past disinflation, price increases moderated to 4.5% m/m in twelve months, from a peak of 75% m/m.

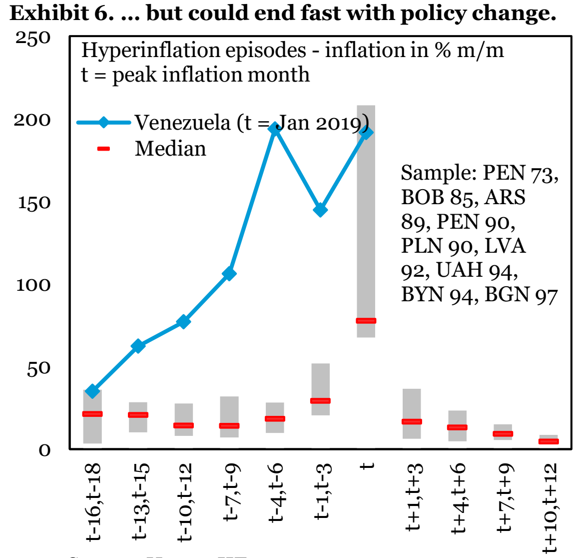
Venezuela is in a deep depression that is unlike the typical V-shaped recession in EM. The cumulative GDP decline since 2013 is comparable to the experience of FSU states in the early 1990s, raising the risk of a slow recovery in a scenario where policy reform takes place. Although hyperinflation has set in, historical experience suggests it could end relatively fast under stabilization policies.

Exhibit 5. Hyperinflation is in full swing, ...



Source: National Assembly, IIF

Exhibit 6. ... but could end fast with policy change.



Source: Haver, IIF