Venezuela Needs Debt Restructuring

By Steven T. Kargman

But it won't happen with the current regime in power.

Venezuela is currently facing truly monumental challenges as the grave humanitarian crisis confronting the country has been escalating in major and deeply worrisome ways. The crisis—which has manifested itself in severe shortages of food and medicine, a collapsing health care system, extremely high poverty rates, increasing crime rates, widespread malnutrition, and a rise in diseases such as malaria—requires the immediate, focused, and sustained attention of the international community.

Ultimately, though, Venezuela's economic and financial situation will also need to be addressed as part of a broader effort to reverse the downward spiral in Venezuela. The country will undoubtedly require a major debt restructuring in coming years in light of the huge, unmanageable debt burden (estimated to be $150 billion or greater) facing the Republic of Venezuela and its state-owned oil company, PDVSA, as well as the growing number of payment defaults and the associated build-up of significant payment arrearages (estimated now to exceed $6 billion).

Nonetheless, Venezuela and PDVSA face a two-sided conundrum when it comes to any potential restructuring of their outstanding debt. While a debt restructuring might be an eminently sensible course of action for Venezuela to pursue in the near term as part of any overall attempt to fix the Venezuelan economy, it is difficult to envisage for the reasons outlined here how such a restructuring could take place now or

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in the foreseeable future while the current regime remains in power.

The other side of the conundrum facing Venezuela, to be discussed in a future issue of *TIE,* is that the resulting delay in initiating a restructuring of Venezuela's debt is only likely to exacerbate the difficulties of achieving a successful debt restructuring, particularly in view of the continued deterioration of Venezuela's economy and the threat posed by creditor lawsuits against both the Republic and PDVSA.

CURRENT OBSTACLES

Venezuela could well benefit from a debt restructuring at the earliest possible date in order to avoid further defaults and the associated arrearages, but also so that, subject to U.S. sanctions being lifted, Venezuela could regain access to the capital markets and borrow at less-than-exorbitant interest rates. As Venezuela's foreign exchange reserves continue to dwindle to historically low levels, Venezuela desperately needs new financing in order to fund, for example, much-needed imports on which it so heavily depends for the functioning of its economy as well as for basic societal needs such as food and medicine.

It is very unlikely that a Venezuelan debt restructuring can take place anytime soon under current circumstances, especially with the government in the hands of President Nicolás Maduro and his regime. The presence of U.S. sanctions against Venezuela and a number of key Venezuelan government officials pose two significant obstacles to a debt restructuring.

First, under existing U.S. sanctions, it would be virtually impossible for U.S. creditors to negotiate a debt restructuring with the Venezuelan negotiating team as it was originally constituted by the Maduro regime. Last year, the Maduro regime appointed the country's then-Vice President Tareck El Aissami to lead the Venezuelan negotiating team, but El Aissami also happened to be a "specifically designated national" who was targeted under U.S. sanctions for his alleged role in drug trafficking. By the terms of the sanctions, U.S. creditors would have been prohibited from having any contact with him (or any other individuals targeted by the sanctions) in a negotiating context or otherwise.

Second, under the terms of the sanctions, U.S. bondholders would not be able to participate in any bond exchange whereby old bonds would be exchanged for new bonds incorporating the terms of any restructuring deal. A bond exchange would inevitably be an integral part of any future Venezuelan debt restructuring as it has been in so many other recent sovereign debt restructurings (such as Greece, Argentina, and others) where bonds have constituted a major portion of the sovereign's outstanding debt. In the case of Venezuela, bonds of the Republic and PDVSA taken together represent approximately $60 billion of Venezuela's overall outstanding debt.

It is difficult to envisage how such a restructuring could take place while the current regime remains in power.

The sanctions generally prohibit U.S. persons from acquiring "new debt" issued after August 25, 2017, by the Venezuelan government and PDVSA (where the debt has a maturity of longer than ninety days), and the new bonds containing the restructured terms of the old debt would be seen as constituting "new debt" for the purposes of the sanctions.

Another major obstacle to any restructuring arises from Venezuela's relationship—or lack thereof—with international financial institutions. To the extent any debt restructuring would require external financial assistance from official sector institutions such as the International Monetary Fund or other multilateral institutions (the World Bank, the Inter-American Development Bank, CAF, and so forth), such assistance is not likely to be forthcoming in the near term, at least with the Maduro regime in power.

The current Venezuelan government has not had regular engagement in recent years with institutions such as

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Venezuelan eating from the trash due to shortages in 2017.

the IMF, and the Venezuelan government under both the Chavez and Maduro regimes has regularly denounced the Washington-based international financial institutions. For its part, the IMF has not conducted a so-called "Article IV consultation" with Venezuela in over a decade, and yet such an Article IV consultation is considered a key part of the IMF's regular country surveillance activities for its member countries. Further, this past May the IMF officially censured Venezuela for not providing the IMF with certain types of economic data which the IMF would consider to be a prerequisite for it to re-engage with Venezuela.

Even if the current Venezuelan government were somehow to re-establish relations with the official sector, it is unlikely that the Maduro regime would be willing to make the changes to its economy that the official sector would require as a precondition for providing any new financing to Venezuela as part of an overall debt restructuring deal. Furthermore, any possible new financing from the private sector as part of an overall debt restructuring deal would probably not be forthcoming for the same reason: the current regime's likely unwillingness to put forward what the private sector would regard as a "credible" economic and financial plan (or an acceptable "adjustment" plan in official-sector parlance).

