

Venezuela Macro View

VEF Devaluation: Rain Check or Back on Track?

- Expectations associated with a VEF devaluation have moved from “an almost sure event” to a “postponed until further notice occurrence”. The reason for this change was President Chávez’s health setback early in December, which brought to a halt the enactment of important economic measures, including the so much needed VEF devaluation among them. In particular, arguments that justify the need for this measure are deep capital account imbalances and the fact that the controlled FX system creates a heavy burden for issuers of USD denominated debt such as the sovereign and PDVSA. Nonetheless, we continue to believe the most important motivation to devalue is related to the boost in fiscal revenues the devaluation can bring, especially for PDVSA.
- However, the possibility of an early announcement of these measures has resurfaced once again. In the last few days we have noted that the effects of a below-average supply of USD in terms of reducing economic activity and accelerating inflation are acknowledged by the government and believe they have begun a review of different mechanisms to devalue the FX.
- This has led us to consider the possibility of a devaluation taking place sooner-rather-than-later. That being said, we take the opportunity to we analyze some of the most common questions, along with our view, regarding an eventual VEF devaluation.

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VEF Devaluation: Rain Check or Back on Track?

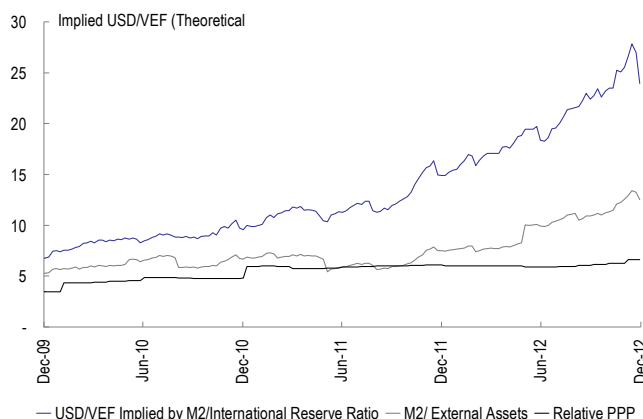
Expectations associated with a VEF devaluation have moved from “an almost sure event” to a “postponed until further notice occurrence”. The reason for this change was President Chávez’s health setback early in December, which brought to a halt the enactment of important economic measures, including the so much needed VEF devaluation among them. In particular, arguments that justify the need for this measure are deep capital account imbalances and the fact that the controlled FX system creates a heavy burden for issuers of USD denominated debt such as the sovereign and PDVSA. Nonetheless, we continue to believe the most important motivation to devalue is related to the boost in fiscal revenues the devaluation can bring, especially for PDVSA.

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- **What is the possibility of a VEF devaluation to be announced in the coming days?** In our view, this probability has increased and believe one of the goals of the travel of Vice-president Nicolás Maduro and Oil minister Rafael Ramírez to Havana could be to seek the approval of President Chávez to take such measures.
- **Politically speaking, it is better for Mr. Maduro if this announcement is made by President Chávez.** VEF devaluation announcements are fairly unpopular among Venezuelans and we believe President Chávez is the only figure within Chavismo with enough political capital to take this measure. The government could also use this as an opportunity to show the President is in charge and making decisions after all the uncertainty that has surrounded his health condition.
- **Not only that, but we believe it is unlikely to see the VEF being devaluated this year if the decision has to be announced by a new government.** We believe that if this announcement is not made by Mr. Chávez and a transition takes place, it will be difficult for the new government to announce a VEF devaluation taking place at least in 2013.
- **What measure could be announced?** As we have mentioned before, it seems there are two different proposals for the devaluation. From one side, the central bank would likely have proposed a unification of the current two tier system around an exchange rate that will be set between 6 and 8 coupled with a reopening of the parallel exchange rate market administered by the central bank. On the other side, the Ministry of Finance would prefer to maintain the two tier system and depreciate both exchange rates. Recently announcements by Vice-president Maduro leads us to believe that if the devaluation materializes, we could see a continuation of the two tier system, with the CADIVI rate increasing to VEF6.0-6.5 and the SITME rate going up to the VEF7.0-7.5 range.

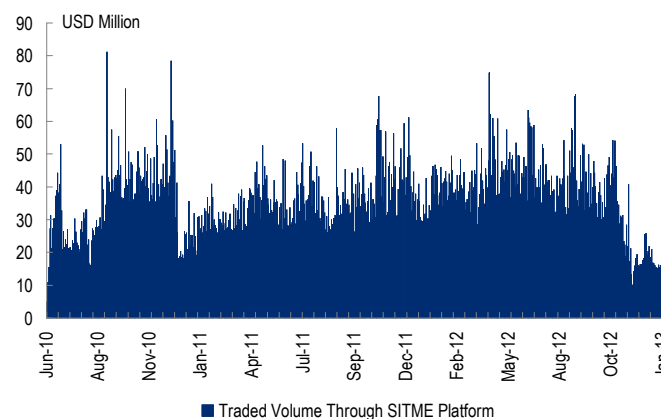
- **How can devaluations pressures be measured?** There are no easy and accurate ways to measure FX misalignments. Nonetheless, we think that observing the behavior of “theoretical measures” for the nominal exchange rate is useful to highlight the deviations of the current two-tier fixed FX regime versus what an FX floating rate could be. Figure 1 shows three alternative measures for the nominal exchange rate: the monetary aggregate M2 divided by international reserves; M2 divided by international reserves plus USD-denominated funds, and a purchasing power parity measure. While all of these indicators present different prints, the main conclusion is that they all point to an exchange rate which is overvalued at the current VEF4.3 for CADIVI and VEF5.3 for SITME operations.
- **How the USD availability for the private sector is going to evolve during 2013?** In our view, the reduction in SITME volumes is clearly associated with low levels of USD-denominated bonds held by the central bank (see Figure 2). This could be fixed by a private placement of PDVSA debt to the central bank, as part of the debt the oil company has with the monetary authority. Nevertheless, when we look at the average volumes observed last year between January and October (USD42 million) and compare them with the observed volumes so far this year (USD14 million) it is clear that even with a devaluation taking place and a replenishment of the USD-denominated debt by the central bank, trading volumes at SITME will be lower than the figures observed in 2012. In particular, we expect for trading volumes to stabilize around USD25-30 million by midyear. This means that the private sector will continue to struggle to gain access to USD-denominated debt.

Figure 1. Theoretical FX measures



Source: Citi Research

Figure 2. SITME's daily traded volumes have been decreasing



Source: BCV and Citi Research

- **Later-rather-than-sooner, what additional measures could be adopted on the FX front?** We have always considered that the cost at which USD-denominated debt has to be issued by the sovereign and PDVSA in order to supply the SITME market to be extremely high and hence have argued in favor of the need to consider a different mechanism. In our view, a reopening of the parallel exchange rate market, either controlled by the central bank or by government banks, is inevitable; but then the question is when this could happen. For now, we expect the view of the Ministry of Finance will prevail and both CADIVI and SITME will remain; but this may change in the future as the FX misalignments continue.

Appendix A-1

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