One final obstacle is that if any restructuring deal were to be reached between the creditors and the Maduro regime, it is not clear that potential restructuring bondholders would want to take the new debt securities that would be issued by the Venezuelan government as part of any bond exchange. The Maduro regime has been seeking authorization for new debt issuances from its newly created body, the Constituent Assembly, rather than from the long-standing legislative body created pursuant to the Venezuelan constitution, the National Assembly.

Creditors might balk at taking new bonds authorized solely by the Constituent Assembly because of serious questions under Venezuelan law (that is, Venezuela's Constitution and/or its public finance law) as to whether such new bonds would be considered to have been duly authorized and validly issued. It is not beyond the realm of possibility that any possible successor government to the Maduro regime might seek to challenge the legal validity of such bonds on those same grounds.

OVERCOMING OBSTACLES?

Nonetheless, the foregoing obstacles to a restructuring of Venezuelan debt in the near term could lose some of their force under a few different hypothetical scenarios. One scenario would involve a situation in which the Maduro regime were no longer running the government in Venezuela and a more democratic, reform-minded government were somehow to come to power.

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In that situation, it is not be inconceivable that the U.S. government might consider lifting or at least substantially revising the sanctions currently in place against Venezuela. Similarly, under those circumstances, the international financial institutions might consider the possibility of putting together a rescue package.

A second scenario would be that a group of non-U.S. creditors (that is, non-U.S. persons who are thus not subject to current U.S. sanctions) could negotiate a restructuring plan with the current Venezuelan regime and U.S. creditors could find such a plan to be acceptable. In that case, U.S. creditors might seek relief from the sanctions from the U.S. Treasury Department's Office of Foreign Assets Control so that they could join the non-U.S. creditors in such a restructuring.

Whether OFAC would grant such relief is an unknown. Moreover, whether a restructuring under such circumstances would be viable is also an unknown because it is unclear whether any of the international financial institutions such as the IMF would be willing to provide a rescue package to Venezuela as long as the Maduro regime remains in power.

A third scenario, which has been a subject of speculation among some observers, would be that, even if the Maduro regime were to remain in power, a new, different type of a lender of last resort—a provider of liquidity when no other sources of liquidity are available—would appear on the scene for Venezuela. In other words, the Maduro regime would not be looking to the usual lender of last resort in many sovereign debt situations—the IMF—but rather would perhaps be looking to either one or both of Venezuela's largest bilateral creditors, China and Russia.

Nonetheless, it is unclear and remains to be seen whether China or Russia would be willing to extend the substantial amounts of new credit to Venezuela—the many billions of dollars—that could well be necessary to turn around the Venezuelan economy and resolve its financial situation, particularly given the already significant outstanding exposures of these two countries to Venezuela. China has approximately $20 billion of outstanding exposure to the Republic and PDVSA (from an original exposure of approximately $60 billion), while Russia has approximately $7.5 billion of outstanding exposure (including money owed to the Russian state-owned oil company, Rosneft).

Russia and China have already shown some flexibility on their outstanding loan exposures to Venezuela. For example, Russia rescheduled approximately $3.1 billion of debt a year ago by stretching out the payment term to ten years and requiring only limited payments in the first six years, and China in the last few years reportedly agreed for a period of time to defer payments of principal and take payments of interest only. Perhaps significantly, though, China then apparently let that arrangement lapse so that Venezuela had to resume making principal payments in addition to the interest payments it had already been making.

However, the fact that Russia and China have shown some flexibility on their outstanding loans is a different matter than their agreeing to take losses on those loans, and a very different matter altogether than their agreeing to put substantial new amounts of money into Venezuela as effectively a lender of last resort. It is not clear how much of an appetite one or both of these countries would have for "throwing good money after bad," especially in the context of Venezuela's deeply troubled economy, or even how willing China or Russia would be to take losses on their outstanding exposures.

Both China and Russia may, however, have broader non-financial considerations at play when considering how much more deeply to get involved in Venezuela on a financial basis. They may weigh possible considerations such as advancing their geopolitical/strategic objectives, establishing or expanding a footprint (whether commercial/economic, military, or otherwise) in Latin America, securing long-term supplies of natural resources, and so forth.

At a minimum, one or both countries may find the prospect of expanded participation in the Venezuelan oil industry to be a very attractive, if not irresistible, target of opportunity. It has been reported that both countries have already increased their equity stakes in a couple of joint ventures with PDVSA, going from a 40 percent participation in the joint ventures to a 49 percent participation. This is a departure from the usual 60 percent PDVSA/40 percent foreign investor structure found in these joint ventures. As these transactions expanding the non-Venezuelan equity stakes in the joint ventures were not approved by the National Assembly, there might be questions about their validity under Venezuela's hydrocarbons law.

Even so, it remains to be seen how much additional financial exposure China and Russia would be willing to assume in the case of Venezuela. Thus, it is an open question as to whether either or both would be willing to act as a lender of last resort by providing the very substantial amounts of new money that Venezuela would undoubtedly require to help it emerge from its current deep financial and economic (as well as social) crisis. ◆